Flash news

9 July 2017

Capital gains arising to Netherlands entity on sale of shares of its Indian subsidiary deriving its value from immovable property is not taxable in India under the India-Netherlands tax treaty

Background

Recently, the Andhra Pradesh and Telangana High Court in the case of Venenberg Facilities BV[1] (the taxpayer) held that capital gains arising out of the sale of shares by the taxpayer of its Indian subsidiary deriving its value from the immovable property are not taxable in India under the India-Netherlands tax treaty (the tax treaty).

The High Court observed that Assessing Officer (AO) and Commissioner of Income-tax (Appeals) [CIT(A)] are incorrect in applying Article 13(1) of the tax treaty by equating alienation of a company's shares to alienation of its immovable property. The High Court concurred with Tribunal's decision that alienation of shares by the taxpayer does not fall under Article 13(1) of the tax treaty and by virtue of a residuary clause in Article 13(5) of the tax treaty, gains will be exempt from tax in India.

Facts of the case

- The taxpayer is a resident of Netherlands. The taxpayer made investments in the equity share capital of an Indian company from August 1997 to March 2000. In the month of December 1999, the Indian company became a wholly owned subsidiary of the taxpayer. The taxpayer made the aforesaid investments in the Indian company on approval granted by the Foreign Investment Promotion Board (FIPB). Indian company commenced the business of developing, maintaining and operating an industrial park in India after obtaining requisite approvals.
- During the Financial Year (FY) 2004-05, the taxpayer sold all its shares in the Indian company to Singapore company for a consideration of INR 224.50 crore in terms of the Share Purchase Agreement dated 17 December 2004. Further, as a sum of INR4.9 million was paid to the taxpayer by Singapore company towards interest on delayed payment of sale consideration.
- The taxpayer claimed that the capital gains were not taxable in India under Article 13 of the tax treaty. In the alternative, the taxpayer claimed that as Indian company was registered under Section 10(23G) of the Income-tax Act, 1961 (the Act), the capital gains arising from the transfer of its shares were exempt from tax under the Act. As regards taxability of the interest paid to it by Singapore company, the taxpayer claimed that payment and receipt thereof was in Netherlands, and therefore it could not be said to have accrued or arisen through or from any property in India or from any asset or source of income in India or through transfer of a capital asset situated in India.
- The AO rejected all the claims of the taxpayer. The AO observed that the value of the transferred shares comprised mainly business purpose immovable property located in India, therefore, Article 13(4) of the tax treaty would not be applicable. Article 13(5) of the tax treaty, being the residuary clause, would be applicable only if the

---

[1] DDIT v. Venenberg Facilities BV (ITTA Nos. 55 and 71 of 2014 and Writ Petition No. 41469 of 2015) – Taxsutra.com

© 2017 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

capital gains were not taxable under any other paragraph of Article 13 of the tax treaty. Since shares of Indian company partake the character of immovable property under the Act, the capital gains arising from the alienation of such shares are chargeable to tax in India under Article 13(1) of the tax treaty.

- With respect to the claim of exemption under Section 10(23G), the AO observed that as the investments in Indian company were made between August 1997 and March 2000, it could not claim exemption under Section 10(23G) of the Act. Further, to claim the benefit of Section 10(23G) of the Act, the concern has to be notified under Section 80-IA(4)(iii) of the Act, but industrial parks were included in the ambit of 'infrastructure facility' under Section 80-IA(12)(ca) only in the year 2000, relevant to the Assessment Year (AY) 2000-01. Therefore, the AO held that any investment made in Indian company prior to 1 April 2002 would not be eligible for exemption under Section 10(23G) of the Act.

- As regards the last limb of the taxpayer's claim with regard to non-taxability of the interest, the AO observed that the interest arose through a transaction involving sale of a capital asset situated in India, and therefore it would be deemed accrue or arise in India under Section 9(1)(v) of the Act.

- The CIT(A) upheld the order of the AO. However, the Tribunal held that a share in a company could not be considered to be immovable property and therefore, Article 13(1) of the tax treaty is not applicable to the present case. As Article 13(4) could not be invoked because the immovable property of Indian company was used for its business, the residuary provisions of Article 13(5) of the tax treaty are applicable. The taxpayer was entitled to claim exemption under Article 13(5) of the tax treaty as the same were taxable in Netherlands. With respect to the alternate claim of the taxpayer that it would be entitled to exemption under Section 10(23G) of the Act, the Tribunal allowed taxpayer's claim and rejected the finding of the AO that the investments made prior to 1 April 2002 by the taxpayer were not eligible for exemption thereunder.

- With respect to the taxability of the interest paid by Singapore company to the taxpayer, it was held that Section 9(1)(v) of the Act had no applicability and therefore, the interest could not be said to have accrued or arisen or deemed to have accrued or arisen in India.

High Court's decision

Taxability of capital gains under the tax treaty

- The lower authorities finding are now sought to be discarded by the tax department. Before the High Court, the tax department fairly concedes that Article 13(1) was wrongly applied by the lower authorities and contends that Article 13(4) is applicable, as the exclusionary clause therein would not apply. However, this issue was never raised by the tax department before the Tribunal.

- The High Court observed that the tax department should have exercised revisionary power under Section 263[2] of the Act when this error on the part of the AO in applying Article 13(1) of the tax treaty was noticed. Neither the AO, who did not choose to amend her order by submitting a report, nor the CIT(A) took remedial steps at the right time.

- Even thereafter, it was open to the tax department to raise the issue before the Tribunal by filing cross-objections. However, at that stage also, the tax department did not raise such issues. It is only before this High Court that the issue as to whether the transaction in question would fall within Article 13(4) of the tax treaty was raised. The AO is misconceived in his opinion that Article 13(1) of the tax treaty would be applicable, by treating the sale of shares as equivalent to the sale of immovable property.

- The High Court did not agree with the tax department that the question as to the applicability of Article 13(4) of the tax treaty would be a pure question of law. Whether immovable property from which the company's shares principally derived their value was property in which the business of the company was carried on or not is a question of fact.

- Without a factual finding as to whether the immovable property of Indian company was property in which its business was carried on, the question of applying one or the other parts of Article 13(4) at this stage would not arise. Thus, the appeal would have to be restricted to the finding of the Tribunal that Article 13(1) of the tax treaty had no application to the transaction.

[2] Section 263 of the Act permits revision of any order of the Assessing Officer if the Principal Commissioner/Commissioner considers such order to be erroneous in so far as it is prejudicial to the interests of the revenue.

© 2017 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

- In the case of Vodafone International Holdings B.V.[3], the Supreme Court observed that a company is a separate legal persona and the fact that all its shares are owned by one person has nothing to do with its separate legal existence. This being the settled legal position, the analogy adopted by the AO that by virtue of their shareholding in the company, the shareholders acquire rights in the property owned by such company does not withstand judicial scrutiny.
- Further, the lower authorities failed to note the difference between alienation of the company's immovable property, falling under Article 13(1) of the tax treaty, and alienation of the company's shares by a shareholder, attracting Article 13(4) or (5) thereof. The legal distinction between the concept of a 'share sale' as opposed to an 'asset sale', succinctly summed up by the Supreme Court in Vodafone International Holdings B.V., was completely ignored by the AO and the CIT(A).
- The Tribunal rightly held that alienation of shares by the taxpayer to Singapore company did not fall under Article 13(1) of the tax treaty and the residuary clause in Article 13(5) thereof would have application. The High Court confirmed the finding of the Tribunal that the capital gains earned by the taxpayer from the said transaction are covered by the exemption provided under Article 13(5) of the tax treaty, and hence it would not be taxable in India.
- The High Court observed that it was not required to go into the alternate claim of the taxpayer that it is also entitled to exemption from taxation under Section 10(23G) of the Act since it is already held that the gain is not taxable under Article 13(5) of the tax treaty.

Taxability of interest

- Section 9(1)(v) of the Act provides that income by way of interest payable by a person who is a non-resident, where such interest is payable in respect of any debt incurred, or money borrowed and used, for the purposes of a business or profession carried on by such person in India, would be deemed to be income accruing or arising in India.
- Section 9(1)(v) of the Act has no applicability whatsoever to the interest paid to the taxpayer by Singapore company as there is no evidence of debt being incurred or monies being borrowed for any business purposes in the present case. As rightly pointed out by the Tribunal, the provisions of Section 9(1)(v) of the Act cannot be stretched beyond what has been spelt out therein in clear terms.
- Further payment of the said interest did not partake the nature of penalty charges as it was not penal in character, in any manner. Therefore, Article 11(1) of the tax treaty applied, and irrespective of whether such interest accrued or arose or is deemed to have accrued or arisen in India under Section 9(1)(i) of the Act, it stood exempted from taxation in India under the tax treaty. The finding of the Tribunal to this effect, therefore, does not warrant interference.

Our comments

Article 13(5) of India-Netherlands tax treaty

The High Court in this case has dealt with an issue with respect to taxability of transfer of shares of an Indian company comprising mainly immovable property by a Dutch company to another foreign company. The High Court observed that the Article 13(1) of the tax treaty applicable only to transactions of transfer of immovable property and not to transfer of shares. Transfer of shares is different from the transfer of immovable property. Lower authorities failed to raise the issue with respect to taxability of such transaction under Article 13(4) of the tax treaty before the Tribunal. Therefore, the High Court has not considered the issue under Article 13(4) of the tax treaty.

The High Court has upheld the Tribunal's decision and allowed the taxability of such transaction in the Netherlands as per Article 13(5) of the tax treaty.

As per domestic tax law of the Netherlands, capital gains are included in taxable profits and subject to the normal corporate tax rate. However, participation exemption has been provided to capital gains i.e. the capital gains on the sale of shares in both domestic and foreign subsidiaries are exempt from corporate tax upon satisfaction of the prescribed conditions.

Recently, Limitation of Benefit (LOB) Article has been introduced in the India-Mauritius and India-Singapore tax treaty. This LOB Article has restricted the capital gain tax exemption in the source country. However, no such LOB Article has been introduced in the India-Netherlands tax treaty. Article 13(5) of the India-Netherland tax treaty still provide the benefit of exemption of capital gains tax in the source country in the cases of corporate organisation, reorganisation, amalgamation, division or similar transactions.

---

[3] Vodafone International Holdings B.V. UOI [2012] 341 ITR 1 (SC)

© 2017 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

Multilateral Convention

Capital gains from alienation of shares or interests of entities deriving their value principally from immovable property

Recently, India, amongst 67 countries, has signed the Multilateral Instrument (MLI) to implement tax treaty related measures to prevent Base Erosion and Profit Shifting (BEPS). MLI will operate to modify tax treaties between two or more parties to the Convention. It will not function in the same way as an amending protocol to a single existing treaty, which would directly amend the text of the Covered Tax Agreement (CTA). Instead, it will be applied alongside existing tax treaties, modifying their application in order to implement the BEPS measures.

Article 9 of MLI deals with capital gains from the alienation of shares or interests of entities deriving their value principally from immovable property. This provision is in parts. The first part deals with treaties which already contain a provision enabling the source country to tax gains from the alienation of shares or other rights of participation if the shares or rights derive more than a specified percentage of their value from immovable property situated in the country of source. MLI proposed to enlarge the scope of such provision providing rights to tax the gains to source country:

a) If the specified value threshold is met at any time during the 365 days preceding the alienation; and

b) To alienation interests that are comparable to shares, such as interests in a partnership or a trust

The second part provides to introduce a provision that such gains derived from the alienation of shares in entities deriving their value principally from immovable property may be taxed in source country into a CTA that does not have such a rule. This rule also encompasses the 365-day threshold and the sale of comparable interest. India has opted to adopt both the parts i.e. to modify existing provisions of CTAs that confer such a taxing right to the source country; as well as to introduce a provision to this effect in CTAs that do not currently have such a provision. However, its applicability to India's treaties will depend on whether its treaty partners have also chosen to adopt these parts.

Pursuant to Article 9(7) of the MLI, the Netherlands considers that its tax treaty with India contains a similar kind of provision and therefore the same may be amended as per first part provided above.

It is pertinent to note that the MLI does not deal with the exclusion provided under Article 13(4) of the India-Netherlands tax treaty to transfer of shares deriving value from the immovable property if in such property the business of the company was carried on. It would be interesting to see whether taxpayers will be able to claim exclusion provided under Article 13(4) to transfer of shares having an underlying value from immovable property and in such property the business of the company was carried on.

Prevention of treaty abuse

In MLI, Article 7 provides three approaches for prevention of treaty abuse:

- Principal Purpose Test (PPT)
- Simplified Limitation of Benefits (LOB) provisions
- Detailed LOB provisions

India has opted to apply the 'simplified LOB' provisions in respect of its CTAs. Further, it will also follow the PPT test.

The Netherlands has not opted for Simplified LOB clause. The Netherlands opted for Article 7(4) of MLI. Article 7(4) provides that where a benefit under a CTA is denied to a person under provisions of the CTA on the basis that principal purpose or one of the principal purposes of any arrangement or transaction, or of any person concerned with an arrangement or transaction, was to obtain those benefits, the competent authority of the Contracting Jurisdiction that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement. The competent authority of the contracting jurisdiction to which a request has been made under this paragraph by a resident of the other contracting jurisdiction shall consult with the competent authority of that other contracting jurisdiction before rejecting the request.

As per the MLI, the LOB provisions may get introduced in future, which may impact the India-Netherlands tax treaty, when both the countries will agree on the same approach. Accordingly, the taxpayer will require to satisfy LOB conditions to avail the benefit of Article 13(4) or 13(5) of the tax treaty.

Meaning of 'property in which the business of the company was carried on'

Article 13(4) of the India-Netherlands tax treaty provides that gains derived by a resident of one of the States from the alienation of shares (other than shares quoted on an approved stock

© 2017 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

exchange) forming part of a substantial interest in the capital stock of a company, which is a resident of the other state, the value of which shares is derived principally from immovable property situated in that other state other than property in which the business of the company was carried on, may be taxed in that other state.

In the instant case, at the Tribunal has held that the assets of the Indian company are immovable property but the same is used in its business, and therefore Article 13(4) of the India-Netherlands tax treaty cannot be invoked. Accordingly, the capital gains on such transaction would be taxable in the Netherlands and not in India. The High Court has not dealt with the Article 13(4) of the tax treaty while deciding this issue.

In view of above, it is important to understand the meaning of 'property in which the business of the company was carried on'. Paragraph 8 of Article 13 (Capital Gains) of the UN Commentary 2011 provides that Article 13(4) excludes from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities.

On combine reading of the Article 13(4) and the UN commentary, can it be said that the immovable property i.e. in the instant case industrial park in the business of developing, maintaining and operating an industrial park (leasing infrastructure facilities to software development companies under STP scheme) is the 'property in which the business of the company was carried on' or 'immovable property used by the Indian company in their business activities'?

The Supreme Court in the case of Chennai Properties[4] dealt with the issue with respect to the characterisation of income from the business of letting out of properties. On the one hand it has been held by various courts that such income is taxable as 'business income'. On the other hand, some of the courts have held that such income is taxable as 'income from house property'. The Supreme Court held that the main object of the taxpayer is to acquire and hold the properties and to let out those properties as well as make advances upon. Letting of the properties is the business of the taxpayer. The taxpayer, therefore, rightly disclosed the income under the head 'income from business' and it cannot be treated as 'income from the house property'. The Supreme Court in the case of Rayala Corporation[5] has relied on its decision in the case of Chennai Properties and held on similar lines.

[4] Chennai Properties & Investments Ltd. v. CIT [2015] 56 taxmann.com 456 (SC)
[5] Rayala Corporation (P.) Ltd. v. ACIT [2016] 72 taxmann.com 149 (SC)

However, the Supreme Court in the case of Raj Dadarkar[6] based on peculiar facts of the case observed that apart from relying upon the clause in the partnership deed to show its objective, the taxpayer has not produced or referred to any material. The taxpayer has not established that he was engaged in any systematic or organised activity of providing service to the occupiers of the shops/stalls so as to constitute the receipts from them as business income. It was for the taxpayer to produce sufficient material on record to show that its entire income or substantial income was from letting out of the property, which was the principal business activity of the appellant. Accordingly, income from letting of shops/stalls is taxable as income from house property.

In view of above Supreme Court decisions, income from leasing/let out of the property can be considered as 'income from business' if:

- The main objective of the taxpayer is to acquire and hold the properties and to let out those properties
- Letting out of the property is the principal business activity of the taxpayer
- Its entire income or substantial income was from letting out of the property.

In view of above judicial precedents, if letting out of the property is the principal business activity in accordance with the main object of the company and its entire income or substantial income is from letting out of the property then the taxpayer may be able to demonstrate that the income from letting out of property is taxable as 'business income'.

[6] Raj Dadarkar and Associates v. ACIT [2017] 81 taxmann.com 193 (SC)

www.kpmg.com/in

Ahmedabad
Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru
Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala,
Bengaluru – 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh
SCO 22-23 (Ist Floor)
Sector 8C, Madhya Marg
Chandigarh – 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai
No.10, Mahatma Gandhi Road
Nungambakkam
Chennai – 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Gurugram
Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurugram, Haryana – 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad
Reliance Humsafar, 4th Floor
8-2-618/2, Road No.11, Banjara Hills
Hyderabad – 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Jaipur
Regus Radiant Centres Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road
Jaipur, Rajasthan, 302018.
Tel: +91 141 - 7103224

Kochi
Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata
Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091
Tel: +91 33 4403 4000
Fax: +91 33 4403 4199

Mumbai
Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai – 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business park
Tower-B, Plot# 7, Sector 142,
Expressway Noida, Gautam Budh Nagar,
Noida – 201305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex, Mundhwa Road,
Ghorpadi, Pune – 411001
Tel: +91 20 6747 7000
Fax: +91 20 6747 7100

Vadodara
iPlex India Private Limited,
1st floor office space, No. 1004,
Vadodara Hyper, Dr. V S Marg
Alkapuri, Vadodara – 390 007
Tel: +91 0265 235 1085/232 2607/232 2672

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2017 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.