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TAX FLASH NEWS

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Capital Gain arising on sale of Indian real estate companies' shares is not taxable in India under Article 14 of the India-Spain tax treaty

Recently, the Mumbai Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Merrill Lynch Capital Market Espana SA SV[1] (the taxpayer) held that capital gain arising on sale of Indian real estate companies' shares is not taxable in India under Article 14 of the India-Spain tax treaty (tax treaty). These companies were engaged in the business of real estate development and not in the business of holding real estate assets as investments. There was no indirect transfer of ownership of immovable properties by transfer of shares. The Tribunal observed that merely because a company deals in real estate development, it does not imply that it consists principally of immovable property.

Facts of the case

The taxpayer is a foreign institutional investor (FII), a Spain based company. During the Assessment Year (AY) 2013-14 and 14-15, the taxpayer earned capital gains on sale of shares in real estate companies which were included in BSE realty index. These companies were dealing in real estate sector including development of properties, residential as well as commercial. Value of shares of these companies is derived from the value of immovable properties held by such companies. The Assessing Officer (AO) observed that under Article 14(4) of the tax treaty, gains from the alienation of shares of a company value, directly or indirectly, derived from principally of immovable property, was to be taxed in the source jurisdiction. The AO observed that it is immaterial whether these properties were held as stock in trade or as investments. Thus, the AO held that the capital gain on sale of these shares of Indian real estate companies was taxable in India under Article 14(4) of the tax treaty.

The Commissioner of Income-tax Appeal [CIT(A)] held that there was no indirect transfer of ownership of immovable properties by transfer of these shares, and in terms of the UN Model Convention commentary, the provisions of Article 14(4) of the tax treaty come into play only in the cases of indirect transfer of ownership of immovable property by the transfer of shares. It was observed that the taxpayer's shareholding in these companies was well under 7 per cent and 'with such miniscule shareholding, the taxpayer cannot be treated as having acquired any right in stock in trade of those companies' and the taxpayer had no effective right to occupy the immovable properties of those companies. Accordingly, the CIT(A) held that the gains on sale of shares in real estate companies was not taxable in India.

During the year, the taxpayer also earned profit/gain on account of foreign exchange transactions and claimed as exempt under Article 14 of the tax treaty. The taxpayer contended that such gains were in the nature of arbitrage and entered into in accordance with Reserve Bank of India (RBI) regulations, to hedge investments. The payment of margin money for derivative transactions, were capital assets, and the gains arising from these transactions were to be treated as capital gains. It was also contended that in case these transactions were not treated as capital gains, it should be treated as business profits which cannot be brought to tax in India, as the taxpayer did not have Permanent Establishment (PE) in India.

The AO observed that the taxpayer was permitted to invest in derivatives only and not permitted to invest in foreign exchange. Thus, no capital gains can accrue to the taxpayer on account of its activities in the foreign exchange market as the income was in the nature of business income. Further, as an investor, the taxpayer cannot carry out any business activity and accordingly, receipt on account of foreign

[1] JCIT v. Merrill Lynch Capital Market Espana SA SV (ITA No. 6108/Mum/2018 and 6109/Mum/2018) – Taxsutra.com

exchange transactions was in the nature of income from other sources and it was taxable in India as per Article 23(3) of the tax treaty. The Commissioner of Income-tax Appeal [CIT(A)] held decision in favour of the taxpayer.

Tribunal decisions

Capital gain on sale of shares of companies engaged in real estate development activities

Article 14(4) of the tax treaty provides that gains from the alienation of shares of a company 'the property of which consists, directly or indirectly, principally of immovable property' situated in a tax treaty partner jurisdiction will be taxable in that jurisdiction. The general principle that, except in the specified situations, capital gains can only be taxed in the residence jurisdiction. The taxation in source jurisdiction is not a rule, but rather exception to a rule. In order to invoke an exception, enabling taxation of capital gains in the source jurisdiction, the gains must arise in the hands of the Spain based company (i.e. the taxpayer in this case) (a) on alienation of shares in other contracting state (i.e. in India in this case); (b) the property of such a company, shares in which are sold by the taxpayer, must consist of 'principally' of immovable properties; (c) such a holding of, principally, the immovable properties may be direct or indirect (i.e. through a step down subsidiary or under any other arrangement). Under Article 14(4), thus, it is only on satisfaction of these conditions the gains, in the hands of a tax resident of Spain, on alienation of shares in Indian company can be brought to tax in India.

On a perusal of plain legal principles and on a reasonable interpretation of tax treaty provisions, it cannot fall in the kind of cases visualised under Article 14(4) of the tax treaty. The Tribunal relied on the decision of K.P. Varghese[2] which dealt with the principles governing interpretation of tax. The Supreme Court, in the case of Azadi Bachao Andolan[3] observed that the principles adopted in the interpretation of treaties are not the same as those adopted in the interpretation of statutory legislation. Further, Article 31(1) of the Vienna Convention States that 'A treaty shall be interpreted in good faith in accordance with the ordinary meaning given to the terms of the treaty in their context and in the light of its object and purpose'. Accordingly, the mandate of Article 31(1) has to be borne in India while interpreting Article 14(4) of the tax treaty.

As per Article 14(1) of the tax treaty, the gains on alienation of immovable properties are taxable in source jurisdiction. Further, Article 14(4) is only an extension of Article 14(1), inasmuch much as whether the taxpayer owns the immovable property in the treaty partner jurisdiction on its own, or through a web of corporate structures, the gains on account of value appreciation on of such immovable properties must be taxed in the source jurisdiction as well. The taxation will infringe neutrality if it is to depend on the manner in which the assets are held, and that is the unambiguous object that Article 14(4) seeks to achieve. UN Model Commentary and the OECD Model Commentary provide threshold to trigger the taxation on alienation of shares of a company where underlying assets constitute immovable property is of fifty percent or more of the aggregate value of assets.

In the OECD Model Convention, in the place of 'principally', the threshold test itself is prescribed at fifty percent of the aggregate value of asset. The expression 'principally' was clearly defined, until the 2017 update, in the UN Model Convention itself as such. However, in the 2017 update, the UN Model Convention provided for a specific minimum threshold trigger to be decided between the contracting state. This interpretation of the scope of 'principally' must be understood in the context of the purpose of the tax treaty provision.

The wordings of UN and OECD Model Convention do differ from the provision in the tax treaty. However, it was not tax department's case that the intent and purpose for which Article 14(4) of the tax treaty was introduced was different. Therefore, the taxability of gains on sale of shares in companies principally holding the immovable property can be taxed in the source jurisdiction when such an alienation of shares, directly or indirectly and on standalone basis or in conjunction with other transactions, results in the control and enjoyment, of the underlying property.

The scheme of Article 14, has its fundamental principle that, as a rule, capital gains are taxable only in-residence jurisdiction, and the exceptions are applicable when the gains relate to immoveable property, when gains relate to assets of the PE or fixed place of business as the case may be, or when gains relate to alienation of shares in a company forming part of a participation of at least 10 per cent in a company which is a fiscally domiciled in a jurisdiction.

In the present case, while the taxpayer did not sell more than 2 per cent shares in any of the six realty companies as an investor. There was no question of holding any controlling interest or even significant interest in these companies. These holdings therefore cannot give, or be even part of an effort to get, controlling right or any other right to occupy the property. All these companies are engaged in the business of real estate development rather than in the business of holding real estate as investments. The business model of realty companies is focused on gains from real estate development rather than gains from holding the immovable properties.

[2] K.P. Varghese v. ITO [1981] 131 ITR 597 (SC)
[3] Union of India v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

Article 14(4) is to be read along with and to supplement Article 14(1) of the tax treaty, the gains on sale of such shares cannot indeed be taxed in the source state under Article 14(4) of the tax treaty. While the expression 'principally' is not specifically defined in the India-Spain tax treaty, as evident from the subsequent clarifications in the model convention commentaries, and in the absence of anything to suggest there was a different intention at an earlier point of time, the threshold test can be safely applied at 'fifty percent' of total assets.

The sale of shares in only such companies are covered as hold, directly or indirectly, at least fifty percent of the aggregate assets consisting of immovable property. Just because a company is dealing in real estate development does not imply, or even suggest, that over fifty percent of its aggregate assets consist of immovable properties. It is not the case before us that predominant part, or fifty percent, of aggregate of assets of these companies consist of immovable properties. Accordingly, capital gain was not taxable in India.

Applicability of Article 23 of the tax treaty to gain on account of foreign exchange transaction

A perusal of tax treaty provision indicates that Article 23 of the tax treaty is applicable only when an item of income of a resident of a contracting state is such that it is not expressly dealt with in the preceding articles (i.e. Article 6 to 22) of the tax treaty. Article 23 of the tax treaty does not apply to items of income which can be classified under Articles 6-22 whether or not taxable under these Articles, and when income from gains on settlement of forward contracts was covered by Article 7 or Article 14 when conditions laid down therein are satisfied, Article 23 would not have any application in the matter.

The AO contended that as an investor, the taxpayer cannot carry out any business activity and, therefore, it cannot be said to be a business activity. However, the Tribunal observed that whether legal or illegal, and, whether with regulatory approvals or without regulatory approvals, fruits of pursuits in the course of business were taxable as business profits nevertheless. The Tribunal relied on various decisions[4]. Article 7 of the tax treaties refers to 'profits of an enterprise' and does not even remotely suggest the compliance with all regulatory framework as a sine qua non for the tax treaty protection. Once it has been observed that the forward exchange contracts were entered into, with or without the regulatory approval, in the course of business, such contracts could either be in the revenue field or in capital field. These two paths are mutually exclusive, and it cannot be visualised a third path.

If a view was taken that these gains were in the capital field, the gains were taxable as capital gains which were governed by Article 14 of the tax treaty. It was not the case of the AO that the gains on settlement of forward foreign exchange contracts were covered by any of the exception clauses. The tax department could not point out the specific provisions of Article 14(1) to 14(5) of the tax treaty by which these gains are covered. Therefore, taxability of such gains, i.e. capital gains, was covered by Article 14 and it was not taxable in the source jurisdiction, as the conditions precedents to the taxability in source jurisdiction, i.e. coverage by Article 14(1) to 14(5), were not satisfied. Whichever way one looks at the gains in question, the taxability of these gains is very well expressly dealt with by the provisions of Article 7 or Article 14 of the tax treaty. Accordingly, Article 23 of the tax treaty does not apply to the facts of the present case.

Our comments

The issue with respect to the taxability of capital gain arising on sale of Indian real estate companies' shares has been a subject matter of debate before the Courts/Tribunal.

The Mumbai Tribunal in taxpayer's earlier cases[5] while dealing with the similar issue held that capital gain on sale of shares of companies engaged in real estate development activities was not taxable in India under Article 14(4) of the tax treaty.

The Tribunal in the instant case has held that capital gain arising on sale of Indian real estate companies' shares is not taxable in India under Article 14 of India-Spain tax treaty. The Tribunal observed that merely because a company deals in real estate development, it does not imply that it consists principally of immovable properties.

The Tribunal also held that merely holding shares in a company engaged in real estate development would not lead to taxation in the source country, i.e. country in which the immovable property is located. The quantum of stake held by the taxpayer and whether assets of such company comprise 50 per cent or more from immovable property needs to be factored while determining the taxability under the tax treaty.

The Tribunal in the present case has dealt with the expression 'principally' and observed that it is not specifically defined in the India-Spain tax treaty. Drawing support from various commentaries of Model Convention, the term 'principally' may be interpreted as 50 per cent or more of the aggregate value of assets.

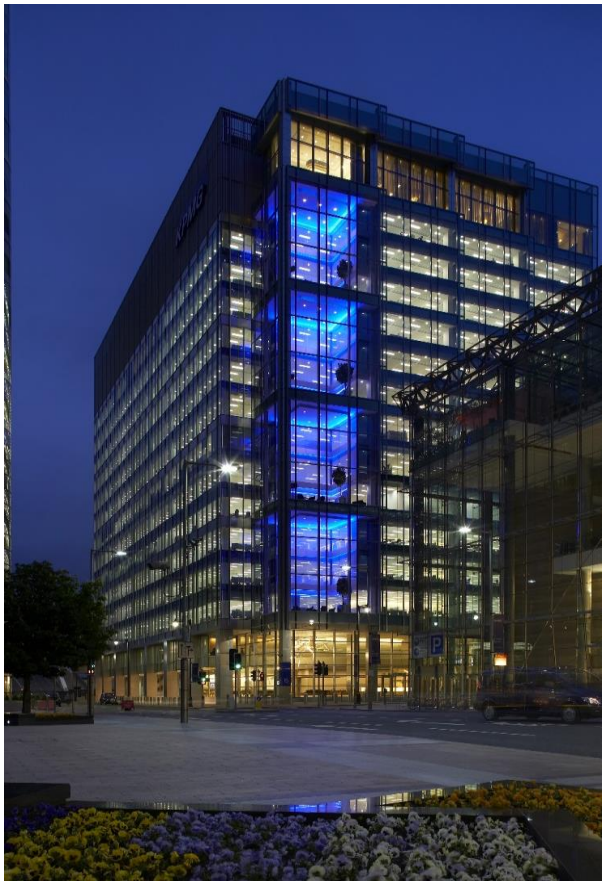
[4] CIT v. Piara Singh [1980] 124 ITR 40 (SC), CIT v. S C Kothari [1971] 82 ITR 794 (SC)

[5] DCIT v. Merrill Lynch Capital Market [2018] 100 taxmann.com 281 (Mum), ACIT v. Merrill Lynch Capital Market Espana S.A.S.V [2017] 86 taxmann.com 161 (Mum)

The Delhi High Court in the case of Copal Research Limited, Mauritius & Ors[6] explained the meaning of the term 'substantially' used in the context of indirect transfers. It was held that gains arising from the sale of a share of a company incorporated overseas which derives less than 50 per cent of its value from assets in India would not be taxable under Section 9(1)(i) of the Act.

Further, the AAR in the case of GEA Refrigeration Technologies GmbH[7] held that gains arising from indirect transfer of shares of an Indian company on sale of shares of German company shall not be taxable in India under the provisions of Section 9(1)(i) of the Act as German company derives its value substantially from its other companies whereas its value of assets in Indian company is a mere 5.40 per cent, far lower than the requirement of 50 per cent. Hence, it fails the test of deriving value substantially from the Indian company.

It is important to note that the Finance Act, 2015 introduced Explanation 6 to Section 9(1)(i) of the Act to provide that a share/interest will be deemed to derive its value substantially from assets located in India if the value of Indian assets exceeds the 50 per cent of the value of all assets owned by the foreign company/entity and the value of Indian assets exceeds INR100 million.



[6] DIT v. Copal Research Limited [2014] 371 ITR 114 (Del)
[7] GEA Refrigeration Technologies GmbH (AAR No. 1232 of 2012)

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