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Recent Trends and Developments in Capital Gains

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Contents

Domestic Provisions relating to Capital Gains

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Scope of Capital Gains

<u>Section 45</u>: Any profits or gains arising from the **transfer** of a **capital asset** effected in the previous year shall be chargeable to income-tax under the head "Capital gains“ and shall be deemed to be the income of the previous year in which the transfer took place.

<u>Section 2(14)</u>: "capital asset" means—

(a) property of any kind held by an assessee, whether or not connected with his business or profession;

(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 (15 of 1992);

[(c) any unit linked insurance policy to which exemption under clause (10D) of section 10 does not apply on account of the applicability of the fourth and fifth provisos thereof,]

Capital Asset- Exclusions

Capital asset does not include—

(i) any stock-in-trade [other than the securities referred to in sub-clause (b)], consumable stores or raw materials held for the purposes of his business or profession ;

(ii) personal effects, that is to say, movable property (including wearing apparel and furniture) held for personal use by the assessee or any member of his family dependent on him, but excludes—

- (a) jewellery;
- (b) archaeological collections;
- (c) drawings;
- (d) paintings;
- (e) sculptures; or
- (f) any work of art.

(iii) agricultural land in India

(iv) 6½ per cent Gold Bonds, 1977, or 7 per cent Gold Bonds, 1980, or National Defence Gold Bonds, 1980, issued by the Central Government;

(v) Special Bearer Bonds, 1991, issued by the Central Government ;

(vi) Gold Deposit Bonds or deposit certificates

Classification of Assets

1) Short term capital asset
2) Long term capital asset

Particulars	Short Term Capital Asset	Long Term Capital Asset
Period of Holding in case of listed shares and Mutual Funds	Upto 12 months	More than 12 months
Period of Holding in case of unlisted shares and immovable property	Upto 24 months	More than 24 months
Period of Holding in case of any other assets	Upto 36 months	More than 36 months

Citicorp International Finance Corporation (Mumbai Tribunal)

Facts

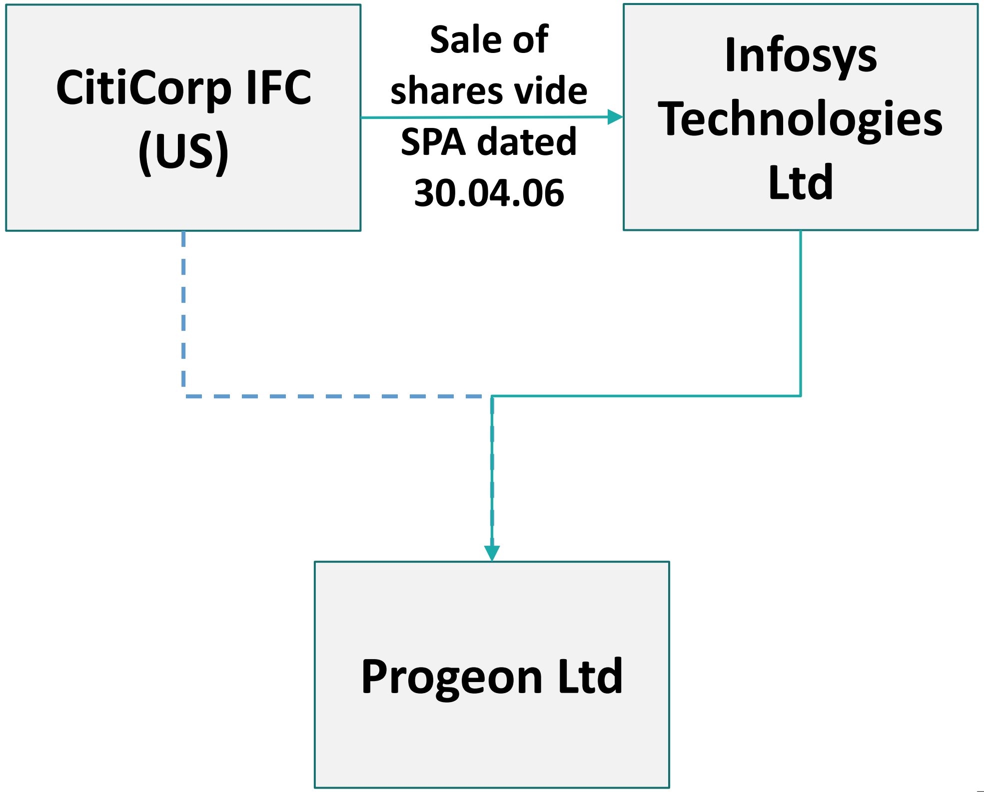
The Assessee is a US-based company and acquired CCPS of Progeon Ltd on June 14, 2002 which was **later converted into equity shares on June 30, 2005.**

The Assessee transferred shares of Pregeon to Infosys vide SPA dated April 20, 2006.

The SPA contained clause on 'conditions precedent' with a stipulation that such conditions are not fulfilled there was a right to rescind the contract. The shares were actually transferred on **June 30, 2006** and income was claimed as LTCG.

Issue: Whether the effective date of transfer is date of SPA or the date when the transfer was effected and accordingly, gains will be taxed as LTCG or STCG?

Decision: Date of agreement could not be date of sale and, thus, shares were to be treated as long-term capital asset liable to long-term capital gains.



Taxability for Non-residents

Nature of Income	IT Act	DTAA
Business/Profession	S. 9(1)(i)	Article 7, 14 r.w. Article 5
Immovable Property	S. 9(1)(i)	Article 6
Capital gains	**S. 9(1)(i)**	**Article 13**
Salary	S. 9(1)(ii)	Article 15
Dividend	S. 9(1)(iv)	Article 10
Interest	S. 9(1)(v)	Article 11
Royalties	S. 9(1)(vi)	Article 12
Fees for Technical Services	S. 9(1)(vii)	Article 12

Section 9(1)(i)- Relevant Portion

- **Income deemed to accrue or arise in India.**

9. (1) The following incomes shall be deemed to accrue or arise in India :—

[27](*i*) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or **through the transfer of a capital asset situate in India.**

....

Explanation 5.[29]—For the removal of doubts, it is hereby clarified 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:

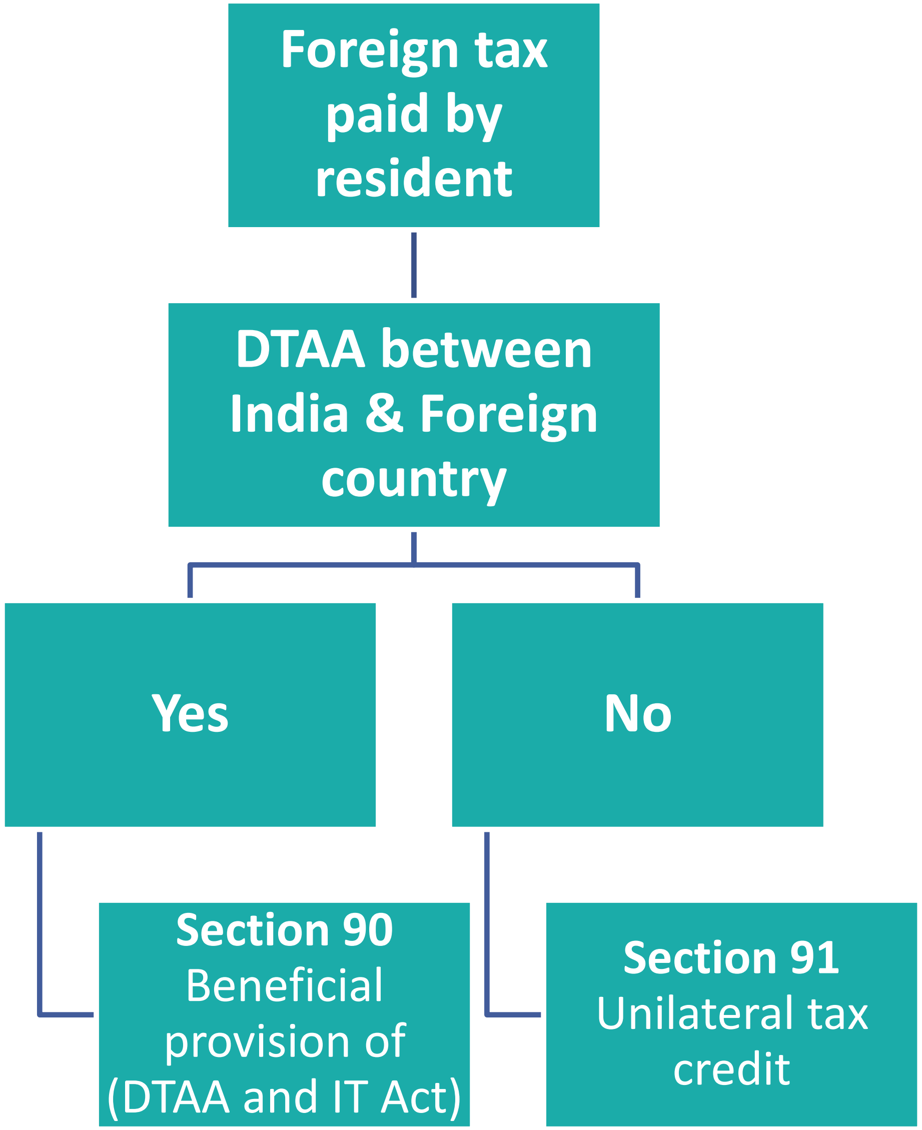
Double Taxation relief provisions in Income-tax Act

Section 90

- Regulates a case where India has a tax treaty
- Provisions of the tax treaty or domestic laws, whichever is more beneficial shall apply
- GAAR provisions will override Treaty provisions
- To avail benefits under DTAA, a certificate of residence is necessary (TRC).

Section 91

- Relief from double taxation if India has no tax treaties
- Person resident in India is allowed credit of foreign taxes paid against amount of Indian taxes.



OECD Model on Capital Gains (Article 13)

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OECD Model on Capital Gains (Article 13)

Gains from the alienation of immovable property may be taxed in the source state

Gains from alienation of movable property of a permanent establishment (alone or with the whole enterprise) then source state may tax such gains

Gains from the alienation of ships or aircraft or of movable property of such ships or aircraft is taxable only in the residence state

Gains from the alienation of share or comparable interest (such as interest in partnership or trust) are generally taxed in the residence state. However, if such shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property situated in source state at any time during the 365 days preceding the alienation, then source state can also tax gains from such alienation.

Gains derived from alienation of any other property shall be taxable in the residence state of the alienator.

Language of Indian Treaties on Capital Gains

India-Mauritius DTAA

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Gains from alienation of movable property of a permanent establishment (alone or with the whole enterprise) then source state may tax such gains

Gains from the alienation of ships or aircraft or of movable property of such ships or aircraft is taxable only in the state where the PoEM of resident enterprise is situated

Gains from the alienation of shares acquired on or after 1st April 2017 will be taxed in the source state. However, if the shares are alienated between April 1, 2017 and March 31, 2019, then only 50% of the tax rate of the source state will be applicable on such alienation

Gains derived from alienation of any other property shall be taxable only in the residence state.

"alienation" means the sale, exchange, transfer, or relinquishment of the property or the extinguishment of any rights therein or the compulsory acquisition

India-Singapore DTAA – Article 13

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Gains from the alienation of shares acquired before 1st April 2017 will be taxed in the residence state

Gains from the alienation of shares acquired on or after 1st April 2017 will be taxed in the source state

If the shares are alienated between April 1, 2017 and March 31, 2019, then only 50% of the tax rate of the source state will be applicable on such alienation

Gains derived from alienation of any other property is only with the residence state.

India-Singapore DTAA – Article 24A (LoB clause)

A resident will not be entitled to the benefits Treaty if its affairs were arranged with the primary purpose to **take advantage of the benefits of the Treaty**

A shell or conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State. Consequently, it will not be entitled to the benefits of the Treaty.

A company will be deemed to be shell or conduit company if its annual expenditure on operations in that Contracting State is less than S$200,000 in Singapore or Indian Rs.5,000,000 in India for each of the 12-month periods in the immediately preceding period of 24 months from the date on which the gains arise for acquisition before April 1 2017.

A resident of a Contracting State is deemed not to be a shell or conduit company if:

- it is listed on a recognised stock exchange of the Contracting State; or
- it meets the annual expenditure test, as mentioned above

The cases of legal entities not having bona fide business activities will not be entitled to benefits under the Treaty

Judicial Trends

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BG Asia (AAR-Delhi)

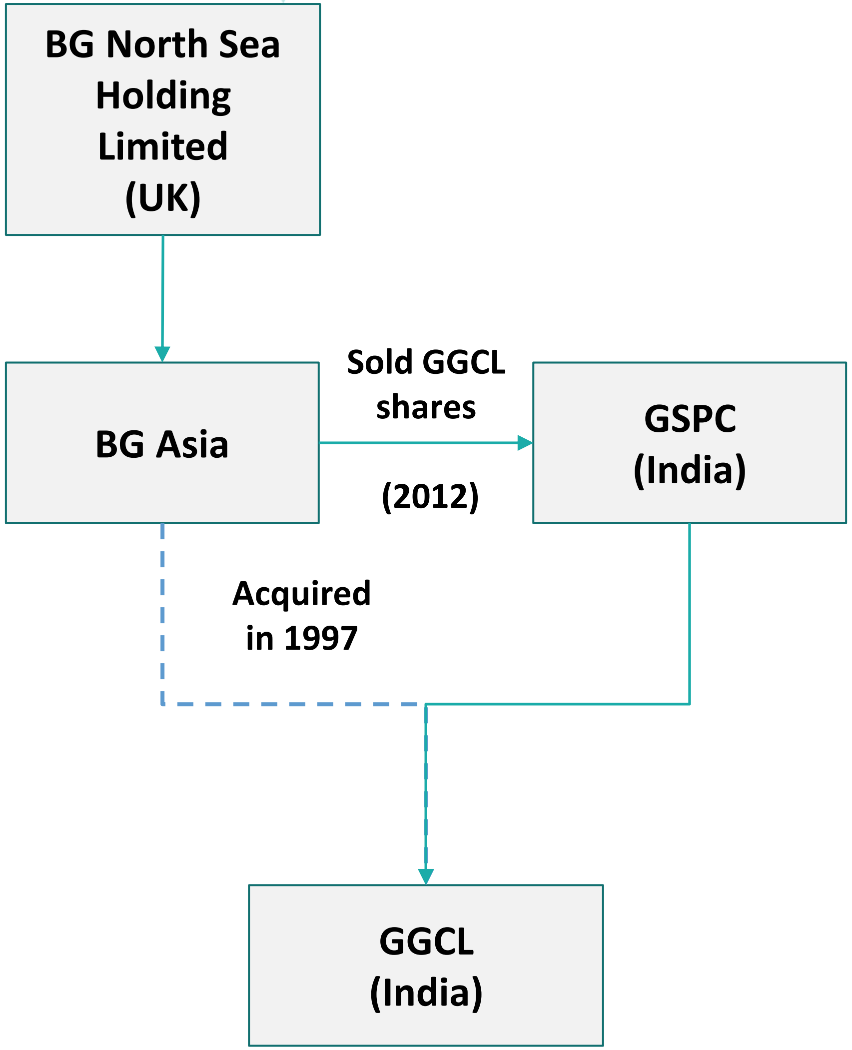
Facts

- BG Asia is a tax resident of Singapore and a 100% subsidiary of UK based company, made significant investments in the group companies situated in India, Singapore, Egypt, etc.
- BG Asia held 65.122% of total issued and paid-up equity capital of GGCL, an Indian company listed on recognised stock exchanges in India. BG Asia proposed to sell the shareholding in GGCL to another Indian company – GSPC (Buyer Co) in an off-market transaction

Issue: Whether the taxpayer is liable to capital gains tax in India under the provisions of the Act or treaty

Decision

- AAR held that the affairs of the assessee-company were not arranged with a primary purpose of availing treaty benefits
  - The shares of GGCL were held by BG Asia since 1997, even prior to the introduction of the 2005 Protocol in the India Singapore DTAA exempting capital gains tax;
  - Control & management of BG Asia was located in Singapore;
  - Decision to divest non-core business interest not limited to India but extended to investments in Brazil and Italy pursuant to *bonafide* business restructuring



Whether TRC can be questioned?

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Blackstone Capital Partners – TRC (Delhi HC- 2023)

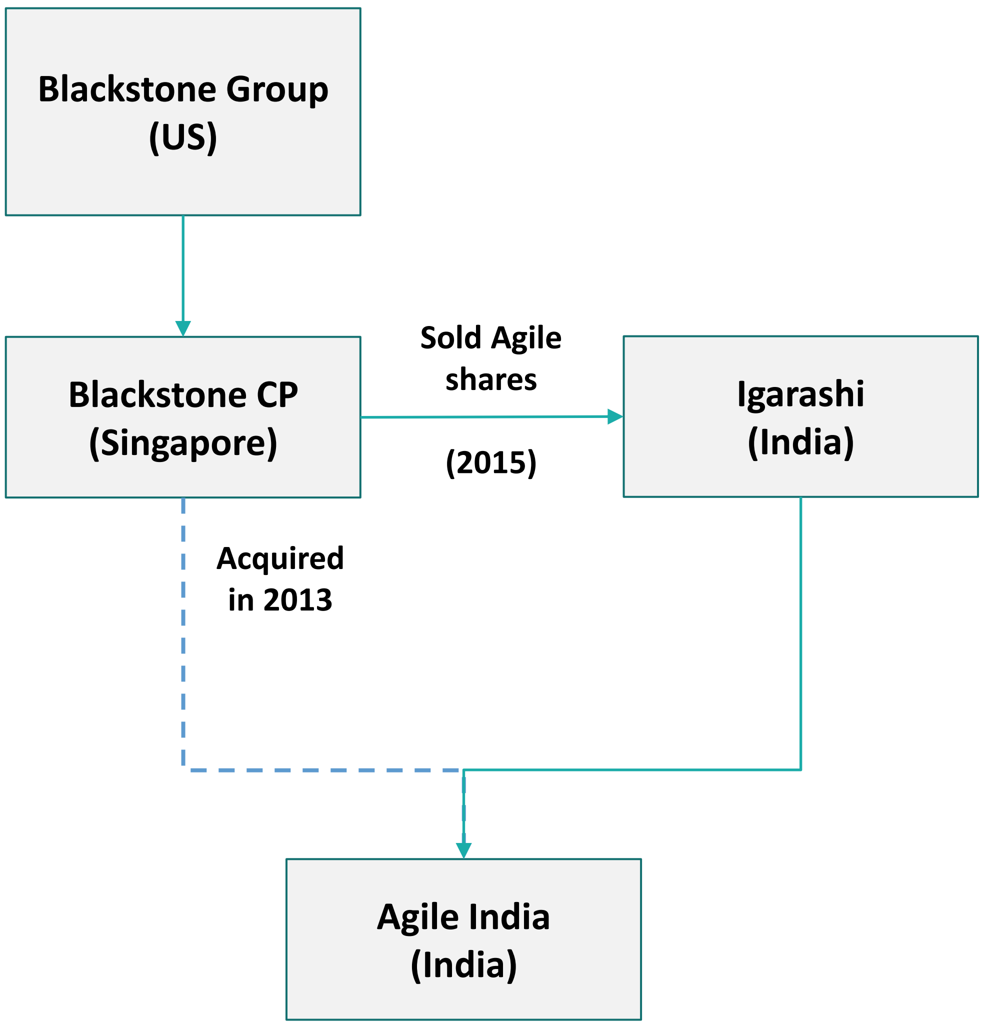
Facts

- Blackstone Singapore claimed non-taxability in India – Article 13(4) of India-Singapore Tax Treaty
- Blackstone Singapore furnished TRC and report from independent CA fulfilling LOB test under India-Singapore Tax Treaty
- Indian Tax authorities initiated re-assessment proceedings basis the argument that Blackstone US financed the transaction Thus, the applicable tax treaty would be India-US and not India-Singapore.

Issue: Whether Indian tax authority can question TRC issued by another jurisdiction and reassess issues of residence status, treaty eligibility and legal ownership.

Decision

- Indian tax authority cannot question TRC; tax administration instructions, Circulars, press releases, and SC judgments applied
- As per Singapore tax laws, IRAS issues TRC after thorough enquiry, satisfying that a company is managed and controlled in Singapore. Thus, the Indian tax authority cannot disregard TRC.



Bid Services Division Limited- (Bombay HC- 2021)

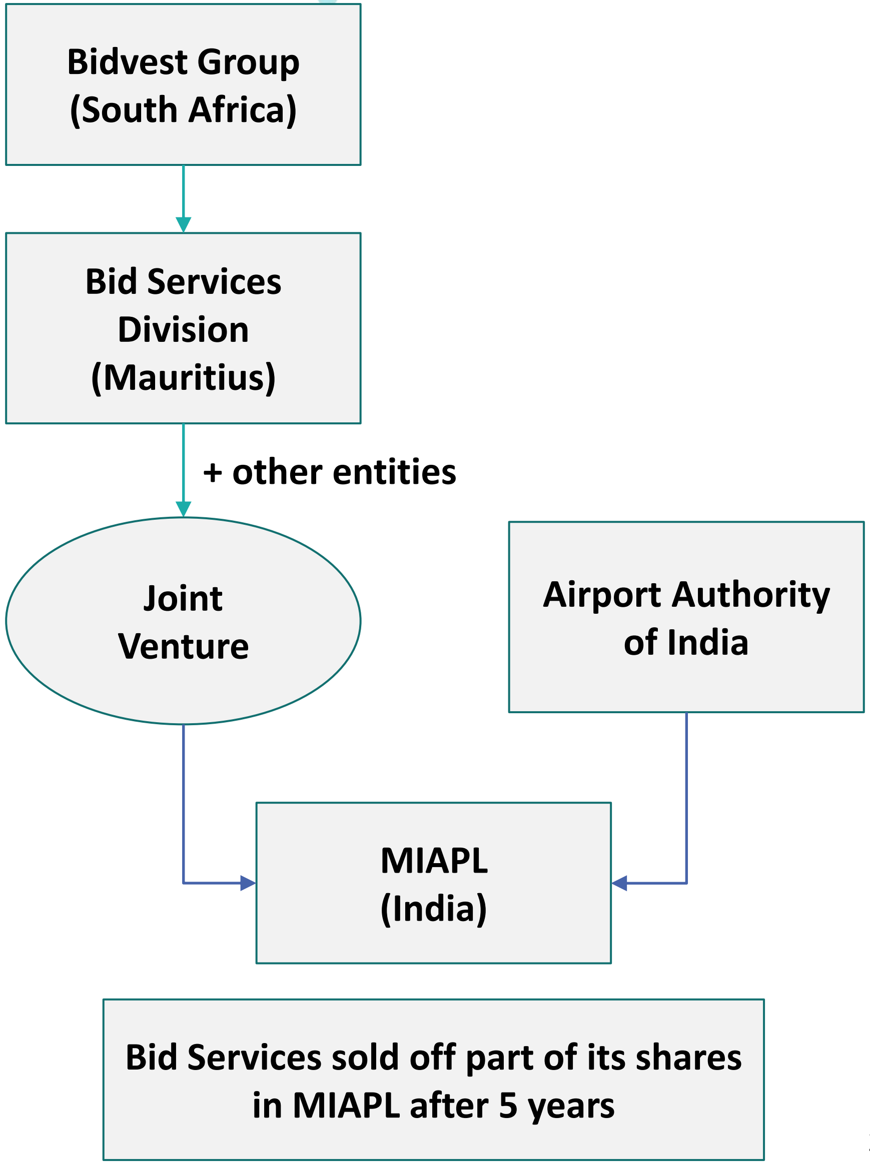
Facts

- Bid Service Mauritius (BSM) held Category-I Global Business Licence and TRC issued by Mauritian Authorities.
- It incorporated a Joint Venture along with other entities for a bidding process for the development of Mumbai Airport in India. Pursuant to a successful bidding, JV entities and Airport Authority of India, held shares of MIAPL.
- AAR held that since BSM was ultimately held by South African entity and was incorporated two weeks before the final bid, it was a tax avoidance tool.

Issue: Whether the Indian tax authority can question TRC issued by another jurisdiction.

Decision

- Given that Bid Services holds valid TRC, it cannot be a device to avoid tax absent any element of fraud or illegality.
  - Article 27A- disentitles shell/conduit companies from taking benefit under the Treaty
  - Circular No 789 dated 13 April 2000- TRC will constitute sufficient evidence for the status of residence and beneficial ownership



M/s Tata Sons Ltd (Mumbai Tribunal)

Facts: The assessee had acquired shares of Tata Tele-Services Company Ltd (TTSL) at various points of time. Subsequently, TTSL had incurred substantial losses in the course of its business which had resulted in a large part of the paid-up share capital of TTSL being utilized so as to finance/bear the said loss. In view of such losses, the "Scheme of Arrangement and Re-structuring" between TTSL and its shareholders was entered into whereby the assessee's shares in TTSL were reduced to half, without any consideration payable to the shareholders in respect of the shares which were to be cancelled. **The Assessee claimed this reduction of share capital as long-term capital loss and sought to set it off against LTCG.**

Whether the capital loss on account of reduction in share capital could be set off against LTCG

Decision: A "capital asset" is subject to tax if there is a 'transfer' u/s 2(47) of the Act. Thus, if the right of the assessee in the capital asset stands extinguished either upon amalgamation or by reduction of shares, it amounts to 'transfer' of shares and therefore, computation of capital gains has to be made. There was a loss on the capital account due to a reduction in capital invested, and therefore, any loss on the capital account is a capital loss and not a notional loss. Thus, the same has to be allowed or set-off against any other capital gain.

Flagship Indian Investment Co. (Mauritius) Ltd. (Mumbai Tribunal- 2010)

Facts: The assessee was a Mauritius-based that had incurred capital loss and had claimed same to be carried forward to the subsequent assessment year to be set off against profit of the succeeding years.
The AO was of the view that since the capital gains were not taxable in India as per the provisions of Article 13 of the India-Mauritius DTAA, capital loss was also exempted and, therefore, the assessee was not entitled to claim the benefit of carry forward of such capital losses.

Whether the assessee can be allowed to carry forward the capital loss to the subsequent assessment years.

Decision: If the assessee opts beneficial treatment under the Treaty, then the entire income is exempt. However, assessee can choose to avail provision of the Act if they are more beneficial. Accordingly, carryforward provision under the Act will apply.

Recent Trends for Denial of Benefits of Treaty for Capital Gains Exemption

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New Avenues for denying Treaty Benefits

The recent trend indicates that the tax authorities have come up with new avenues to challenge treaty benefits for capital gains, such as invoking:

- Beneficial Ownership
- Principal Purpose Test
- General Anti-avoidance Rules
- Substance-based test (expenditure thresholds)
- Conduit test - Control & Management
- Liable to tax vs subject to tax

Beneficial Ownership

(Blackstone FP Capital Partners Mauritius V Ltd- Mumbai Tribunal) [(2022) 138 taxmann.com 328]

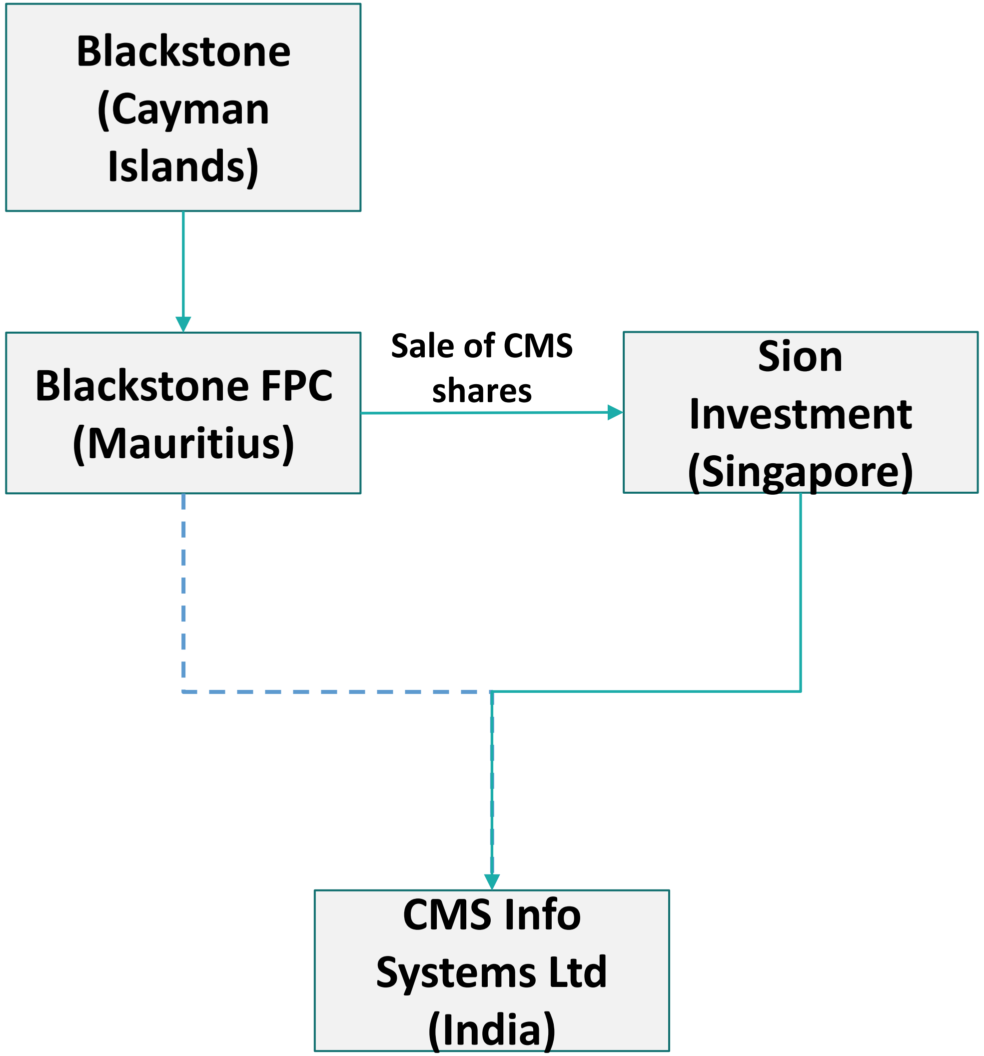
Facts

- Blackstone held a global business license (GBL) and TRC issued by Mauritius Authorities.
- The Indian tax authorities held that it had no independent existence and that its entire activity was controlled and directed by Cayman Island parent entity.

Issue: Whether the concept of beneficial ownership is a *sine qua non* for entitlement to treaty benefits?

Held:

- The condition of Beneficial Ownership is absent from Article 13 of the India-Mauritius Treaty - Tax on capital gains from the alienation of shares.
- Unless a condition is specifically set out in the treaty provision itself, it cannot possibly be inferred or added – Against principles of interpretation (Good Faith principle) under VCLT



General Anti Avoidance Rules (GAAR)

- Introduced with effect from April 1, 2017
- Non-obstante provision – Overrides all provisions of the Act including SAAR
- GAAR applicable in case of treaty cases - Even if not beneficial to the taxpayer
- GAAR Panel constituted in 2022 - First case pending for adjudication in Telangana High Court

- 'impermissible avoidance arrangement' – Main purpose – tax benefit; and satisfies any of tainted element tests
  - Lack of commercial substance
  - not in accordance with arm's length
  - results in direct or indirect abuse of the provisions of the Act
  - carried out in a manner which is not bona fide

- Exceptions to GAAR application

  (a) Tax benefit in an arrangement does not exceed INR 30 million;
  (b) FPI/FII - not taken treaty benefit
  (c) investment made by a non-resident - offshore derivative instruments issued by FPI/FII
  (d) Income arising from transfer of investments made before April 1, 2017

Interplay of PPT with Domestic GAAR

Particulars	Domestic GAAR	PPT under the Treaty
Applicability of test	Main Purpose is tax benefit and one of the tainted elements are satisfied	One of the principal purposes is **tax benefit** and such purpose is not in accordance with the object and purpose of treaty/article
Effects	Re-characterization of transaction, re-allocation of income (including denial of treaty benefit)	Denial of Treaty Benefit
Burden of Proof	A deeming fiction creates Primary onus on taxpayer, though, shifts to the Revenue.	Burden of proof on administration which later shifts to taxpayer – Objective & Subjective test determines it.
Grandfathering	Yes	No
Approval	3 Stage Approval for invoking GAAR	No*

**Action Plan 6 Report recommended that countries having approval process for invoking domestic anti-abuse measures to deny treaty benefit can have the same procedure laid down for invoking PPT*

Limitation on Benefits - Objective

To exclude conduit/shell companies from availing tax benefits under the treaty arrangements by recognising considerable nexus between the Contracting States.

To discourage Treaty shopping

The term ‘conduit/shell’ has been used in the LOB clause of DTAA between India – Mauritius under Article 27A which provides conditions for recognition or identification of such companies.

Similarly, in the LOB clause of DTAA between India – Singapore under Article 24A provides conditions for recognition or identification of conduit/shell companies.

"Liable to Tax" – Meaning

Section 2(29A) of the Income Tax Act, 1961 (Inserted by FA, 2021)

'liable to tax', in relation to a person and with reference to a country, means that there is an income-tax liability on such person under the law of that country for the time being in force and shall include a person who has subsequently been exempted from such liability under the law of that country.

"The term 'liable to tax' should be defined to say that there should be tax laws in force in the other State, which provides for taxation of such person, irrespective that such tax fully or partly exempts such persons from charge of tax on any income in any manner".

Azadi Bachao Andolan v. UOI

Linklaters LLP v. ITO - Liable to Tax

Facts: Taxpayer was a UK-based LLP, which is a fiscally transparent entity i.e., the income is taxed in the hands of its partners and not LLP. The Tax authorities took a position that taxpayer constituted ‘business connection’ in India. However, Taxpayer contended treaty benefit to claim no PE is being formed.

Whether fiscally transparent entity can claim Treaty benefit in the present case?

Held: For claiming treaty benefit, a person’s income should be subjected to residence-type taxation, on account of some locality related attachment, in that Contracting State. Thus, as long as partnership firm is taxable in respect of its profits not in its own right but in the hands of the partners, as long as entire income of the partnership firm is taxed in the residence country, treaty benefits cannot be declined.

Azadi Bachao Andolan v. UOI - Subject to Tax

‘Subject to Tax’ means the ‘Actual payment of Tax’, the term ‘Subject to Tax’ has a narrow meaning and it refers to the amount of income (net of deductions) on which tax has been levied

Being “Liable to Tax” and “actually taxed” are two different things

It’s possible for a person to be “Liable to Tax” under statute but may not be “actually taxed”.

Actual payment of Tax is not necessary for “Liable to Tax” but relevant for “Subject to Tax”

Income which is statutorily exempted from taxation cannot be said to be ‘Subject to Tax’

Every person who is ‘Subject to Tax’ in a state is necessarily ‘Liable to tax’ in the state. However, every person who is ‘Liable to tax’ may not be ‘Subject to Tax’ in that state.

Thank you!

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