Tax Flash News

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Rights entitlements are not akin to shares

Executive summary

In a recent decision in the case of *Vanguard Index Fund*[1], the Mumbai Bench of the Tribunal addressed the taxation of gains from the transfer of rights entitlements as per the India-Ireland tax treaty (the Treaty).

The Revenue contended that the rights entitlements are similar to the shares in a company and thus, taxation of gains from the transfer of rights entitlements should be equivalent to that of shares in an Indian company, making them taxable in India as per the Treaty.

However, the Tribunal examined the legal nature of rights entitlements, distinguishing them from shares, and concluded that the gains were not taxable in India as per the Treaty.

Facts of the case

The taxpayer. a tax resident of Ireland, earned capital gains from the transfer of 'rights entitlement' (right to subscribe the shares of an Indian company) and claimed exemption under the Treaty.[2]

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[1] *Vanguard Emerging Markets Stock Index Fund A Series of VISPLC* v. *ACIT* (ITA No. 4657/Mum/2023). Source: Taxsutra

[2] Article 13(6) of the Treaty

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It has also incurred capital loss from the transfer of shares in the Indian companies which was carried forward to subsequent years (i.e., without setting off against the gains which were claimed to be exempt).

The tax officer denied the exemption arguing that rights entitlements are closely related to shares. Thus, the taxation of gains from the transfer of rights entitlements should be equivalent to that of shares in an Indian company, making them taxable in India as per the Treaty. The tax officer also held that the taxpayer should set off these gains against the carried-forward capital loss.

Relevant Treaty provisions

Article 13(5) of the Treaty allows India to tax gains from the alienation of shares in an Indian-resident company.

A residual clause, Article 13(6), stipulates that gains from alienating property not specifically mentioned in the article by a tax resident of Ireland should be taxable only in Ireland.

Broadly, gains from alienating Indian-resident company shares are taxable in India, while gains from other properties are taxable in Ireland.

Taxpayer's contentions

Rights entitlement is distinct from equity shares. Gains from the alienation of rights entitlement should fall under the residual clause and not Article 13(5).

Under the Companies Act, shareholders have the option to subscribe to additional shares or renounce/sell their rights entitlements, which differ from shares themselves.

The Securities and Exchange Board of India (SEBI) requires rights entitlement to be credited separately in demat accounts with a distinct ISIN (International Securities Identification Number).

The National Stock Exchange (NSE) charges Securities Transaction Tax (STT) on rights entitlements at a rate applicable to options, not equity shares, and the Securities Contracts (Regulation) Act, 1956, classifies rights entitlements as options to purchase the shares.

The capital gains taxation provisions under the Income-tax Act, 1961 also distinguishes between shares and rights entitlements.

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Reliance was placed on the Supreme Court decision in *Navin Jindal*[3], which recognised rights entitlements as independent assets transferable separately from existing shares.

The 2019 Multilateral Instrument (MLI) amendment to the Treaty included 'comparable interests' under Article 13(4)[4] but not Article 13(5) indicating a deliberate exclusion of rights entitlements from taxation under Article 13(5). Article 13(4) deals with the taxation of shares deriving value from immoveable property.

Clarification[5] issued in the context of the India-Mauritius tax treaty showed that only shares in a company (not derivatives or rights entitlements) were intended to be taxed in the source country.

Undefined treaty terms are interpreted according to domestic law, and the Companies Act, 2013 provides a restrictive definition of shares to mean a share in the share capital of a company and includes stock. An asset, which may come into existence or derive its value from another underlying asset (for instance, 'derivative'), cannot be regarded as being same as the original asset.

Both OECD and UN Model Commentaries suggested that gains from securities, other than shares explicitly covered, should be taxed in the resident state.

Revenue's contentions

Rights entitlements, allowing shareholders to acquire additional shares at a discount, are closely linked to equity shares.

'Shares' under Article 13(5) should be interpreted broadly to include 'comparable interests' and should stand for tradable securities. This is also supported by the MLI amendments to Article 13(4).

The separate ISIN for rights entitlements reflects their different base price from current equity shares, but this does not alter their fundamental nature as part of equity capital.

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[3] *Navin Jindal* v. *ACIT* [2010] 320 ITR 708 (SC)

[4] Article 13(4) provides that gains derived by a resident of Ireland from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in India if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property (real property) situated in India.

[5] Clarification by the Economic Affairs Secretary to 'Business Standard' newspaper in an article dated 21 August 2015

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Decision

Rights entitlement differs from shares based on SEBI regulations, Companies Act, and judicial precedents.

The absence of ‘comparable interests’ in Article 13(5) of the Treaty suggests that rights entitlement should not be treated as shares.

Gains from the sale of rights entitlement should not be taxed in India as per the residual clause of the capital gains article.

Following the decision in *J.P. Morgan*[6], gains exempt under the Treaty need not be set off against the loss from the alienation of shares of Indian companies, allowing such losses to be carried forward.

Our comments

By distinguishing rights entitlement from shares, the decision has reinforced the principle that treaty provisions should be interpreted based on their specific wording rather than inferred meanings. Investors should carefully evaluate the classification of financial instruments under the treaty before assuming taxability in India.

[6] *ACIT* v. *J. P. Morgan India Investment Company Mauritius Ltd* [2023] 198 ITD 392 (Mumbai - Trib.)

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