Centre for Tax Laws (CTL)
Directorate of Distance Education
NALSAR University of Law, Hyderabad
In collaboration with
TAXMANN

<u>Course Material</u>

M.A. (INTERNATIONAL TAXATION)

1.2.8. INCOME FROM IMMOVABLE PROPERTY AND CAPITAL GAINS

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Module I – Income from Immovable Property

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1. Introduction

Income from immovable property has been taxed since the middle ages, which explains its long tradition in public finance. Public finance economists have analysed the taxation of immovable property with respect to the considerations of efficiency, effectiveness, equality, budgetary and political economy. Recently, the analysis has been extended to assess its fit as a macro prudential policy tool to affect the housing market, given the role of the housing market in the wake of the economic and financial crisis. Furthermore, international institutions such as the European Commission and the OECD seem to prefer immovable property taxation over other forms of taxation, as they keep requesting a tax shift from labour to immovable property taxation.

Immovable property can be rented in a market by a landlord, used for own consumption and used as investment by an owner-occupier or for a business input. These different purposes of immovable property would call for taxation of income generated by various purposes.

2. Allocation Rule [Article 6 Paragraph 1]

Paragraph 1 of Article 6 states that income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

Paragraph 1 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source. Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral conventions to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such income.

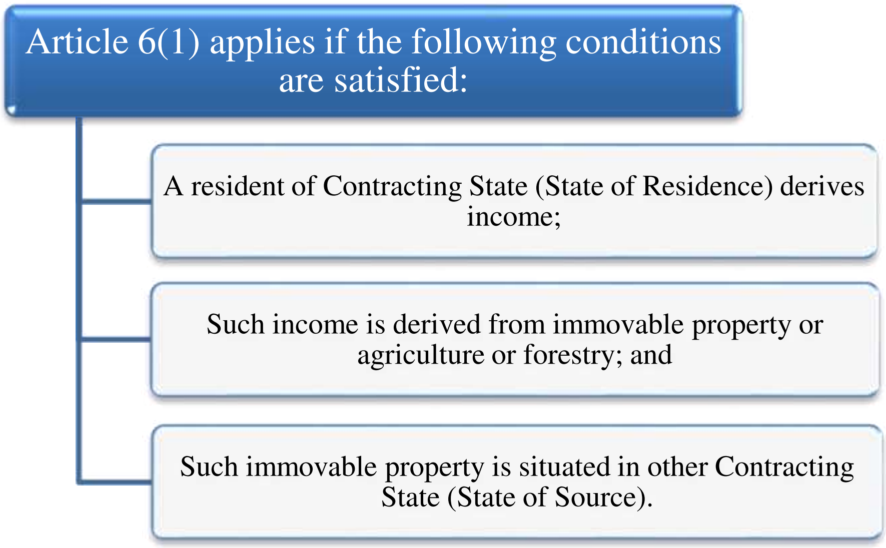

Fig.

Conditions of Applicability of Paragraph 1of Article 6

Note: This article does not extend to income earned by a resident from property situated in State of Residence or any third state.

3. <u>Definition of "Immovable Property"</u>

Paragraph 2 of Article 6 defines that the term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.

According to the general rule whatever is affixed or attached to land becomes part of the land.

Some the specific inclusions and exclusions are as follows:

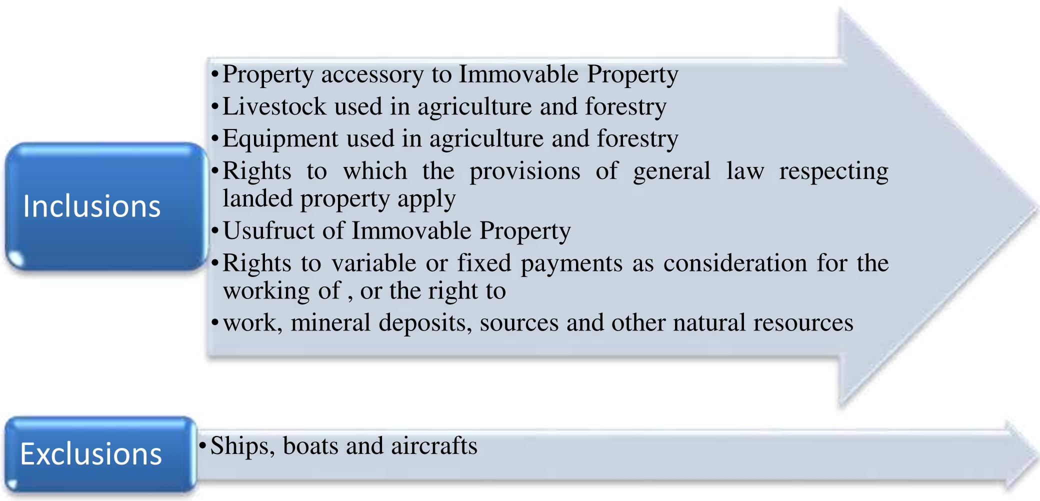

Fig. Inclusions and Exclusions from the term 'Immovable Property'

Note: Domestic law is irrelevant if items are specifically included or excluded in the treaty.

Defining the concept of immovable property by reference to the law of the State in which the property is situated, as is provided in paragraph 2, helps to avoid difficulties of interpretation over the question whether an asset or a right is to be regarded as immovable property or not. The paragraph, however, specifically mentions the assets and rights which must always be regarded as immovable property. In fact, such assets and rights are already treated as immovable property according to the laws or the taxation rules of most OECD member countries. Conversely, the paragraph stipulates that ships, boats and aircraft shall never be considered as immovable property. No special provision has been included as regards income from indebtedness secured by immovable property, as this question is settled by Article 11.

3.1 Meaning of "Immovable Property" in India

As per the definition under **section 269UA** of Income Tax Act, 1961, "Immovable Property" includes:

a) Land or building or part thereof;
b) Plant & machinery, furniture, fittings and other things transferred along with land or building; and
c) Including rights pertaining to above.

Illustration 1: Company Atlanta Inc, a foreign company has given a loan to Company M, an Indian company, repayment of which is secured by the property owned by Company M. Along with the loan amount, Atlanta Inc. will also earn interest income. Whether such interest income earned will be taxed under Article 6?
Solution: As the income from such indebtedness is specifically included in the definition of 'interest' in Article 11, such interest will not be taxed under Article 6; but shall be taxed under Article 11.

4. <u>Income from Legal Use of Immovable Property [Article 6 Paragraph 3]</u>

According to paragraph 3 of Article 6, the provisions of paragraph 1 shall apply to the income derived from the direct use, letting, or use in any other form of immovable property.

4.1. Coverage of Article 6

Article 6 focuses on income from immovable property but not all income from immovable property are included in this article. The article specifically includes some incomes; whereas others which are not included, are covered elsewhere.

4.1.1. Incomes specifically covered by Article 6

Article 6 specifically covers the following incomes:

a) Income derived from direct use, letting or use in any other form [Article 6(3)]
b) Capital gains derived from transfer of immovable property in absence of Article 13(1)
c) Payments for grant of license to extract natural resources – not covered by 'Royalty".

4.1.2. Incomes not covered by Article 6

Article 6 does not cover the following incomes which are covered by other articles or law of the contracting state. Such incomes are as follows:

a) Interest paid on a mortgage on immovable property (Article 11)
b) Capital gains from transfer of immovable property (Article 13)
c) Distribution of dividends by a company referred to in Article 13(4)
d) Income from immovable property by virtue of holding of shares in a company, owning the immovable property.

Note: Scope of income to be covered within Article 6 or otherwise depends upon negotiation between contracting states.

4.2. Meaning of "Use"

The term "use" in the definition of immovable property includes following forms of exploitation:

a) Direct use
b) Letting out
c) Use in any other form

Note: a) There is no specific definition of the term "letting out". Therefore, "letting out" may include subletting based on local laws of the country where the property is situated.
b) There is no specific definition of the term "used in any form". Therefore, such situations are governed by the local laws of the country where the property is situated.

5. <u>Income from Immovable Property of an Enterprise [Article 6 Paragraph 4]</u>

According to paragraph 4 of Article 6, the provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

This paragraph of the article extends the scope of situs based taxation by including income earned by an enterprise. It further includes income from immovable property earned by permanent establishment of non-resident in source country.
Example: Relinquishment of property for use by third party.

Note: Principles laid down in Article 7 do not apply to Article 6. This is an exception to the general rule under Article 7 that income must be attributable to a Permanent Establishment (PE) in order to be taxable in the Source State.

It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner in which income from immovable property is to be taxed.

6. Comparative Analysis on Article 6 in OECD, UN and US Model Conventions

Both OECD and UN models are identical. Most of the Indian DTAAs are based on UN Model. Following is the table showing a comparative analysis of Article 6 in OECD, UN and US Model Conventions:

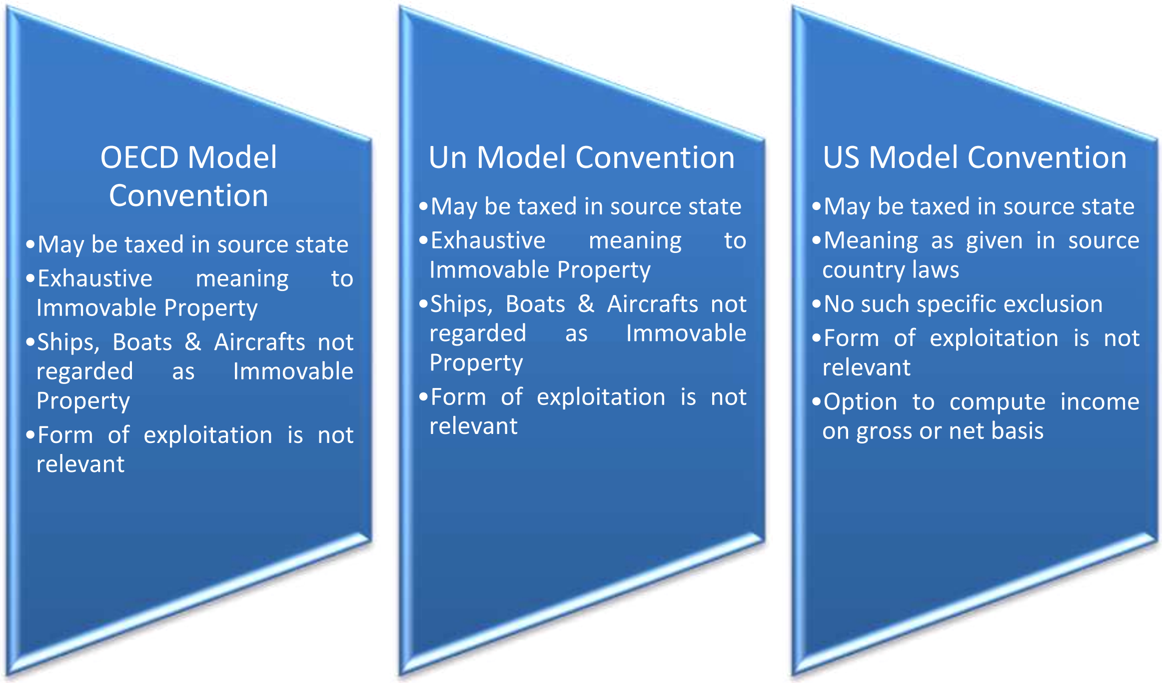

Fig. Comparative Analysis of Article 6 in OECD, UN and US Model Conventions

7. Case Studies Relevant to Article 6

Case studies give detailed insights into the practical application of the laws. Below are some of the case studies relevant to Article 6:

CIT v. Voest Alpine A.G. (Delhi HC)
Issue Involved: Whether consideration paid for technical services would be taxable as fees for technical services under Article 6? Whether consideration paid for furnishing technical services outside India, shall be taxable in India? **Case Scenario:** The assessee, Austria based Company had entered into agreement with an Indian company for furnishing know-how and technical assistance for producing hydro power equipment. **Judgement Involved:** The court held that: 1. Consideration paid for technical services would be taxable as fees for technical services under Article 7 of the DTAA between India – Austria, to the extent the amounts were attributable to the activities performed by the assessee in India. 2. Consideration paid for right to use technical information and know-how would be taxable

as royalty under Article 6 of the DTAA between India - Austria.

3. Consideration paid for furnishing technical services outside India, shall not be taxable in India.

Conclusion: Any consideration paid for technical services would be taxable as fees for technical services under Article 7. Further, consideration paid for right to use technical information and know-how would be taxable as royalty under Article 6. Also, consideration paid for furnishing technical services outside India, shall not be taxable in India.

Royal Bank of Canada v HMRC [2020]
Issue Involved: Whether the payments by Canadian Oil and Gas Company were chargeable to UK Corporation Tax under domestic law? **Case Scenario:** A Canadian bank loaned funds to a Canadian oil & gas company, to help fund the exploration and extraction of oil in the UK sector of the North Sea. At the time, licences for this activity were only issued to UK resident companies. The common practice at the time was for non-resident companies to enter into an "Illustrative Agreement" with a UK resident subsidiary licence holder. Under such agreements, the development and exploitation costs would be incurred by the non-resident parent company in return for the licence holder's share of the oil won from licensed area. The Canadian company was in financial difficulties and sold its interest in the oilfield to the BP group. The consideration for the sale included an entitlement to royalty payments contingent on production from the oil field linked to the excess of the market price of the oil above an agreed level. The Canadian company subsequently went into receivership, by which time, the oil price had risen, and some payments were made pursuant to the sale agreement. After the remainder of its assets were sold, the Canadian company still owed the bank about CAD $185 million and its rights to all future payments were formally assigned to the Bank with the approval of the Canadian courts. BP subsequently transferred its interest in the field to another oil company and the bank became entitled to the royalty payments pursuant to a novation agreement between all three parties. The bank accounted for the payments for Canadian tax as receipts of its banking business in Canada and as a partial recovery of the bad debt it had previously recognised in respect of its loan to the Canadian company. **Judgement Involved:** Corporation Taxes Act 2009 of UK brings into charge "any profits arising to a non-UK resident company… from exploration or exploitation rights". "Exploration or exploitation rights" are defined to mean "rights to assets to be produced by exploration or exploitation activities or to interests in or to the benefit of such assets". The Tribunal rejected the taxpayer's argument that the payments were receipts of the bank's banking trade and not profits from exploration or exploitation rights. It held that the Bank has rights to the benefit of the oil won from the by virtue of the royalty payments. The judge considered that the term "benefit of" denotes a broad and less legalistic approach to the question. It was common ground that, although the bank had a permanent establishment in the UK, the payments in question were not attributable to that permanent establishment. UK taxing rights were dependent on qualification of the payments as income from immovable property within

Article 6. The Article is unusual in that it is rarely construed by courts and the OECD Commentary is among the briefest for distributive articles.

Article 6(2) which is patterned on the OECD Model generally requires immovable property to be defined in accordance with the law of the Contracting State in which the property is situated. However, it includes in any event “rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources”. Both parties agreed that this specific inclusion in the definition determined the issue.

The taxpayer argued that this expression is concerned with a grant, not a transfer, of a right to work and that the payments must be made in consideration of the grant of the right to work to be income from immovable property. The Tribunal concluded that the definition in Article 6(2) should not be confined to payments made directly to the owner of the rights in exchange for the grant of a right to exploit them.

The judge said that there was no reason for limiting the scope of Article 6(2) to cover only payments which are made directly to the owner of the rights in exchange for the grant of a right to exploit them. The apparent purpose of granting taxing rights on profits from natural resources to the state where the resources are situated would otherwise potentially be capable of avoidance by simply granting a licence to work those resources at a price equal to the cost of the works, then the grantee assigning that right to a third party in exchange for payment of substantial royalties. The focus must be on the ultimate source of the profit and it would be irrational and inconsistent with the apparent purpose of the provision if it were possible to avoid local taxation on that profit simply by interposing an assignment of the royalty rights (possibly even to an associated company resident in a low tax jurisdiction) after they had been granted.

The First-tier Tribunal (Tax Chamber) (“FTT”) held that the payments were income from immovable property. Accordingly, the UK had taxing rights in respect of the payments.

Conclusion: From above, it can be concluded that the payments were income from immovable property and the UK Tax Corporation had the right to tax such income from immovable property.

Test Your Knowledge

QUESTIONS	
1.	Whether the following would be considered as 'immovable property' for the purposes of Article 6: a) Right to enjoy immovable property on a time sharing basis; and b) Machinery embedded in the earth to constitute a fertilizer plant.
2.	An Indian Company Asopalav Inc. has earned income from disposal of rubber fields at Malaysia. Whether such capital gains earned from transfer of the immovable property would be taxable under Article 6?
3.	Define immovable property as per Article 6.
4.	Which incomes are specifically included and excluded from the income from immovable property as per Article 6?

SOLUTIONS	
1.	a) It would depend primarily on the meaning of 'immovable property' in the domestic laws of the Contracting State in which the property is situated. b) It should be noted that it is irrelevant that the definition of immovable property as per domestic law includes machinery embedded in the earth to constitute a fertilizer plant. For the purposes of Article 6, it is important to consider the intention for such embedment. In this case, it is embedded permanently and hence, it is an immovable property.
2.	In absence of Article 13 regarding Capital Gains in the erstwhile India-Malaysia treaty, it was held that disposal of Immovable Property is also a form of use, as 'direct use…or use in any other form' is wide enough to cover transfer, sale or exchange of the property.
3.	Paragraph 2 of Article 6 defines that the term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.
4.	Article 6 focuses on income from immovable property but not all income from immovable property are included in this article. Article 6 specifically covers the following incomes: a) Income derived from direct use, letting or use in any other form [Article 6(3)] b) Capital gains derived from transfer of immovable property in absence of Article 13(1) c) Payments for grant of license to extract natural resources – not covered by 'Royalty". Article 6 does not cover the following incomes which are covered by other articles or law of the contracting state: a) Interest paid on a mortgage on immovable property (Article 11) b) Capital gains from transfer of immovable property (Article 13) c) Distribution of dividends by a company referred to in Article 13(4) d) Income from immovable property by virtue of holding of shares in a company, owning the immovable property.

Income from Immovable Property and Capital Gains

Module II – Capital Gains

1. <u>Introduction</u>

Economists generally agree that gains from capital are a proper source of taxation in developing countries. This view was expressed in the Technical Assistance Conference on Comparative Fiscal Administration in Geneva in 1951 and more recently in the Santiago Conference on Fiscal Policy for Economic Growth in Latin America. A capital gains tax is on the appreciation of capital assets and is commonly imposed only when the increase in value is realized through sale or exchange. It should be distinguished from net wealth tax, death duties, and other capital taxes in that these are assessed on the total value of assets.

Capital gains in developing countries differ from those in developed countries. In the former, capital gains are mainly from the sale or exchange of real estate, and in the latter, chiefly from the sale of securities. Three reasons account for the preponderance of capital gains from real estate in developing countries:

- the concentration of wealth held in real estate;
- the dominance in the corporate sector of foreign corporations whose shares are owned by non-residents who are taxed abroad; and
- the widespread use of bearer shares, which limits the effectiveness of taxation of capital gains from shares.

Because capital gains in developing countries result largely from investments in land, the taxation of these gains is justifiable in that such investments are not socially productive and are highly speculative. Therefore, a capital gains tax discourages investments that are not in line with the social and economic objectives of developing economies. A capital gains tax is on an increment which generally accrues to the high-income group and thus provides an element of progressivity in the tax system. This function is particularly important in developing countries with a high concentration of wealth and/or with an otherwise regressive tax system. A capital gains tax combined with a well-structured progressive income tax and levies on capital would be useful in promoting tax equity.

Article 13 is one of the most commonly used Article and it provides for the taxation of income arising from transfer of a capital asset, including transfer of shares. The right to tax income from capital gains may be exclusively with the Residence State, or shared between the Residence and Source States.

2. <u>Point of Accrual [Article 13 Paragraph 1]</u>

Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State **may** be taxed in that other State.

The use of the word **'may'** states that both the countries i.e. the Source State and the Residence State have the right to tax the aforesaid income. The country of source is the country where the immovable property is physically located. If such income is taxed in the Source State, the State of

Residence will either grant credit for taxes paid in Source State or exempt such income in accordance with Article 23 of the tax treaty.

Note: This Article does not specify how to compute the capital gain tax. The computation of the same is left upon the domestic laws.

3. Definition of Alienation of Property

There is no specific definition for capital gains in this article. The words **"alienation of property"** is used to cover, in particular, capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation (compulsory acquisition by the Government), the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.

4. Alienation of Whole Enterprise [Article 13 Paragraph 2]

Paragraph 2 of Article 13 states that gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

Article 13(2) of the OECD MC and UN MC are similar, except that the OECD MC does not refer to provision of independent personnel services from a fixed base. The said reference is absent on account of deletion of Article 14 from OECD MC i.e. Provision of Independent Personnel Services. As per paragraph 2 of Article 13, gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of **movable property pertaining to a fixed base available to a resident in the other Contracting State for the purpose of performing independent personal services**, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

The paragraph makes clear that its rules apply when movable property of a PE or fixed base is alienated as well as when the PE as such (alone or with the whole enterprise) or the fixed base as such is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the PE. The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in Article 13(6).

The term "movable property" means all property other than immovable property which is dealt with in Article 13(1). It includes also incorporeal property, such as goodwill, licences, etc.

According to paragraph 3 of Article 13, gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

Article 13(3) of the OECD and UN MC are identical. As per this para, gains from the alienation of ships or aircraft, or of movable property pertaining to the operation of ships or aircraft are taxable only in the State of the enterprise operating such ships and aircraft.

5. Exit Taxation [Deemed Realization]

Tax aspects can highly influence a person's decision to migrate, especially when a State decides to tax unrealized capital gains. Typically, capital gains are taxed on realization, that is, when the asset is effectively alienated. While this holds true to any change of residence in a domestic situation, where the taxpayer remains under the tax jurisdiction of the State, the same cannot be said on a cross-border migration. Whenever the latter happens, States seek to reduce the risk of losing tax revenue they would be entitled to if the taxpayer had not moved by applying a so-called exit tax, which in essence is a tax on unrealized capital gains.

5.1. Purpose of Exit Tax

The purpose of the regulation is to adjust the Polish tax provisions to the EU law. The proposed amendments are intended to correspond with Article 5 of the EU Council Directive 2016/1164 dated 12 July 2016, (hereinafter: "the ATAD Directive") which regulates the unrealized capital gains taxation in the case of transfer of taxpayer's assets or permanent establishment out of a tax jurisdiction, as well as in the case of change of the tax residence of a taxpayer.

According to the ATAD Directive, the tax levied on unrealized capital gains is intended to ensure that if a taxpayer moves assets or its tax residence out of the tax jurisdiction of a state, that state is allowed to tax the economic value of any capital gain created in its territory even though that gain has not yet been realized at the time of the exit.

The regulation is aimed at preventing the erosion of tax base in the internal market and the transfer of profits outside the territory of the internal market.

The exit tax is intended to be imposed on:

a) transfer of an asset (including an enterprise or an organized part thereof) outside the territory of Poland if as a result of the transfer Poland loses (wholly or in part) the right to levy tax on income potentially derived from the sale of the asset, provided that the transferred asset remains the property of the same person;
b) change of a taxpayer's tax residence if, as a consequence, Poland lose (wholly or in part) the right to levy tax on income derived from the sale of an asset owned by the taxpayer as

a result of the change of the country of residence (for natural persons) or the registered seat or the place of effective management (for legal entities) to another country.

5.2. Exit Tax in United States

The exit tax occurs from U.S. persons at the time of expatriation from the United States. If a person is a U.S. Citizen or Long-Term Resident covered expatriate, the exit tax calculations kick-in. At that time, the covered expatriate will evaluate their potential tax liability had they sold all of their assets on the day before expatriation. Most of the calculations are handled on a Mark-to-Market basis, with some exceptions, such as deemed distributions. Depending on what the total gain is, if the gain exceeds the exemption amount (currently $725,000), the expatriate may have to pay a U.S. Exit Tax, or apply for a bond (which can be very expensive). If a person is a covered expatriate (which includes U.S. citizens and certain Legal Permanent Residents), then they have to file a Form 8854 at the time of expatriation.

In order to determine if there is an exit tax:

a) The covered expatriate must determine their basis in each asset;
b) Then they must determine the FMV on the day before expatriation;
c) Each asset is then calculated as if it was sole on the day before expatriation (aka deemed sale); and
d) Up to $725,000 of the deemed gain is excluded.

The year in which a person or an enterprise expatriates is liable to exit tax in that financial year. Income tax shall be calculated on the net unrealized gain on property as if the property had been sold for its fair market value (FMV) on the day before the expatriation date ("mark-to-market tax"). This applies to most types of property interests held on the date of expatriation.

Gains from deemed sales are taken into account without regard to other U.S. internal revenue laws. Losses from deemed sales are taken into account to the extent otherwise allowed under U.S. internal revenue laws. However, section 1091 (relating to the disallowance of losses on wash sales of stock and securities) doesn't apply.

The mark-to-market tax does not apply to the following:

a) Eligible deferred compensation items.
b) Ineligible deferred compensation items.
c) Specified tax deferred accounts.
d) Interests in non-grantor trust.

Instead, item (a) is subject to withholding at source provided that an irrevocable waiver is made on initial filing of this form of any right to claim any reduction in withholding under an applicable treaty between the United States and a foreign country and timely notify the payer on Form W-8CE. To timely notify the payer on Form W-8CE one must file the Form W-8CE with the payer on the earlier of:

a) The day prior to the first distribution on or after the expatriation date, or
b) 30 days after the expatriation date.

Item (d) is also subject to withholding at source, and is treated as having waived any right to claim any reduction in withholding under an applicable treaty between the United States and a foreign country, unless one elects to be treated as having received the value of entire interest in the trust by obtaining a ruling from the IRS to that effect.

In the case of item (b), a person or an enterprise is treated as receiving the present value of the accrued benefit as of the day before the expatriation date and they should include this amount on the Form 1040 or 1040-SR for the year that includes the expatriation date.

In the case of item (c), a person or an enterprise is treated as receiving a distribution of its entire interest in the account on the day before its expatriation date and should include this amount in Form 1040 or 1040-SR for the year that includes the expatriation date.

6. Alienation of Shares [Article 13 Paragraph 4]

According to Paragraph 4 of Article 14, gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State 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, as defined in Article 6, situated in that other State.

Note - Article 13(4) of the OECD MC is identical to Article 13(4) in the UN MC.

By providing that gains from the alienation of shares or comparable interests which, at any time during the 365 days preceding the alienation, deriving more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State may be taxed in that State, paragraph 4 provides that gains from the alienation of such shares or comparable interests and gains from the alienation of the underlying immovable property, which are covered by paragraph 1, are equally taxable in both States.

Paragraph 4 allows the taxation of the entire gain attributable to the shares or comparable interests to which it applies even where part of the value of these shares or comparable interests is derived from property other than immovable property located in the Source State. The determination of whether shares of a company or comparable interests derive, at any time during the 365 days preceding the alienation, more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company, entity or arrangement without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property).

7. Gain from Interest in Partnership and Trust

Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

This paragraph is only provided in UN Model and provides for taxation of a gain from the alienation of shares and comparable interests as contemplated in the Article 13(5) but excludes gains from the alienation of shares to which Article 13(4) of the UN MC applies. The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 365 days preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations.

8. Other Capital Gains

Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3, 4 and 5 of Article 13 shall be taxable only in the Contracting State of which the alienator is a resident.

9. Beneficial Owner of Capital Gains

A beneficial owner is an individual who gets to enjoy ownership benefits even though the title to some form of the property is in the name of another individual. It also refers to any individual or group of individuals who have the power to vote or control the transaction decisions, either directly or indirectly, with regards to specific security, such as shares belonging to a company.

Beneficial ownership differentiates itself from legal ownership. In most of the cases, the legal, as well as the beneficial owners, are the same. However, there are some situations where the beneficial owner of a property may wish to remain anonymous, legitimate, and sometimes not-so legitimate.

Beneficial Owner in case of Capital Gains means the assesse that enjoys the ownership of such benefits from capital gains.

10. Depreciation in Capital Gain

Depreciation is a benefit that is available at the time of claiming it because it is reduced from the income and the associated taxes that are paid. But the real challenge is when the property is sold. All of the depreciation that is claimed over the years affects the actual capital gain on the property and also the capital gains tax that is paid. Depreciation does not offset the gain; it can actually increase the amount of capital gains realized on the sale of property.

10.1. Cost Basis Reduction

With business personal property or rental real estate, the income-tax filing function of depreciation reduces the cost basis of the property when it is disposed of The capital gain on the sale of the item is the selling price minus the cost basis.

Example:
Mohan purchased a vehicle for $10,000 and deducted $9,000 from his income tax for depreciation over several years, his actual cost basis of the vehicle was $1,000. He sold the car for $2,000, his taxable gain was $1,000, which is the amount of the sale that exceeds the cost basis of the property.

10.2. Recaptured Depreciation

With property sold at a capital gain, the gain that is attributable to the depreciation of the property is taxable at a higher rate. Normal capital gains may be taxed at either 15 or 25 per cent, depending on the income; taxpayer has to pay taxes on depreciation recovery at a higher rate than the normal income rate. The reason for this higher tax is that the depreciation is reduced from the taxable income when it is claimed, so the recapture of this depreciation increases the taxable ordinary income.

10.3. Losses Offsetting Gains

Ordinary losses that are not attributable to depreciation also offset capital gains on other property or investments that are sold in the same year.

Example:
Mahesh sold his residential real estate and realized a $20,000 gain on the property, and also sold some stocks for a $10,000 loss during the same year; his total taxable capital gain was $10,000. He can also claim a deduction for a capital loss for the year but only up to a maximum of $3,000 per year.

10.4. Capital Gain on Sale of Depreciable assets

According to Section 50 of Income Tax Act, 1961 if the person sells a capital asset that forms part of the block of assets on which depreciation has been allowed as per the provisions of the Income Tax Act, the income from such sales is a capital gain.

The calculation of capital gain or loss arising on the sale of depreciable assets can be divided into two categories:

a) Where some assets are sold from the blocks of assets.
b) Where all assets of the block are transferred and the block of assets ceases to exist.

10.4.1. Some assets are sold from the blocks of assets

If a part of such capital asset forming part of a block of asset has been sold and after deducting the net consideration received from sale of such asset from the written down value of the block of such asset the written down value comes to nil then the gain arising shall be treated as short term capital gain and in such case where written down value has become nil, no depreciation shall be available on such block of asset even if some assets are physically left in the block of assets.

10.4.2. All assets of the block are transferred and the block of assets ceases to exist

If the whole of the capital assets forming part of a block of assets have been sold during a year and the assessee has suffered a loss after deducting the net sale consideration from the written down value of the block of assets, then such loss shall be treated as short term capital loss and no depreciation shall be allowed from such block of assets.

It was decided by ***Chandigarh tribunal in (2004) 3 S.O.T. 521/ 83 T.T.J. 1057*** if the whole of capital assets in a block have been sold in a year and some gain arises after the sale such gain shall not be treated as short term capital gain if some new asset has been purchased within the same year in the same block of assets and the total value of new and old capital assets in the same block is more than the sale consideration of the assets sold, since the block of asset does not cease to exist in such case as is required u/s 50(2).

Example:
Written down value of five machineries as on 01-04-2020 was Rs. 5,00,000. These five machineries were sold on 01-05-2020 at Rs. 6,00,000 and a new machinery was purchased on 01-06-2020 for Rs. 2,50,000.

In the given case, the difference between the WDV and sale value i.e. Rs. 1,00,000 cannot be treated as short term capital gain in the year 2020-21 since new machinery has been purchased in the same block of asset afterwards in the same year and the total of new and old machinery is more than the sale value of the machineries sold as a result the block of asset continue to exist.

11. <u>Redemption of Securities</u>

The term redemption has different uses in the finance and business world. In finance, redemption refers to the repayment of any fixed-income security at or before the asset's maturity date. Bonds are the most common type of fixed-income security, but others include certificates of deposit (CDs), Treasury notes (T-notes), and preferred shares.

People who invest in fixed-income securities, such as bonds, receive fixed interest payments at regular intervals. Bonds can be redeemed before or on their maturity date. If such securities are redeemed at the time of maturity, an investor receives the par value (also called the face value) of the bond. This refers to the original value of the bond when it was first issued and is the amount of money the issuer of the bond agrees to repay the bondholder.

The redemption of an investment may generate a capital gain or loss, both of which are recognized on fixed-income investments and mutual fund shares. Taxation of capital gains is reduced by capital losses recognized in the same year. Mutual fund gains and losses are included in the same capital gain calculation.

To compute the capital gain or loss on redemption, the investor must know the cost basis, which is the original value or purchase price of the asset. Bonds can be purchased at a price other than the par or face amount of the bond.

Example:
An investor buys a $1,000 par value corporate bond at a discounted price of $900 and receives $1,000 par value when the bond is redeemed at maturity. The investor has a $100 capital gain for the year, and the tax liability for the gain is offset by any capital losses the investor might have. If the same investor purchases a second $1,000 par value corporate bond for $1,050 and the bond is redeemed for $1,000 at maturity, the $50 capital loss reduces the $100 capital gain for tax purposes.

11.1. Types of Redemptions

Most redemption is made for cash. So when a mutual fund investor requests redemption, the fund management company will issue the investor a cheque for the shares at market value. But there are cases where redemptions may be made in-kind.

11.1.1. In-kind Redemptions

In-kind redemptions are non-monetary payments made for securities or other instruments. Rarely used in the mutual fund industry, in-kind redemptions are common with exchange traded funds (ETFs). Fund managers may feel redemptions hurt long-term investors. Therefore, instead of paying out cash to those who wish to exit a fund, they offer positions in other securities on a pro-rata basis.

ETFs are generally considered more tax-friendly than mutual funds. By issuing shares in-kind, the ETF does not have to sell securities to raise cash for redemption payouts. This, in turn, eliminates the need for capital gains distributions, cutting down the investor's tax liability.

11.1.2. Mutual Fund Redemptions

The redemption of fund shares from a mutual fund company must occur within seven days of receiving a request for redemption from the investor. Because mutual funds are priced only once per day, investors who wish to redeem their money must place the order before the market's close or the time set by the mutual fund.

Money is redeemed at the fund's net asset value (NAV) for the day, which is calculated as the sum of the value of the assets of a fund less than its liabilities. Once the sale is completed, clients typically receive their funds including any gains via check or direct deposit to their bank account.

Some mutual funds may have redemption fees attached in the form of a back-end load. A back-end load is a sales charge—a percentage of the fund's value that declines over time. If the investor holds the fund shares for a longer amount of time, the back-end load charged when the shares are redeemed is smaller.

Investments in mutual funds are designed for individuals who buy and hold fund shares for the long term and selling fund shares after a short period of time results in higher costs to the investor. The investor pays sales charges and annual fees for professional portfolio management and the fund's accounting and legal costs.

12. Immovable Property [Article 22 Paragraph 1]

As per Paragraph 1 of Article 22, capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

Paragraph 2 of Article 6 defines that the term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.

12.1. Taxation of Non-residents of Immovable Property in the Source Country

Paragraph 1 of Article 6 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source. Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral conventions to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such income.

13. Capital represented by Ships/Aircrafts [Article 22 Paragraph 3]

According to Paragraph 3 of Article 22, capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

14. Residual Clause [Article 22 Paragraph 4]

According to Paragraph 4 of Article 4, all other elements of capital of a resident of a Contracting State shall be taxable only in that State. This is a residual clause and is applicable to all the gains not covered elsewhere.

15. Section 9 under Income-tax Act, 1961

Section 9 under Income-tax Act, 1961_talks about the categories of income deemed to accrue or arise in India. This is an important concept because it serves as a foundation for taxation of income of a person. This section provides for taxation on both, residents as well as non-residents.

Section 9 originally brings a **"source income"** rule of taxation, ranging from income from a business connection to royalty paid by the government as accruing or deeming to accrue from India for the purposes of taxation. Due to its nature of taxing non-resident corporations as well, this section has been criticised as ultra vires to the Constitution of India on the grounds of being outside the legislative competence of the legislature as well as violation to the fundamental rights.

15.1. Income deemed to accrue or arise in India through Business Connection [Section 9(1)(i)]

The term business connection has been explained in Explanation 2 to section 9(1)(i) which include any business activity carried out through a person, acting on behalf of the non-resident.

'Business connection' shall include any business activity carried out through a person acting on behalf of the non-resident. ***[Explanation 2 to section 9(1)(i)]***

For a **business connection** to be established, the person acting on behalf of the non-resident:

a) must have an authority, which is habitually exercised in India, to conclude contracts on behalf of the non-resident or habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by that non-resident and such contracts are:
   - in the name of the non-resident; or
   - for the transfer of the ownership of; or
   - for the granting of the right to use, property owned by that non-resident or that non-resident has the right to use; or
   - for the provision of services by that non-resident, or

b) Where he has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident, or

c) Who habitually secures orders in India, mainly or wholly for the non-resident. Further, there might be situations when the person acting on behalf of the non-resident secure order for other non-residents. In such situation, business connection for other non-residents would be established if:
   (i) such other non-resident controls the non-resident, or
   (ii) such other non-resident is controlled by the non-resident, or
   (iii) such other non-resident is subject to same control as that of non-resident.

However, such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having independent status, if they are acting in ordinary course of business.

Where a business is carried on in India through a person referred to in (a), (b) or (c) above, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India. ***[Explanation 3 to Section 9(1)(i)]***

In the case of a non-resident, the following shall not, however, be treated as business connection in India: ***[Explanation 1 to section 9(1)(i)]***

(i) Where all the operations are not carried out in India *[Explanation 1(a) to section 9(1)(i)]*: In the case of a business of which all the operations are not carried out in India, the income of such business shall be deemed to accrue or arise in India shall be only for such part of income as is reasonably attributable to the operations carried out in India. Therefore, it provides that such part of income which cannot be reasonably attributed to the operations in India shall not be deemed to accrue or arise in India.

(ii) Purchase of goods in India for export ***[Explanation 1(b) to section 9(1)(i)]:*** In the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export.

(iii) Collection of news and views in India for transmission out of India ***[Explanation 1(c) to section 9(1)(i)]:*** In the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India.

(iv) Shooting of cinematograph films in India ***[Explanation 1(d) to section 9(1)(i)]:*** In the case of a non-resident, no income shall be deemed to accrue or arise in India through or from operations which are confined to the shooting of any cinematograph film in India, if such non-resident is :

a. an individual, who is not a citizen of India or
b. a firm which does not have any partner who is a citizen of India or who is resident in India; or
c. a company which does not have any shareholder who is a citizen of India or who is resident in India.

(v) Activities confined to display of rough diamonds in SNZs ***[Explanation 1(e) to section 9(1)(i)]:*** In case of a foreign company engaged in the business of mining of diamonds, no income shall be deemed to accrue or arise in India to it through or from the activities which are confined to display of uncut and unsorted diamonds in any special zone notified by the Central Government in the Official Gazette in this behalf.

15.1.1. Income from Property, Asset or Source of Income in India

Any income which arises from any property in India (movable, immovable, tangible and intangible property) would be deemed to accrue or arise in India. For example, hire charges or rent paid outside India for the use of the machinery or buildings situated in India, deposits with an Indian company for which interest is received outside India, etc.

15.1.2. Income through Transfer of Capital Assets Situated in India

Capital gains arising through or from the transfer of a capital asset situated in India would be deemed to accrue or arise in India in all cases irrespective of the fact whether

a) The capital asset is movable or immovable, tangible or intangible;
b) The place of registration of the document of transfer etc., is in India or outside; and
c) The place of payment of the consideration for the transfer is within India or outside.

The expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of". ***[Explanation 4 to section 9(1)(i)]***

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. ***[Explanation 5 to section 9(1)(i)]***

However, ***Explanation 5 to section 9(1)(i)*** shall not apply to an asset or capital asset, which is held by a non-resident by way of investment, directly or indirectly in:

a) An asset or capital asset, which is held by a non-resident by way of investment, directly or indirectly, in Category-I or Category-II foreign portfolio investor under the Securities and Exchange Board of India

b) A Foreign Institutional Investor as referred to in clause (a) of the Explanation to Sec. 115AD for assessment year commencing on or after 01.04.2012 but before 01.04.2015.

Explanation 6 to section 9(1)(i) states that the share or interest in a company or entity registered or incorporated outside India, shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets, -

(i) exceeds the amount of 10 crore; and
(ii) represents at least 50% of the value of all the assets owned by the company or entity, as the case may be.

Note: Definitions of the various terms used are provided in the table below:

Terms	**Definition**
Value of an asset	The fair market value as on the specified date, of such asset without reduction of liabilities, if any, in respect of the asset, determined in prescribed manner.
Specified date	Specified date means: ***(i)*** the date on which the accounting period of the company or, as the case may be, the entity ends preceding the date of transfer of a share or an interest. ***(ii)*** the date of transfer shall be the specified date of valuation, in a case where the book value of the assets of the company or entity on the date of transfer exceeds by at least 15%, the book value of the assets as on the last balance sheet date preceding the date of transfer.
Accounting period	Each period of 12 months ending with 31st March. **Different date of year-end:** Where a company or an entity, referred to in ***Explanation 5***, regularly adopts a period of 12 months ending on a day other than 31st March for the purpose of—

	(i) complying with the provisions of the tax laws of the territory, of which it is a resident, for tax purposes; or *(ii)* reporting to persons holding the share or interest, Then the period of twelve months ending with the other day shall be the accounting period of the company or, as the case may be, the entity.
First Accounting Period	It shall begin from the date of its registration or incorporation and end with the 31st March or such other day, as the case may be, following the date of such registration or incorporation.
Later accounting period	The later accounting period shall be the successive periods of twelve months
Accounting period of an entity which ceases to exist	If the company or the entity ceases to exist before the end of accounting period, as aforesaid, then, the accounting period shall end immediately before the company or, as the case may be, the entity, ceases to exist.

Explanation 7 to section 9(1)(i): No income shall be deemed to accrue or arise to a non-resident from transfer, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, referred to in the ***Explanation 5***;

(i) If such company directly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer,

a) neither holds the right of management or control in relation to foreign company or entity;
b) nor the voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the foreign company or entity; or

(ii) If such company indirectly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer,

a) neither holds the right of management or control in relation to foreign company or entity;
b) nor holds any right in, or in relation to, such foreign company or entity which would entitle him to the right of management or control in the company or entity that directly owns the assets situated in India;
c) nor holds such percentage of voting power or share capital or interest in foreign company or entity which results in holding of (either individually or along with associated enterprises) a voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the company or entity that directly owns the assets situated in India;

However in case where all the assets owned, directly or indirectly, by a company or an entity reffered to in Explanation 5, and not located in India, the income of non-resident transferor, from transfer outside India of a share of, or interest in, such company or entity, deemed to accrue or arise in India under this clause, shall be only such part of the income as is reasonably attributable to assets lacated in India and determined in such manner as may be prescribed.

"Associated enterprise", in relation to another enterprise, means an enterprise:

- that participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or
- in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise.

15.1.3. Income from Salaries Earned in India [Section 9(1)(ii)]

Income, which falls under the head "Salaries", deemed to accrue or arise in India, if it is earned in India. Salary payable for service rendered in India would be treated as earned in India.

Further, any income under the head "Salaries" payable for rest period or leave period which is preceded and succeeded by services rendered in India, and forms part of the service contract of employment, shall be regarded as income earned in India.

15.1.4. Income from Salaries Payable by the Government for Services Rendered Outside India [Section 9(1)(iii)]

Income from 'Salaries' which is payable by the Government to a citizen of India for services rendered outside India would be deemed to accrue or arise in India.

However, allowances and perquisites paid or allowed outside India by the Government to an Indian citizen for services rendered outside India is exempt, by virtue of section 10(7).

15.1.5. Dividend paid by an Indian company outside India [Section 9(1)(iv)]

Dividend paid by an Indian company outside India is deemed to be accrues or arise in India and would be taxable in India in the hands of non-resident shareholders.

It is clarified that the dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets situated in India would not be deemed to income accruing or arising in India by the virtue of the provision of ***Explanation 5 to section 9(1)(i).***

15.1.6. Interest payable outside India [Section 9(1)(v)]

Under section 9(1)(v), an interest is deemed to accrue or arise in India if it is payable by –

(i) the Government;
(ii) a person resident in India;
(iii) a non-resident, when it is payable in respect of any debt incurred or moneys borrowed and used, for the purpose of a business or profession carried on in India by him.

Explanation Section 9(1)(v) states that in case of a non-resident, being a person engaged in the business of banking, any interest payable by the permanent establishment (PE) in India of such non-resident to the head office or any PE or any other part of such non-resident outside India shall be deemed to accrue or arise in India and shall be chargeable to tax in addition to any income attributable to the PE in India and the PE in India shall be deemed to be a person separate and independent of the non-resident person of which it is a PE and the provisions of the Act relating to computation of total income, determination of tax and collection and recovery shall apply accordingly.

"Permanent Establishment" includes a fixed place of business through which the business of the enterprise is wholly or partly carried on.

15.1.7. Royalty [Section 9(1)(vi)]

Royalty will be deemed to accrue or arise in India when it is payable by -

(i) the Government;
(ii) a person who is a resident in India except where it is payable for the transfer of any right or the use of any property or information or for the utilisation of services for the purposes of a business or profession carried on by such person outside India or for the purposes of making or earning any income from any source outside India, or
(iii) a non-resident only when the royalty is payable in respect of any right, property or information used or services utilised for purposes of a business or profession carried on by such person in India or for the purposes of making or earning any income from any source in India.

15.1.8. Fees for Technical Services [Section 9(1)(vii)]

Any fees for technical services will be deemed to accrue or arise in India if they are payable by -

(i) the Government.
(ii) a person who is resident in India except where the fees is payable in respect of technical services utilised in a business or profession carried on by such person outside India or for the purpose of making or earning any income from any source outside India.
(iii) a person who is a non-resident, only where the fees are payable in respect of services utilised in a business or profession carried on by the non-resident in India or where such services are utilised for the purpose of making or earning any income from any source in India.

Fees for technical services mean any consideration (including any lumpsum consideration) for the rendering of any managerial, technical or consultancy services (including providing the services of technical or other personnel). However, it does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head ‘Salaries’.

15.1.9. Any Sum of Money paid by a Resident Indian to a Non-Corporate Non-Resident or Foreign Company [Section 9(1)(viii)]

Income arising outside India, being any sum of money paid without consideration, by a Indian resident person to a non-corporate non-resident or foreign company would be deemed to accrue or arise in India if the same is chargeable to tax under section 56(2)(x) i.e., if the aggregate of such sum received by a non-corporate non-resident or foreign company exceeds Rs. 50,000.

It may be noted that this deeming provision applies only to sum of money paid outside India to a non-corporate non-resident or foreign company, and not in respect of property, movable or immovable, transferred outside India without consideration or for inadequate consideration to a non- corporate non-resident or foreign company.

16. <u>Transfer [Section 2(47) of Income Tax Act, 1961]</u>

The term “transfer”, in relation to a capital asset, includes-

a) the sale, exchange or relinquishment of the asset; or
b) the extinguishment of any rights therein; or
c) the compulsory acquisition thereof under any law; or
d) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment; or
e) the maturity or redemption of a zero coupon bond; or
f) any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882; or
g) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

17. <u>Capital Assets</u>

As per Section 2(14) of the Income-tax Act, 1961, capital asset is defined as property of any kind held by an assessee whether or not connected with his business or profession, but not including:

a) Any stock-in-trade and raw materials held for the purposes of his business or profession;
b) Personal effects, i.e. to say, movable property (including wearing apparel and furniture, but excluding jewellery, archaeological collections, drawings, paintings, sculptures and any work of art) held for personal use by the assessee or any member of his family dependant on him;

c) Agricultural land in India not being situated within the jurisdiction of a municipality or within 8 km. of a municipality as may be notified;
d) Gold bonds;
e) Special Bearer Bonds, 1991; and
f) Gold Deposit Bonds.

Note: "Personal Effects" like silver utensils, wearing apparel, etc. are not treated as capital assets.

18. The Vodafone and Cairn Controversy

Issue Involved: The issue before the Apex court was whether the Indian Revenue Authority had power to tax a sale of shares between two non-resident companies on an offshore transaction whereby the controlling interest of a resident Indian corporation is purchased on the basis of that transaction.

Case Scenario: In February 2007, the Dutch group Vodafone International Holding (VIH) purchased 100% of the shares in CGP Investments (Holding) Ltd (CGP), a Cayman Islands group, from Hutchison Telecommunications International Limited for USD 11.1 billion. 67% of Hutchison Essar Limited (hereinafter HEL), an Indian Company, was governed by CGP through various transitional organizations/ authoritative courses of action. The acquisition resulted in Vodafone acquiring control over CGP and its subsidiaries downstream, including eventually Hutchison Essar Limited. HEL was a joint effort between the gathering at Hutchison and the gathering at Essar. As of November 1994, it had obtained telecom licences to provide cell contact in different circles in India.

In September 2007, Vodafone Company received a show-cause notice from the Indian Tax Department to explain why tax was not withheld on payments made to HTIL in connection with the transaction in question above. The tax department argued that the aforementioned transaction involving the sale of CGP shares had an effect on the aberrant or indirect sale of India-based properties.

The revenue argued that the entire trade of HTIL's selling of CGP to VIH was in the substance transfer of capital assets in India and therefore triggered capital gain taxes, which culminated in the transfer of all direct/indirect rights in HEL to VIH, and that the entire selling of CGP was a tax evasion scheme.

Judgment Involved: Key principles set out in the decision were:

- It was not possible to read the tax legislation dealing with transfers of capital assets situated in India as extending to indirect transfers: that would amount to reading words into the provision under Section 9(1) of the Income Tax Act 1961 (IT Act) which were not there.

- There was nothing objectionable about multinationals using special purpose vehicles (SPVs) and holding companies in cross border structures for tax planning, commercial and regulatory reasons. However, if a SPV or a holding company was created without any commercial or business substance only to avoid tax, then the tax authorities may ignore such entity. Structuring transactions to achieve tax efficiency is permissible provided that the structure used is not a sham or a colorable tax avoidance device.

- The corporate veil could not be pierced except in exceptional circumstances where companies were used as tax avoidance devices or to perpetrate tax evasion such as round tripping of funds back into India.

- While looking at such structures, the courts and the tax department should look at transactions as a whole and not dissect them at the outset in search of an unacceptable tax motive. The factors that the tax authorities and courts should consider include:
  (i) duration of time for which such structure has been in existence,
  (ii) the period of business operations in India,
  (iii) the timing of the exit, and
  (iv) the continuity of business on such exit.

- The burden is on the tax authorities to determine the dominant purpose of a transaction and to establish that a given transaction is a sham or a colourable device designed to avoid tax.

- Whether a structure represents a genuine tax planning on the one hand or a sham or a colourable device to avoid tax on the other has to be determined at the threshold, by looking at the transaction as a whole in the context to which it properly belongs and not by dissecting the individual parts and looking at them in isolation. According to the Supreme Court, examples of colourable devices include structures that are "used for circular trading or round tripping or to pay bribes." On the other hand, structures designed to avoid the lengthy approval and registration processes in India may be permissible.

Following its holistic approach, the Supreme Court found that the transaction between Vodafone and the Hutchison Group was exactly as the parties contemplated: an offshore sale between offshore parties of an offshore asset and was not subject to tax in India.

Conclusion: The Supreme Court denied the Indian government's review petition for the decision in Vodafone, leaving legislation as the government's only option to overturn the ruling. Therefore, the Indian Revenue Authorities can't tax the above transaction. However, the above judgement has been nullified by retrospective amendments in Section 9(1) which are discussed below:

Explanation 4 to section 9(1)(i) was included to clarify that the expression "through" shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".

Explanation 5 to section 9(1)(i) was inserted to clarify 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.
However, ***Explanation 5 to section 9(1)(i)*** shall not apply to an asset or capital asset, which is held by a non-resident by way of investment, directly or indirectly in:

a. An asset or capital asset, which is held by a non-resident by way of investment, directly or indirectly, in Category-I or Category-II foreign portfolio investor under the Securities and Exchange Board of India

b. A Foreign Institutional Investor as referred to in clause (a) of the Explanation to Sec. 115AD for assessment year commencing on or after 01.04.2012 but before 01.04.2015.

Explanation 6 to section 9(1)(i) was also inserted which states that the share or interest in a company or entity registered or incorporated outside India, shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date, the value of Indian assets, -

(i) exceeds the amount of 10 crores; and
(ii) represents at least 50% of the value of all the assets owned by the company or entity, as the case may be;

Explanation 7 to section 9(1)(i) was inserted. According to which no income shall be deemed to accrue or arise to a non-resident from transfer, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, referred to in the ***Explanation 5***;

(i) If such company directly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer,

a. neither holds the right of management or control in relation to foreign company or entity;
b. nor the voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the foreign company or entity; or

(ii) If such company indirectly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer,

a. neither holds the right of management or control in relation to foreign company or entity;
b. nor holds any right in, or in relation to, such foreign company or entity which would entitle him to the right of management or control in the company or entity that directly owns the assets situated in India;
c. nor holds such percentage of voting power or share capital or interest in foreign company or entity which results in holding of (either individually or along with associated enterprises) a voting power or share capital or interest exceeding 5% of the total voting power or total share capital or total interest, as the case may be, of the company or entity that directly owns the assets situated in India.

However in case where all the assets owned, directly or indirectly, by a company or an entity referred to in Explanation 5, and not located in India, the income of non-resident transferor, from transfer outside India of a share of, or interest in, such company or entity, deemed to accrue or arise in India under this clause, shall be only such part of the income as is reasonably attributable to assets located in India and determined in such manner as may be prescribed.

QUESTIONS	
1.	P Ltd. was set up in Netherlands. It bought a stake of 10% in an Indian Company. Now, P Ltd wishes to sell off its stake in Indian Company. It disposes its holding in two tranches- 4% in first tranche and balance 6% in another tranche in the next financial year. Determine the taxability of P Ltd.
2.	What is redemption of securities? What are the types of redemption?
3.	What is exit taxation? What are the provisions of exit taxation in United States?
4.	Define ‘Associated Enterprise’ and ‘Fees for Technical Services’.

Test Your Knowledge

SOLUTIONS	
1.	Gains from the alienation of shares issued by a company resident in the other State which shares form part of at least a 10 per cent interest in the capital stock of that company, may be taxed in that other State if the alienation takes place to a resident of the other State. Shares sold in the first as well as the second tranche individually constitute less than 10% interest in the capital of Indian Company. Purpose of Article seems to grant taxation rights to the source country, whenever there is alienation of substantial shareholding (irrespective of when the shares are sold). Alternate view of tax office: Capital gains taxable in India even if sale < 10% but cumulatively exceeds 10% across different years. If the buyer is non-resident, it would not be taxable in India.
2.	The term redemption has different uses in the finance and business world. In finance, redemption refers to the repayment of any fixed-income security at or before the asset's maturity date. Bonds are the most common type of fixed-income security, but others include certificates of deposit (CDs), Treasury notes (T-notes), and preferred shares. People who invest in fixed-income securities, such as bonds, receive fixed interest payments at regular intervals. Bonds can be redeemed before or on their maturity date. If such securities are redeemed at the time of maturity, an investor receives the par value (also called the face value) of the bond. This refers to the original value of the bond when it was first issued and is the amount of money the issuer of the bond agrees to repay the bondholder. The redemption of an investment may generate a capital gain or loss, both of which are recognized on fixed-income investments and mutual fund shares. Taxation of capital gains is reduced by capital losses recognized in the same year. Mutual fund gains and losses are included in the same capital gain calculation. Most redemption is made for cash. So when a mutual fund investor requests redemption, the fund management company will issue the investor a cheque for the shares at market value. But there are cases where redemptions may be made in-kind. **In-kind Redemptions** In-kind redemptions are non-monetary payments made for securities or other instruments. Rarely used in the mutual fund industry, in-kind redemptions are common with exchange traded funds (ETFs). Fund managers may feel redemptions hurt long-term investors. Therefore, instead of paying out cash to those who wish to exit a fund, they offer positions in other securities on a pro-rata basis. ETFs are generally considered more tax-friendly than mutual funds. By issuing shares in-kind, the ETF does not have to sell securities to raise cash for redemption payouts. This, in turn, eliminates the need for capital gains distributions, cutting down the investor's tax liability. **Mutual Fund Redemptions** The redemption of fund shares from a mutual fund company must occur within seven days of receiving a request for redemption from the investor. Because mutual funds are priced only once per day, investors who wish to redeem their money must place the

	order before the market's close or the time set by the mutual fund. Money is redeemed at the fund's net asset value (NAV) for the day, which is calculated as the sum of the value of the assets of a fund less than its liabilities. Once the sale is completed, clients typically receive their funds including any gains via check or direct deposit to their bank account. Some mutual funds may have redemption fees attached in the form of a back-end load. A back-end load is a sales charge—a percentage of the fund's value that declines over time. If the investor holds the fund shares for a longer amount of time, the back-end load charged when the shares are redeemed is smaller. Investments in mutual funds are designed for individuals who buy and hold fund shares for the long term and selling fund shares after a short period of time results in higher costs to the investor. The investor pays sales charges and annual fees for professional portfolio management and the fund's accounting and legal costs.
3.	Tax aspects can highly influence a person’s decision to migrate, especially when a State decides to tax unrealized capital gains. Typically, capital gains are taxed on realization, that is, when the asset is effectively alienated. While this holds true to any change of residence in a domestic situation, where the taxpayer remains under the tax jurisdiction of the State, the same cannot be said on a cross-border migration. Whenever the latter happens, States seek to reduce the risk of losing tax revenue they would be entitled to if the taxpayer had not moved by applying a so-called exit tax, which in essence is a tax on unrealized capital gains. **Exit Tax in United States** The Exit tax occurs from U.S. persons at the time of expatriation from the United States. If a person is a U.S. Citizen or Long-Term Resident covered expatriate, the exit tax calculations kick-in. At that time, the covered expatriate will evaluate their potential tax liability had they sold all of their assets on the day before expatriation. Most of the calculations are handled on a Mart-to-Market basis, with some exceptions, such as deemed distributions. Depending on what the total gain is, if the gain exceeds the exemption amount (currently \$725,000), the expatriate may have to pay a U.S. Exit Tax, or apply for a bond (which can be very expensive). If a person is a covered expatriate (which includes U.S. citizens and certain Legal Permanent Residents), then they have to file a Form 8854 at the time of expatriation. In order to determine if there is an exit tax: ***a)*** The covered expatriate must determine their basis in each asset ***b)*** Then they must determine the FMV on the day before expatriation ***c)*** Each asset is then calculated as if it was sole on the day before expatriation (aka deemed sale) ***d)*** Up to \$725,000 of the deemed gain is excluded. The year in which a person or an enterprise expatriates is liable to exit tax in that financial year. Income tax shall be calculated on the net unrealized gain on property as if the property had been sold for its fair market value (FMV) on the day before the

	expatriation date ("mark-to-market tax"). This applies to most types of property interests held on the date of expatriation. Gains from deemed sales are taken into account without regard to other U.S. internal revenue laws. Losses from deemed sales are taken into account to the extent otherwise allowed under U.S. internal revenue laws. However, section 1091 (relating to the disallowance of losses on wash sales of stock and securities) doesn't apply. The mark-to-market tax does not apply to the following: ***a)*** Eligible deferred compensation items. ***b)*** Ineligible deferred compensation items. ***c)*** Specified tax deferred accounts. ***d)*** Interests in non-grantor trust. Instead, item (a) is subject to withholding at source provided that an irrevocable waiver is made on initial filing of this form of any right to claim any reduction in withholding under an applicable treaty between the United States and a foreign country and timely notify the payer on Form W-8CE. To timely notify the payer on Form W-8CE one must file the Form W-8CE with the payer on the earlier of: ***a)*** The day prior to the first distribution on or after the expatriation date, or ***b)*** 30 days after the expatriation date. Item (d) is also subject to withholding at source, and is treated as having waived any right to claim any reduction in withholding under an applicable treaty between the United States and a foreign country, unless one elects to be treated as having received the value of entire interest in the trust by obtaining a ruling from the IRS to that effect. In the case of item (b), a person or an enterprise is treated as receiving the present value of the accrued benefit as of the day before the expatriation date and they should include this amount on the Form 1040 or 1040-SR for the year that includes the expatriation date. In the case of item (c), a person or an enterprise is treated as receiving a distribution of its entire interest in the account on the day before its expatriation date and should include this amount in Form 1040 or 1040-SR for the year that includes the expatriation date.
4.	**"Associated enterprise",** in relation to another enterprise, means an enterprise: • that participates, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise; or • in respect of which one or more persons who participate, directly or indirectly, or through one or more intermediaries, in its management or control or capital, are the same persons who participate, directly or indirectly, or through one or more intermediaries, in the management or control or capital of the other enterprise. **Fees for Technical Services [Section 9(1)(vii)]**

	Any fees for technical services will be deemed to accrue or arise in India if they are payable by - ***(i)*** the Government. ***(ii)*** a person who is resident in India except where the fees is payable in respect of technical services utilised in a business or profession carried on by such person outside India or for the purpose of making or earning any income from any source outside India. ***(iii)*** a person who is a non-resident, only where the fees are payable in respect of services utilised in a business or profession carried on by the non-resident in India or where such services are utilised for the purpose of making or earning any income from any source in India. **Fees for technical services** mean any consideration (including any lumpsum consideration) for the rendering of any managerial, technical or consultancy services (including providing the services of technical or other personnel). However, it does not include consideration for any construction, assembly, mining or like project undertaken by the recipient or consideration which would be income of the recipient chargeable under the head 'Salaries'.