



## In view of non-discrimination clause of India-Italy tax treaty, capital gain tax exemption is available to non-resident company on amalgamation of foreign companies

### Background

Recently, the Authority for Advance Rulings (AAR) in the case of Banca Sella S.p.A.<sup>1</sup> (the applicant) held that capital gain tax exemption provided under Section 47(vi) of the Income-tax Act, 1961 (the Act) is available to the non-resident taxpayer in the amalgamation of foreign companies by virtue of non-discrimination clause under Article 25 of the India-Italy tax treaty (tax treaty). The AAR observed that if amalgamation results in some special benefits to a local company and its shareholders, there is no reason to deny the same to a foreign company and its shareholders in similar case of amalgamation. Non-discrimination clause seeks to ensure that both countries do not decline any allowance or exemption only on the ground of nationality of taxpayers.

On the issue of taxability of capital gain arising on an amalgamation of two non-resident companies, the AAR held that in the absence of consideration, the transfer cannot be charged to tax as capital gain in India. With respect to the indirect transfer related provisions under Section 9(1)(i) of the Act, the AAR observed that 'substantial' should not be taken as 'close to whole'. Substantial will always mean at least 50 per cent.

### Facts of the case

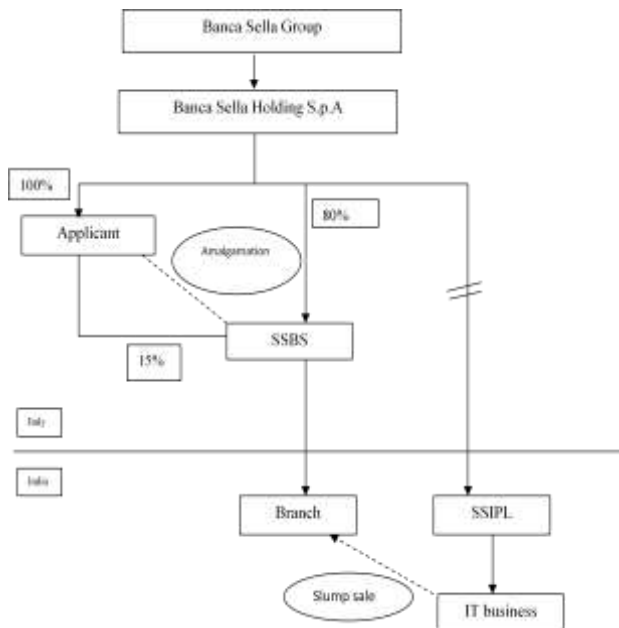
- The applicant is a banking company engaged in the business of collection of savings and exercising the business of credit, in all forms, in Italy and abroad. It is a wholly owned subsidiary company of Banca Sella Holding S.p.A. The applicant also proposes to provide outsourcing services, banking & financial services and other ancillary and incidental services.

- SSBS was one of the group companies of Banca Sella Group. It was incorporated on 1 April 2009. The applicant proposes amalgamation with SSBS. The applicant held around 15 per cent equity stake in SSBS. SSBS was rendering services to entities within Banca Sella Group which were necessary for operational activities of Banca Sella Group as a whole. The main activities so performed amongst others were support services for group direction, business and commercial support services, administrative services, control services and information technology services.
- Banca Sella Group had been carrying out business in India through SSIPL. SSIPL was engaged in the business of Information Technology (software design, development, and other related maintenance services) provided to entities of Banca Sella Group.
- On 15 January 2010, SSBS established the branch office in India. The branch took over the Information technology business of SSIPL as a going concern, on slump sale basis on 15 February 2010, pursuant to the business transfer agreement dated 10 February 2010. SSIPL paid tax on the capital gains on the transaction of business transfer from SSIPL to the branch of SSBS.
- Banca Sella Group has effected a restructuring in Italy, whereby SSBS has been merged with the applicant. The effective date of amalgamation was 30 May 2011. As a result of the amalgamation, shareholders of SSBS (i.e., Holding Co. and Others excluding the applicant)

<sup>1</sup> Banca Sella S.p.A (AAR No. 1130 of 2011) – Taxsutra.com

were allotted additional shares in the applicant company. Consequently, SSBS ceased to exist, and all assets and liabilities of SSBS got vested with the applicant which is now the amalgamated company. Post amalgamation, the branch (now belonging to the applicant)

- The diagram of the group and transaction is as follows:



- The applicant has sought ruling on tax issues arises from an amalgamation.

### Issues before the AAR

- Whether capital gain accruing/arising to SSBS on the transfer of its Indian branch as a consequence of amalgamation would be taxable in India?
- Assuming that capital gain accruing/arising to SSBS is chargeable to tax in India, whether by virtue of non-discrimination clause under Article 25 of the India-Italy tax treaty, the exemption under Section 47(vi) is available to it?
- Whether capital gain accruing/arising to the applicant and other shareholders on the transfer of the shares it holds in SBBS as a consequence of their extinguishment of their shares is liable to tax in India?
- Whether transfer pricing (TP) provisions are applicable in the present case?

### Taxability in the hands of SSBS and applicability of non-discrimination clause

#### Applicant's contentions

- There is no transfer on the amalgamation because a transfer in its general connotation, postulates a change of ownership of property from one person to another both of them and the property existing. In the present case, as a consequence of the amalgamation SSBS would stand dissolved and, therefore, there is no transfer as contemplated. The applicant relied on various decisions<sup>2</sup>.
- Even assuming there is a transfer, there is no consideration which accrues to SSBS and, therefore, there can be no question of levy of capital gains because of absent any accrual of consideration the computation provisions would break down.
- In the present case, the cost of improvement of the business was not ascertainable the charge to capital gains fails as one of the limbs in the computation provision was inapplicable<sup>3</sup>.
- Having regard to the non-discrimination clause under Article 25(1) of the tax treaty, the capital gain is exempt from tax. Exception from applicability of the non-discrimination clause for personal allowance, reliefs, and reduction for taxation purpose would apply to individual only, and not in the present case.

#### Tax department's contentions

- Amalgamation involved extinguishment of rights in the shares of SSBS by all the shareholders including the applicant and this "extinguishment of rights" would also fall squarely within the definition of transfer under the provisions of Section 2(47) of Act.
- The capital asset, being the branch office situated in India, has been parted with or the interest therein has been parted with by SSBS indirectly by way of an agreement and thus, Explanation to Section 2(47) of the Act only fortifies the argument that a 'transfer' of 'capital asset' took place in the present case which attracts the charging provisions of Section 45 of the Act.

<sup>2</sup> CIT v. Texspin Engineering and Manufacturing Works [2003] 263 ITR 345 (Bom), Shaw Wallace & Co.Ltd. v. CIT [1979] 119 ITR 399 (Cal)

<sup>3</sup> CIT v. B.C.Srinivasa Setty [1981] 128 ITR 294 (SC)  
PNB Finance Ltd. v. CIT [2008] 307 ITR 75 (SC)

- The applicant's contention that the transferor has ceased to exist, and, therefore, there is no 'transfer' of capital assets, is misplaced because on the effective date of amalgamation both the transferor as well as the transferee was in existence.
- Every merger has a pre-condition of taking over all the liabilities and assets of the entity which is amalgamating and liabilities also include contingent liabilities including taxes to be paid by the amalgamating company or the transferor. However, some kinds of transactions are exempted from taxation, which specifically find their mention in Section 47 of the Act.
- The cost of acquisition of the Indian branch is known as the Indian branch was acquired by SSBS from SSIPL on a slump sale basis for an agreed price and therefore the cost of consideration is ascertainable. Accordingly, capital gains accrue to SSBS is the market value of SSBS as reduced by the net asset value.

## AAR ruling

- The notional market value of SSIPL cannot be treated as a cost of consideration for the purpose of capital gains in the hands of SSBS which could not receive any consideration before it merged and lost its identity. In the absence of consideration, capital gains cannot be computed. The decision of the Supreme Court in the case of B C Srinivas Setty is applicable to facts of the present case.
- Article 25 of the tax treaty basically means that there is no discrimination between locals and foreigners in the matter of taxation, and no preferential treatment is to be given to local taxpayers. The exception is only in cases of personal allowances, relief, reduction, etc., and these are in the context of individuals and not in the case of companies as the starting word 'personal' denotes.
- If a case of amalgamation results in some special benefits to a local company and its shareholders, there is no reason to deny the same to a foreign company and its shareholders in similar case of amalgamation. It has been observed that non-discrimination clause seeks to ensure that both countries do not decline any allowance or exemption only on the ground of nationality of taxpayers. Therefore, the exemption under Section 47(vi) of the Act is available to SSBS also.

## Taxability in the hands of the applicant and other shareholders

### Applicant's contentions

- On the extinguishment of the shares held by the applicant in SSBS, there is no transfer since the definition of the word 'transfer' provided in Section 2(47) of the Act covers an extinguishment of any right in an asset and not the extinguishment of the asset itself. However, it is an admitted fact that this aspect of the matter is concluded against the applicant by the decision of the Supreme Court in the case *Grace Collis*<sup>4</sup>.
- The asset that stands transferred, viz., the shares in SSBS, is not situated in India and, hence, the capital gains, if any, cannot be regarded as accruing or deemed to accrue or arise in India and, therefore, having regard to the explicit provisions of Section 5(2) of the Act there ought not to be any liability to tax in India.
- As per the Act<sup>5</sup> the shares of SSBS should derive their value substantially from assets located in India and the assets of SSBS located in India constituted about 5.75 per cent of the total cost of the assets of SSBS. The word 'substantial' must be given the meaning that which is close to the whole. If such an interpretation of the word 'substantial' is not accepted, then, the consequence would be that even though say 60 per cent of the value of the shares is derived from assets located in India, nevertheless, 100 per cent of the capital gains that accrues on the transfer of such shares would be chargeable to tax in India.
- The tax treaty provides that gains from the alienation of shares in a company which is a resident of Italy may be taxed in Italy. Therefore, the capital gains arise on the transfer of shares the two Contracting States have ceded the right to tax capital gains, to the country where the company, whose shares is the subject matter of the transfer, is a resident. Since in the present case the shares held by the applicant in SSBS are shares held in a company that is a resident of Italy, India would have no right to tax the gain, if any, arising. Therefore, even in accordance with the provisions of the tax treaty the gains would not be taxable in India.

<sup>4</sup> CIT v. Grace Collis [2001] 248 ITR 323 (SC)

<sup>5</sup> Explanation 5 to Section 9(1)(i) of the Act

- The branch in India was the capital asset of SSBS. It did not have immovable property in India, but it had only movable properties. These movable properties formed part of business properties of the branch, being Permanent Establishment (PE) of SSBS in India. The amalgamation of SSBS into the applicant involved an alienation of PE together with the whole enterprise.

### Tax department's contention

- The word, 'substantially' cannot mean 'wholly' or 'entirely', not even 'almost wholly'. In the Act, 'substantially' has meant different percentages in different sections. In DTC 2013, it was proposed to mean 25 per cent. The Delhi High Court in the case of Copal Research<sup>6</sup> had held that the word 'substantially' would mean 'more than 50%'. Finally, Explanation 6 to Section 9(1)(i) has now defined the word 'substantially'.

### AAR ruling

- As per the decision of the Supreme Court in the case of Grace Collis<sup>7</sup> it is established that it is a case of transfer. However, in the present case, the applicant has not received any consideration and therefore, there would be no taxability in the hands of the applicant.
- As regards the definition of 'substantial' in Explanation 5 to Section 9(1)(i) of the Act it has been observed that 'substantial' should not be taken as 'close to whole'. Substantial will always mean at least 50 per cent. Its dictionary meaning is 'of considerable importance, size or worth'. Moreover, Delhi High Court in the case of Copal Research has settled this issue that it should mean more than 50 per cent.
- The tax department has given a strange method of working out capital gains which are completely on the notional basis and is based on presumptions. Capital gains have to be calculated on real gains and not on the basis of some notional values. In the present case no consideration accrues to the amalgamated company, and no capital gains are chargeable to tax.
- What is important is to see is what has been parted with by the shareholders. The shareholders have parted with their shares in SSBS and not the movable property of the branch. Therefore, the tax department contention that Article 14(2) is applicable because SSBS had a PE in India in the form of its branch is not applicable in the present case. Though, capital gains accrue to shareholders, the same is not chargeable to tax in India in view of Article 14(5) of the tax treaty.

### Applicability of transfer pricing provisions

- The transfer pricing provisions are inapplicable if there is no charge in view of the decision of AAR in the case of Amiantit International Holding Limited<sup>8</sup>.

### Our comments

Generally, a non-discrimination clause in tax treaties provides that nationals of one state shall not be subjected in the other state to any taxation or any requirement connected therewith which is much more onerous than it is on the nationals of that other contracting state.

The Delhi Tribunal in the case of Mitsubishi Corporation India Pvt. Ltd<sup>9</sup> while dealing with disallowance under Section 40(a)(i) of the Act vis-a-vis non-discrimination clause in the India-Japan tax treaty, observed that different tax treatment to the foreign enterprise per se is enough to invoke the non-discrimination clause in the tax treaty.

The AAR in the present case observed that there should be no discrimination between locals and foreigners in the matter of taxation, and no preferential treatment is to be given to local taxpayers.

The Delhi High Court in the case of Copal Research Limited observed that the expression 'substantially' occurring in Explanation 5 to Section 9(1)(i) of the Act would necessarily have to be read as synonymous to 'principally', 'mainly' or at least 'majority'.

The AAR in the present case has also observed that 'substantial' should not be taken as 'close to whole'. Substantial will always mean at least 50 per cent. Since no consideration accrues to the amalgamated company, the capital gain is not chargeable to tax.

Even though the AAR ruling is legally binding only on the parties involved in a particular case, the ruling would have a persuasive value in similar matters before the Indian tax authorities and courts of law.

<sup>8</sup> Amiantit International Holding Ltd [2010] 322 ITR 678 (AAR)

<sup>9</sup> Mitsubishi Corporation India Pvt. Ltd v. DCIT (I.T.A. No.: 5042/Del/11)

<sup>6</sup> DIT v. Copal Research [2015] 371 ITR 114 (Del)

<sup>7</sup> CIT v. Grace Collis [2001] 248 ITR 323 (SC)

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