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TAX FLASH NEWS

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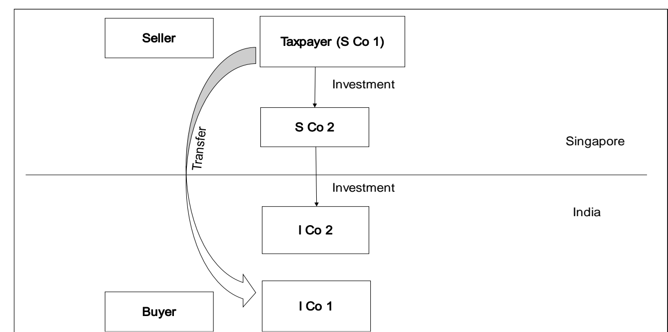
Amendments to the indirect transfer related provisions to exempt small shareholders and to define substantial value are retrospective in nature

Recently, the Delhi Bench of Income-tax Appellate Tribunal (the Tribunal) in the case of Augustus Capital PTE Ltd.[1] (the taxpayer) dealt with the issue of taxability of capital gain arising on transfer of shares of a foreign company which are having underlying asset in India. The Tribunal held that Explanations[2] introduced under Section 9(1)(i) of the Income-tax Act, 1961 (relating to the taxation of indirect transfer) to exempt small shareholders and to define substantial value are retrospective in nature. Such Explanations were in furtherance of the object of the indirect transfer related provisions introduced by the Finance Act, 2012 and it cannot be read in isolation. Accordingly, the Tribunal rejected the Assessing Officer's (AO) contention that such Explanations were prospective in nature and directed to delete the addition made by the tax authorities.

Facts of the case

The taxpayer, a Singapore based entity ('the taxpayer' or 'S Co 1') is in the business of incubation of companies i.e. providing new businesses, with necessary financial support and technical services. The taxpayer made investments in Singapore based entity (S Co 2). The investments made by the taxpayer consists of equity and preference shares of the company. S Co 2 in turn held certain investment in India (I Co 2). During the Assessment Year 2015-16, the taxpayer sold its entire shareholding in S Co 2 to an Indian entity (I Co 1). I Co 1 withheld taxes at source at 43.26 per cent on the entire sales consideration.

The diagram showing the structure of the transaction is as follows:



The taxpayer contended that in view of the amended provisions[3] of Section 9(1)(i)read with Explanations 5, 6 and 7[4], the transaction involving the sale of shares of the foreign company, which held investment in India, was not taxable.

The Assessing Officer (AO) rejected the contention of the taxpayer and observed that Explanation 7 to Section 9(1)(i) is prospective, since it has been inserted by the Finance Act, 2015 and made effective from 1 April 2016, it was not applicable during the year under consideration. Accordingly, the AO computed the long-term capital gains arising from the transfer of shares of the Singapore entity.

[1] Augustus Capital PTE Ltd. v. DCIT (ITA No. 8084/Del/2018, AY- 2015-16) – Taxsutra.com

[2] Explanation 6 and 7 introduced under Section 9(1)(i) of the Act by the Finance Act, 2015

[3] The Finance Act, 2012 introduced indirect transfer provision under Section 9(1)(i) and consequently the income deemed to accrue or arise to non-residents directly or indirectly through the transfer of a capital asset situated in India is to be taxed in India with retrospective effect from 1 April 1962. Explanations 5 to Section 9(1)(i) provides that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

[4] The Act was amended in 2015 to introduce Explanation 6 and 7 which provide that transfer of shares of foreign company are taxable in India only if the shares derive 50 per cent of its value from assets located in India. Further, an exemption was provided to small shareholders.

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Tribunal's decision

Section 9(1)(i) was amended by the Finance Act of 2012 through introduction of Explanation 5 with retrospective effect from 1 April 1962. The language of the provision is very clear as it is provided 'for the removal of doubts' which means that the Explanation had clarified as to when any share or interest in a company incorporated outside India shall be deemed to be situated in India when directly or indirectly its value was substantially derived from assets located in India.

The Delhi High Court in the case of Copal Market Research Limited[5] held that gains arising from the sale of shares of a company incorporated overseas, which derive less than 50 per cent of its value from assets situated in India would not be taxable under Section 9(1)(i) read with Explanation 5 thereto. In this case the share purchase agreement was dated 3 November 2011 (prior to introduction of Explanation 6 and 7).

Pursuant to the decision of the Delhi High Court, the Act was amended and Explanations 6 and 7 were introduced wherein 'exemption' was provided from the applicability of Explanation 5 to small investors.

The Tribunal observed that Explanations 6 and 7 start with 'For the purposes of this clause'. The reference to 'this clause' is to Section 9(1)(i) and Explanation 5 starts with 'For the removal of doubts'. Therefore, Explanations 6 and 7 have to be read with Explanation 5 to understand the provisions of Section 9(1)(i). Since Explanation 5 has been given retrospective effect and Explanations 6 and 7 have been introduced in furtherance of the object of insertion of Explanation 5, these two explanations cannot be read in isolation, but have to be tagged along with Explanation 5 so that both the Explanations have to be given a retrospective effect. Accordingly, the Tribunal directed the AO to read Explanation 7 as applicable for the year under consideration and delete the addition.

Our comments

The issue with respect to taxability of indirect transfer of shares of an Indian company has been a subject matter of litigation before the Courts.

The AAR in the case of GEA Refrigeration Technologies GmbH[6] held that gains arising from the indirect transfer of shares of an Indian company on sale of shares of a German company shall not be taxable in India under the provisions of Section 9(1)(i) as the German company derives its value substantially from its other companies whereas its value of assets in the Indian company was merely 5.40 per cent, far lower than the requirement of 50 per cent. The AAR ruling supports the applicability of 50 per cent threshold and valuation rules for past transactions even if such objective threshold is introduced under the Act with effect from FY 2015-16.

Recently, the AAR[7] on the retrospective application of amendments to indirect transfer taxation provisions held that the amendments, which inserted 50 per cent benchmark to determine substantial valuation from assets in India, is clarificatory in nature. The AAR also held that small shareholder exemption is inserted to address the genuine concerns of small shareholders. The same should apply retrospectively to give a true meaning and make the indirect transfer provisions workable. Hence, on principles, the 50 per cent benchmark and small shareholder exemption can be applied to the transfer of shares during FY 2013-14.

In the present case, the Tribunal has held that Explanations brought to the indirect transfer taxation provisions to exempt small shareholders and to define substantial value are retrospective in nature.

[5] DIT v. Copal Research Limited [2014] 371 ITR 114 (Del)
[6] GEA Refrigeration Technologies GmbH [2018] 401 ITR 115 (AAR)
[7] AAR Nos. 1555 to 1564 of 2013

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