Capital Gains [Article 13] and some related issues

Chapter 45

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Preface

Capital Gain is usually distinguished from other kinds of income. Income earned by dealing "in" assets or property is business income. Income earned on sale of assets "with" which business is done, is "Capital Gain". This is a basic difference. There are of course other differences also.

In this chapter, Capital Gains article as per the Double Tax Avoidance Agreements (DTA) is discussed. Some issues under the Indian Income-tax Act are also dealt with. There are **differences in the meaning** of Capital Gain as per Income-tax Act (ITA) and DTA. Due to differences, there can be many issues. Needless to say, even if gain is taxable under a DTA, it needs to be taxable under the ITA. Only then tax is payable. Taxability under the ITA requires an independent examination. Some issues have been discussed in this chapter. The main thrust of the chapter is Capital Gain as per the UN Model 2011. Additionally OECD model, some DTAs and Income-tax Act have also been discussed.

The domestic law provisions have been discussed in other chapters. Hence in this chapter I have only touched upon some issues under the domestic law. General Anti-Avoidance Rules (GAAR) are not considered. Provisions relating to indirect transfers are also not considered as these have been dealt with in another chapter.

In explaining the provisions, I have considered a **resident of UK, selling assets situated in India**. This example has been kept constant almost throughout.

Abbreviations used in this article:

CG - Capital Gain

COR - Country of Residence

COS - Country of Source

DTA - Double Tax Avoidance Agreement

FB - Fixed Base

ITA - Income Tax Act, 1961 (of India)

OECD - Organisation for Economic Co-operation & Development

PE - Permanent Establishment

UN - United Nations

1. Meaning of the Capital Gains as per DTA

1.1 This is a fundamental issue. The term "Capital Gains" has not been defined under the OECD or the UN model. It will be interesting to note that the term "Capital Gains" has not been used anywhere in the DTA – except in the title of Article 13. The article only uses the word "Gains". The commentary on Capital Gains article uses the phrase "Capital Gains".

1.2 There are several terms which have not been defined in the DTA as these are commonly understood in various countries. The definitions article (Article 3(2) in the models) states that in such cases, the meaning given in the domestic law will apply. Therefore if capital gains are earned in India, the meaning given in Indian Income Tax Act (ITA) will apply.

1.3 Under the ITA also, "capital gain" has not been defined. However, "Gain from transfer of a Capital Asset" is considered as Capital Gain. These are classified as Long Term Capital Gain or Short Term Capital Gain. The important definitions used in ITA are – "Capital Asset", "Transfer", "Long Term Capital Gain", "Short Term Capital Gain", "Long Term Capital Asset", and "Short Term Capital Asset".

1.4 The two main terms are "Transfer" and "Capital Asset". Both these terms are not defined in the DTA. Instead the DTA uses the term "Alienation" for transfer. Whereas for "Capital Asset", there is no corresponding term in the DTA. The DTA refers to "Alienation of …. *different types of assets*". It includes assets which may not be "capital assets" as understood in the ITA.

1.5 By and large, the broad meaning is the same under the Income-tax Act and a DTA. However, there are important differences in the provisions as per DTA & Income-tax Act. Some of these have been dealt with in the relevant paragraphs below.

2. Basic provisions of Capital Gains article

Capital Gain is discussed in Article 13 of the OECD & UN models. The models provide that gains from alienation of assets are taxable in the Country of Residence (COR) – i.e. where the seller is a resident. For some assets, Country of Source (COS) is also given the right to tax – i.e., where the asset is situated (situs of asset). Generally, **the country which has the right to tax the income from the asset, is given corresponding rights to tax Gains** from the sale of such assets. The details are discussed below in the relevant paragraphs.

In very few DTAs (e.g., India-UK & India-USA), it is provided that each country can tax capital gains according to its own domestic law.

If the DTA permits India to tax the capital gains, India can tax it as per its domestic law. The **computation**, disallowance, exemption, rate of tax, etc., apply as per **domestic law**. India may tax the gain as capital gain or any other income.

As per the basic principle of International taxation, a Country of Residence always has the right to tax. The Country of source may be given full / partial / or no rights to tax. There are however few old DTAs where the right to tax Capital gain is only with the Country of source – e.g. Bangladesh, Greece and Egypt.

It will be interesting to keep in mind the following for saving tax on capital gain. For saving tax on capital gain in India, there are provisions available to save the tax by investing in house property or some bonds (e.g. sections 54, 54EC, 54F). These provisions help to save tax in India. However a non-resident could be liable to tax in his home country also. By investing in the specified properties or bonds, he may not get any relief under his country's law. Therefore if he invests the funds in India for saving tax, he may end up paying tax in his country. It may be better to pay up the tax in India, and claim a credit for tax paid in his country.

3. Criteria for taxation of Capital Gains

The taxation of Capital Gains is based on the kind of asset sold. The details are discussed with reference to the UN model.

3.1 Immovable property: [Article 13(1)]

3.1.1 **Basic rule** - Capital Gain earned by a resident (of UK), on sale of immovable property (situated in India), can be taxed in India. UK can also tax the Capital Gain.

3.1.2 The term "immovable property" means property as explained in article 6. Apart from immovable property as generally understood in Income-tax Act, article 6 also considers several kinds of other assets as immovable property. It includes:

- 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.

More details would be explained in the chapter relating to immovable property. As can be seen, several other rights and assets associated with immovable property, agricultural property and even rights of mining, are considered as immovable property.

3.1.3 The immovable property article clarifies that ships, boats and aircraft shall NOT be regarded as immovable property.

3.1.4 If shares of co-operative society or a company are sold, which give rights of occupation of property; then such sale of shares, will be considered as sale of immovable property.

3.1.5 It is immaterial whether property is residential or commercial. It is also immaterial whether immovable property is a capital asset, or stock-in-trade. The COS can levy tax. Whether it will treat the income as Capital Gains or business income or other income, depends on domestic law. In India for capital assets, it is capital gain; for stock-in-trade, it is business income.

3.1.6 Under section 2(47)(v), allowing the possession of the property to be taken for part performance of the contract, is considered as transfer. Therefore there can be a Capital Gain, if the tax payer gives possession of the property in part performance of the contract.

Can such a transfer be considered as Alienation of asset?

As explained in paragraph 4 below, alienation includes partial alienation. Further the meaning of any term has to be applied as per the Domestic law, if it is not defined in the DTA.

Therefore in my view even such transfer will be considered as transfer under the article on Capital Gain.

3.2 Movable property of a Permanent Establishment or a Fixed Base: [Article 13(2)]

3.2.1 **Basic rule** - Capital Gains earned by a resident (of UK), arising from sale of movable property, **which is a part of the business property** of UK resident's **permanent establishment (PE) or a fixed base (FB) in India**, can be taxed in India. It can be also taxed in UK.

The property would usually be equipments, computers, furniture and other assets used in the business.

This article does not apply to **stock-in-trade**. For stock-in-trade, article 7 (business profits) applies. If there is a PE in India, & the assets sold are stock-in-trade then gains can be taxed in India. If there is no PE in India, then sale of stock-in-trade cannot be taxed in India.

The article further states that gains from the sale of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, can also be taxed in India.

Thus the article applies to all business movable properties which form a part of PE or FB.

3.2.2 This clause also applies to gain from **sale of PE or FB itself**. If the PE or FB is in India, & belonging to a UK resident is sold, gains can be taxed in India. (Thus gain on slump sale of undertaking, or sale of a branch of a foreign bank situated in India can be taxed in India.)

3.2.3 Under article 5(4), if a PE is used for **preparatory & auxiliary activities,** or other specified activities like purchase, storage, etc., then it is not considered as a PE. Consequently the commentary clarifies that gain on sale of movable property forming part of such a PE, will also NOT be liable to tax in source country.

3.2.4 It must be noted that this clause applies if the property which is sold, forms a part of permanent establishment or a fixed base. If the movable property does not form part of PE or FB, then the residuary clause–13(6) – will apply (provided that other clauses of article 13 also do not apply).

Example

The UK resident has a PE in India for sale of electronic items. He also has a machine which is leased out to an Indian resident, but does not form a part of any PE. In this situation, this clause does not apply to sale of machine. Sale of such a machine will be governed by article 13(6). In most of the cases, the COS would not be able to tax the gain. See paragraph 3.6.

3.3 Ships and Aircrafts: [Article 13(3)]

3.3.1 **Basic rule** - If a resident (of UK) earns Capital Gains from sale of :

- **ships or aircraft** operated in international traffic,
- boats engaged in inland waterways transport, or
- movable property pertaining to the operation of such ships, aircraft or boats;

the same can be taxed ONLY in the Contracting State in which the **place of effective management** of the enterprise is situated (i.e., UK in our example). India CANNOT tax the Capital Gain. This is in line with the taxation of income earned from operating ships and aircrafts in international traffic which are taxed only where effective management is situated.

Only one country is given rights to tax. In some DTAs, it is only the country of residence which can tax the income. E.g. India-Singapore DTA.

3.3.2 Under article 8(3) (Shipping income), it is stated that if the place of effective management is on the ship itself, the place of effective management is deemed to be where the ship's home harbour is situated. If there is no home harbour, then place of effective management will be in the country where the operator of the ship is resident. These situations equally apply for Capital Gains article also, as per the model commentary.

3.3.3 As article 13(3) is a **special article**, it takes precedence over article 13(2). Any **movable property relating to operation of ships & aircrafts** in international traffic, can be taxed only where the place of effective management is situated. It is immaterial whether there is a PE or not; or whether the asset is a part of the PE or not.

3.3.4 However **immovable property pertaining to operation of ships or aircrafts** (e.g. office premises in source country), can be taxed under article 13(1) in source country.

3.4 Shares, interest in a partnership, trust or estate – the property of which consists principally of immovable property: [Article 13(4)]

3.4.1 **Basic rule -** If a resident (of UK) earns gains from sale of:

– **shares** of the capital stock of a company, or

– an interest in a partnership, trust or estate;

and the property of such a company, partnership, trust or estate consists, directly or indirectly, **principally of immovable property** situated in source country (India), India can tax the gains. UK can also tax the gains.

It is not necessary that company, partnership, trust or estate should be in India. What is relevant is the situation of property. If the property is in India, and it is owned by an Indian entity or a foreign entity, on sale of shares or interest in the entity, India can tax the income.

India does not tax such gains as there is no such system in India. However with effect from A.Y. 2013-14, if immovable property is held through a foreign company, and the value of the share is substantially derived from the value of immovable property, then the shares will be deemed to be located in India. [Explanation 5 to section 9(1)(i)]. Tax will be levied according to the tax payable on sale of shares.

3.4.2 If however, the immovable property owned by such company, trust, partnership or estate, is used for its own business, then this article does not apply. Other clauses will apply. (Exception to paragraph 3.4.1).

If however the company, partnership, trust or estate is in the business of management of immovable property, then this article applies. (i.e., what is stated in paragraph 3.4.1 applies).

Example

Situation 1 : UK resident has invested in A1 India Property Pvt. Ltd. A1 has a flat in a posh locality in Mumbai. That is the only major asset.	On sale of shares of A1, Capital gains can be taxed in India and UK.
Situation 2 : In the above example, the immovable property is used for A1's own business.	On sale of shares of A1, Capital gains will be taxed according to other clauses.
Situation 3 : A1 is in the business of management of immovable property.	On sale of shares of A1, Capital gains can be taxed in India and UK.

3.4.3 The meaning of the term "principally" has been explained to mean that if value of immovable property owned by the company, partnership, trust or estate exceeds fifty percent of the aggregate value of all assets, then it is considered as "principally" consisting of immovable property.

When should the value of the assets be seen? – on the date of sale of shares, or on the last date when the accounts have been audited, or on the date of purchase of property, or some other date?

What happens if the company has incurred losses, with the result that the only value it has is the immovable property? Should it still be considered as a company whose assets principally comprise as consisting of immovable property?

Consider the following balance sheet of the company:

Liabilities	₹	Assets	₹
Share capital	10,000	Land	3,000
Less: Losses	6,000	Machinery	4,000
Net worth	4,000		
Loans	6,000	Debtors and bank	3,000
Total	10,000	Total	10,000

Should gross value be considered where the value of land is less than 50% of the total assets; or should the loss be set off against machinery and other assets and then the value of land be considered (then land value will be more than 50%)?

The DTA does not provide the answer. The OECD model however states in para 28.4 that the value will be determined considering the value of all assets, without considering debts or other liabilities. Even if the debt is secured by mortgage on the relevant immovable property, it should be ignored.

3.4.4 This clause is not there in some of the DTAs entered into by India. Therefore if shares of a company having immovable property as principal asset are sold, the COS cannot levy any tax under this clause.

3.4.5 This clause cannot be used in case of companies which operate like housing or commercial office **co-operative societies**. In such cases, under the ITA itself, the asset is considered as immovable property and not shares. It is the law of the country applying the DTA which is relevant. See paragraph 1 for discussion on this subject.

Even under the DTA, such holding is considered as immovable property.

3.4.6 It should be noted that the **extent of holding in the company** is not relevant. What is relevant is the value of immovable property in the company. The person may hold all shares of the company or only a few. Still the same are taxable in country of source.

3.4.7 There can be a situation where the person who sells the shares is taxed in the COS as the value of property is more than 50% of the value of the company's assets. Subsequently, the company itself sells the property. This will result in a situation, where there will be double tax. The first time the seller of shares pays the tax. The second time, the company itself pays the tax. The purpose of taxing the shares is that in substance, property is being sold. If that is the case, then when actually the property is sold, there should be a set off available of the amount already taxed. Without such a provision, there will be difficulties.

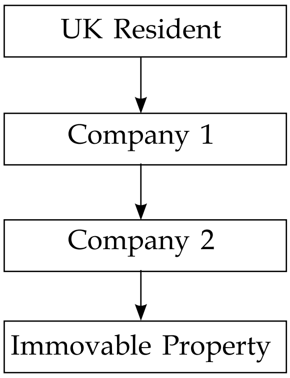
3.4.8 Consider a situation where more than 50% of the value of the Indian company is due to the immovable property. If shares of such a company are sold, the **entire value of the sale** will be taxable in India and not just the value attributable to immovable property.

Further, assume that the company whose shares are to be sold is situated in a country outside India, and the value of that company is mainly due to immovable property in India. The **other assets** of such a foreign company are **situated outside India**. In such a case also, the entire capital gain (value of which is partly attributable to assets outside India), will be taxed in India. Even the language of section 9(1)(i), Explanation 5 supports such a proposition.

Let us make the situation more complex. The company (Indian or foreign) has immovable property in India and the value is more than 50% of its total assets. It owns a ship outside India which is effectively managed from outside India. If the shares of such a company are sold, will India be able to tax the entire sale consideration? In this case, value of the ship is not taxable under article 13(3). However the ship is not being sold. It is the company's shares which are being sold. The article permits India to tax the substance – i.e., immovable property in India. But when it comes to the ship, then can one apply the substance and not tax the capital gain attributable to the ship?

Clearly to tax assets situated outside India is not the intention. However the language of the DTA, supported by the Indian income-tax act, leads to this situation.

3.4.9 Let us consider a situation where the immovable property in India is held through 2 **vertically held companies**. For example, the UK resident holds shares in Company 1. Company 1 holds share in Company 2. Company 2 holds immovable property.



If the UK resident sells shares of Company 1, will capital gain be taxable in India under article 13 (4)?

The language of article 13(4) of UN Model states that if the **"property of the company"** consists **directly or indirectly,** principally of immovable property, then India can tax the gain. Very strictly, immovable property belongs to Company 2 and not of Company 1. Can one say that indirectly the immovable property is of Company 1?

The article is on the line of **"Substance Over Form".** Hence to take a view that assets of Company 1 do not comprise principally of immovable property, will be incorrect. I am of the view that in the above situation, the immovable property is indirectly of Company 1. Hence gain on sale of shares of Company 1 will be taxable in India under this article.

OECD model uses a more specific language which is similar to that in the ITA. (See paragraph 3.6.3). The OECD model article 13(4) states that if more than **50% of the value** of the shares is derived directly or indirectly from immovable property in COS, then gains can be taxed in COS. Value of Company 1 is derived indirectly due to value of immovable property in India. Therefore India can tax the gain on sale of shares of Company 1.

3.5 Shares exceeding certain percentage of investee company: [Article 13(5)]

3.5.1 **Basic rule** - If a UK resident sells share of an Indian company, and the shares exceed a certain minimum percentage of investee's capital, then India can tax the gains. UK can also tax the gains.

The above clause is present in U.N. Model 2001 and most of the DTAs signed by India. U.N. Model 2011 has a slightly different clause. Please see paragraph 3.5.3 below.

This clause is not there in some of the DTAs entered into by India. Therefore if shares of a company are sold, the COS cannot levy any tax under this clause.

3.5.2 Example

A resident of The Netherlands owns shares equal to 20% of the Indian company's shares. The shareholding prescribed in the DTA with The Netherlands is say 10%.

If he sells shares equal to 5%, will the same be taxed in source country? The words used are "Gains .... representing a participation of 10% ....". Shares being sold, represent only 5% (less than 10%). Therefore can the source country tax the capital gains? The DTA or the commentary does not provide an answer. The purpose appears to be that if there is substantial holding, then source country gets the rights to tax, whenever the shares are sold.

If he sells shares equal to 15%, will the same be taxed in source country? The answer is yes.

After selling the 15% stake, if he sells the balance 5% share, will the same be taxed in source country? Technically the answer is no. In such a case, the parties can split the sales so that some portion of profit goes tax free. This is not the intention. A logical answer could be that if in one year, shares sold exceed the percentage prescribed, then the gains should be taxed in COS.

But what if the balance 5% shares are sold in next year, or after 10 years? The answer is not clear. One can take a cue from the articles on PE & business profits. If the PE is closed down, & income which can be attributable to the PE is received in subsequent years, the model commentaries are clear that income can be taxed in the source country. Here also, it is possible to say that, once the holding exceeds the prescribed limit, then whenever the shares are sold, source country can tax the same.

3.5.3 The UN model of 2011 states that if **"at any time during the 12 month period preceding such alienation**, if the alienator **directly or indirectly** held at least ____% of the shares", then the same will be taxable in India.

Thus the minimum percentage criteria has to be considered for 12 months before the alienation. Also, the shares can be held "directly or indirectly". The previous UN model did contain these tests of 12 months and direct and indirect holding.

3.6 Other property: [Article 13(6)]

3.6.1 **Basic rule** - If a UK resident sells any property other than those mentioned in paras 3.1 to 3.5, is taxable ONLY in UK. India CANNOT tax the same.

Thus all **movable property (not forming part of PE)**, cannot be taxed in source country. This is the residuary clause.

3.6.2 Example

If a non-resident owns know-how which is sold to an Indian resident, will it give rise to taxation in India?

Under the Income-tax Act, out right sale of know-how is not considered as royalty u/s. 9(1)(vi). Therefore its taxation is considered as business income or capital gain, depending on facts. More likely it may be sale of capital asset.

Under a DTA, if the asset sold does not fall in the previous articles 13(1) to 13(5), gain will be taxable only in the COR.

3.6.3 Finance Act 2012 has made several and significant amendments to the ITA as a fall out of the **Vodafone judgement** by the Supreme Court. The amendments deal with transfer of assets in India by transfer of shares outside India. (Such a transfer is loosely referred to as "**Indirect transfer**".) There is a separate chapter dealing with this subject. Hence I have only considered one issue vis-à-vis a DTA – more specifically article 13(6).

As discussed above, capital gain on sale of any asset not covered under Article 13(1) to 13(5), is taxable only in the country of residence.

Under Explanation 5 to section 9(1)(i) of the ITA, if there is any share in a company registered outside India, and value of that share is derived substantially from assets in India, then that share shall be deemed to be situated in India. (This is a simplified sentence.)

For example, if a UK company owns shares in a Mauritius company, and the value of Mauritian company is derived substantially from shares it holds in Indian company, then the shares of Mauritius company shall be deemed to be situated in India. Therefore if the UK company sells the shares of Mauritius company to say a French company, it will be considered as transfer of capital asset "**situate in India**".

However let us consider the situation under the DTA. We have to examine whether such a transfer falls within articles 13(1) to 13(5); or 13(6). It may be noted that the ITA (Explanation 5) only deems the asset to be "in India" (i.e., it changes the situs of the asset from "outside India", to in India".) It does not change the **"character"** of the asset, nor the character or status of the assessee, nor the character of income. The **asset continues to remain as "foreign company's share"**.

Under articles 13(1) to 13(5), the situation regarding the foreign company's share is under:

13(1) - It is not immovable property.

13(2) - It is not movable property of a PE.

13(3) - It is not property related to International traffic.

13(4) - It is not share whose value consists principally of immovable property in India.

13(5) - It is not share of an Indian company.

None of the above articles apply. Therefore only the residuary article – 13(6) applies. Under article 13(6), only country of residence can tax it.

Here however there is an issue of which DTA should be considered – India—Mauritius or India-UK. In the above example, the seller is a UK company. The country of residence is not Mauritius. It is UK as UK company is the seller. Therefore India–UK DTA should apply. It is a different matter that under India–UK DTA, India can tax gain on such indirect transfers. However, if UK had an article like article 13(6), then India would not be able to tax capital gain on indirect transfers.

The provisions under ITA are similar to article 13(4) where sale of shares can be taxed in COS, if the value is principally based on immovable property in India. But the principle in article 13(4) is not extended to other articles / assets.

3.6.4 It is this residuary clause under which gains derived by residents of Mauritius, Cyprus, Singapore are not taxed in India.

3.6.5 Some other assets which can fall under the residuary clause are units of a mutual fund, bullion, etc. Sale of these assets will not be taxable in India.

3.7 Hierarchy

One can draw a hierarchy of situations under which there can be different tax implications. The hierarchy can be considered as under:

i) Immovable property gain will be taxed where it is situated. COS and COR can tax the income.

ii) Shipping and aircraft gain is taxable where the a place of effective management is situated or where the owner is a resident. Only one country - where effective management or where the owner is a resident – will tax the gain.

iii) If assets are of a PE, the gain on such assets will be taxed in the country where the PE is situated. COS and COR can tax the income.

iv) Gain on Shares having principal value due to immovable property is taxable in the country of source. COS and COR can tax the income.

v) Gain on Shares exceeding a specified percentage of the investee company is taxable in the country of source. COS and COR can tax the income.

vi) Gain on any other asset is taxable in the country of residence. Only one country - where the owner is a resident – will tax the gain.

The chart giving the hierarchy is given in the Annexure.

4. Meaning of "transfer" / "alienation" as per the DTA

The DTA uses the term "alienation". It does not use the term "transfer". The term "alienation" has not been defined.

However the UN & OECD commentaries state that alienation includes several kinds of transactions. It includes sale or exchange of property including a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.

Thus apart from the normal transfers, it includes gifts and inheritance also. (Some countries have gift tax on capital gains or deemed capital gains; some countries have inheritance tax which is called capital gains tax.)

Prof. Klaus Vogel's commentary states that if it results into a tax liability for the transferor (or estate in case of inheritance), it is covered in this article. If the transfer due to gift, or inheritance, results in the tax liability for the transferee, can it be covered in this article? The DTA does not provide an answer.

The commentaries refer to annuities received on account of transfer of assets. Should the amount received in excess of the initial amount paid, be capital gain, or income from other sources? The commentaries state that both views are possible. It therefore leaves the countries to provide for the same in the DTAs if they consider it necessary. Without the specific provision in the DTA, the domestic law will prevail.

In India, annuities are considered as income from the moment the first annuity is received. If some countries treat the annuities differently, there can be difficulties.

5. Distinction between Long Term Capital Gain and Short Term Capital Gain as per the DTA

There is no distinction between Long Term Capital Gain and Short Term Capital Gain as per the DTA. Any kind of capital gain is covered by this article.

6. Distinction between Capital Gain and Speculation Gain

There is no distinction between Capital Gain and Speculation Gain. The only difference is that if it is business income, it is taxable under article 7, and if it is sale of asset not forming part of the business of the person, it is taxable under article 13. Speculation gain will be considered as business income.

7. Appreciation of an asset

7.1 Normally an appreciation of an asset is not taxable as capital gain. However, some countries tax the appreciation, as if there is a transfer. For example, Australia, Canada and now USA have an exit tax. If residents of these countries emigrate out of these countries, then it is deemed that assets are sold at market price on the date of emigration. Capital Gains tax is chargeable.

The commentaries state that tax on capital appreciation is covered in the DTA (article 2). Thus appreciation of asset is also covered in this article.

In case a US resident emigrates to India, then tax paid at the time of emigration, will be payable in USA.

7.2 Now assume that after a few years, when the person is an Indian resident & he sells the capital assets situated in USA, the same will be taxed in India. Assume further that as per the DTA, only India can tax the gain. Will he get credit for tax paid in USA at the time of emigration? The DTA does not have a specific answer. However if appreciation can be taxed, logically tax credit should also be available.

There can be further practical difficulties. For example, the sale could take place after several years. Will the credit for tax paid in US be given? This is however a subject of foreign tax credit. Therefore it has not been discussed further here.

7.3 It should be noted that on emigration a "deemed sale" is considered. However, in India the cost of the asset will be considered as the original cost, and not the deemed sale value.

For example, the cost of US shares is ₹ 1,00,000. On emigration, the value is ₹ 1,50,000. The person will be liable to tax in US on ₹ 50,000.

Assume that after 3 years the asset is sold for ₹ 2,50,000, the gain in India will be ₹ 1,50,000. (2,50,000 – 1,00,000).

Conversely if the asset is sold for ₹ 75,000, there will be a loss of ₹ 25,000 in India. The person will not get credit for tax paid in the US on ₹ 50,000 at the time of emigration.

7.4 At present the number of people returning to India is few. Hence at present the problem is not a major one. However if more people start returning, there may be a practical difficulties for many.

8. Conversion of "capital asset" into "stock-in-trade"

Normally conversion of capital asset into stock-in-trade is not considered as capital gain. Under Income-tax Act, under section 45(2), such conversion is deemed to be capital gains.

However it may be important to bear in mind that what is covered by the DTA is the taxing rights of capital gains. The manner of taxation is left to the domestic law. Further, as discussed in paragraph 7, appreciation can be considered as capital gains. Therefore if a non-resident has capital assets in India which are converted into stock-in-trade, there can be taxable gains in India.

The appreciation on conversion is taxed only when the asset is sold. The subsequent appreciation (between conversion date and sale of stock in trade), will be considered as business income. This income can be taxed if there is a PE in India.

9. Source Rules / Situs rules

As in case of other incomes, there are **no specific source / situs** rules for incomes / assets provided in this article. The article only states what kind of capital gains can be taxed in the source country and the residence country. Therefore source rules / situs rules have to be considered as per domestic law.

It may be interesting to know that in case of US residents, the source of capital gain for shares is US even if the shares are held outside US. The situs of shares is not relevant. If US residents sell any shares in India, it is not considered as Indian sourced income. Capital gain article as per India-US DTA gives rights to both India & US. However tax credit is given by US as per its own domestic rules. As US considers shares sold by US residents as US source income, no credit is given for Indian taxes. This amounts to double tax. Therefore US residents prefer to invest from a country which has a favourable capital gains article in the DTA with India (e.g., Mauritius and Singapore).

There have been some court decisions on the subject of situs. These have been dealt with in paragraph 12.

10. Other kinds of capital gains typical to Indian ITA

There could be some typical cases under the Indian ITA which can be considered. As there are no precedents with reference to the DTA, these issues are debatable. Therefore, I have only raised the issues, rather than giving a view.

i) Under section 45(1A), if any amount is received from an insurer on account of **damage to the capital asset** as a result of flood, typhoon, etc. it will give rise to capital gain.

Whether such destruction will be considered as alienation? Although the meaning as per the DTA is very wide, still a "destruction" cannot be considered as alienation. Alienation means giving away.

On the other hand, capital gain is not defined. E.g. exit tax & gift tax on capital gain can be considered for the purpose of DTA. In case of exit taxes, there is neither a transfer, nor destruction, nor any change to the asset. Still it can be considered as alienation for this article.

ii) Under section 45(3), **capital asset introduced by a partner in a firm,** or a member in an AOP, will be considered as capital gain. On this, there should be no difficulty that it will be covered under article 13. The taxability will depend on the clause which applies. E.g., if an NRI transfers his bullion lying in India, in the Indian firm, and he does not have a PE in India, then under article 13(6), there can be no capital gains taxable in India.

iii) Under section 50C, **value** of the immovable property has to be considered as per the **stamp duty** authority (subject to conditions). This is a valuation issue. The value as per section 50C can be considered. The manner of taxation is left to the respective countries. In my view, a DTA cannot prevent application of section 50C.

iv) Under Section 50D, if the consideration for transfer cannot be determined, fair market value of the asset shall be considered as the consideration. This is also permitted under a DTA.

v) **Personal effect** is not considered as a capital asset under the ITA. Under a DTA, there is no concept of "personal effect". The taxability depends on the domestic law. With effect from AY 2008-09, following assets have been specifically excluded from the meaning of personal effects - archaeological collections, drawings, paintings, sculptures and any work of art, i.e., these assets will be considered as "capital asset". On sale there can be a taxable capital gain.

vi) Under section 2(42)(v), if a person gives possession of immovable property in **part performance of a contract**, then it is considered as a transfer. Capital gain is taxed under ITA. Even under a DTA, it will be taxed in India.

11. Some specific rules in Indian DTAs

11.1 Situation where there is no article for Capital Gains in a DTA

The DTA which India has signed with Malaysia in 2001 (notified in 2004) does not contain any article on Capital Gain.

In such a case, we have to consider article 21 (other income). As per other income article, ONLY COR has the right to tax. COS does not have the right to tax. But some Indian DTAs – specially the new ones (including the India-Malaysia DTA of 2001), provide that if the income arises in COS, then income can be taxed in COS. Whether income is considered to arise in COS, depends on domestic law of the COS. For example, if the asset is situated in India, India will be able to tax such gain.

11.2 Situations where other income article is also not there

There is only one such DTA with India (with Libya). There is no capital gains article & other income article. In such a case, each country can tax the Capital Gain as per its own law, as there is no restriction provided in the DTA.

11.3 Netherlands DTA

Several multinational companies have their holding companies in Netherlands. The Dutch company is normally a holding company for holding shares and funds for the group. The DTA with India and Netherlands has specific clauses in the Capital Gains article. Article 13(5) provides for taxation of sale of shares. Assume that a Dutch resident sells shares of an Indian company. Following are the implications:

Gains from shares (other than that referred to in other clauses of article 13), are taxable only in Netherlands.

However, if the Dutch company holds at least 10% of the capital of the Indian company, the gains may be taxed in India, if the sale takes place to a **resident of India**. If the sale takes place to any person who is not a resident of India, then the gain is taxable only in Netherlands. This interpretation has been confirmed in the Advance Ruling of VNU International BV (AAR 871 of 2010).

However gain will be taxable only in the Netherlands if such gains are realised in the course of a corporate organisation, reorganisation, amalgamation, division or similar transaction; and the **buyer or the seller** owns at least 10 per cent of the capital of the other. This is confirmed by Advance Ruling in the case of Venenberg Group BV (159 Taxmann 219).

Similar provisions apply in case of Indian resident holding shares in a Dutch company.

Netherlands has a participation exemption relief. If the Dutch company holds at least 5% of the shares of the Indian operating company, then the gains are not taxable in Netherlands. Thus the gains are not taxed at all.

11.4 Switzerland DTA

Under the DTA with Switzerland, normally a Swiss resident who earns gains from sale of shares of Indian company, is not taxable in India. However the gains are taxable in India, if the holding in the Indian company exceeds 10%, or the sale is to another Indian resident.

However in case an Indian resident holds shares in a Swiss company, the gains are taxable only in India. Switzerland does not get the right to tax even if the Indian resident holds shares exceeding 10% of the Swiss company.

In lieu of this right to tax by India, the tax credit has to be given by India for tax paid in Switzerland by the Swiss resident. [Article 21(1)(b)]. This is a peculiar feature of this DTA where the Country of source is required to give a tax credit. Normally it is the country of residence which gives the right to tax.

11.5 Singapore DTA

Singapore DTA has favourable clause for gain on sale of shares. If a resident of Singapore sells shares of an Indian company, the gain is not taxable in India. This benefit was brought about by Article 1 of the Protocol signed between India and Singapore on 29th June 2005. It is with effect from 1st August 2005. I understand that it was brought about at the request of Singapore Government as Mauritius DTA has a similar benefit. Article 1 of the Protocol applies to all assets not covered by Article 13(1) to 13(3) of the main DTA.

There is however a Limitation of Benefits Clause (LOB) which was also brought about with effect from 1st August 2005 (Article 3 of the Protocol). The LOB is very limited in application as it applies only to Article 1 of the Protocol (i.e., sale of other assets (which include shares) not covered in article 13(1) to 13(3) of the main DTA - including shares).

The LOB clause provides for two tests which are discussed below:

The benefit of exemption of tax in India of Capital Gain will not be available if the **affairs of the Singapore resident** are *"arranged with the primary purpose to take advantage of the benefits in Article 1 of this Protocol."* (clause 3(1)). Thus this article considers the "affairs" of the person. "Affairs" has not been defined. Generally it can be considered as transactions and arrangements of the person. Thus if a UK resident forms a company in Singapore with the purpose of taking advantage of capital gain exemption, the benefit will be denied.

Clause (2) of Article 2 of the Protocol provides that a **shell/ conduit company** which claims to be a resident of Singapore, will not be entitled to the benefits of Capital Gain relief. It may be noted that this is an independent test, not related to the first test of "Affairs".

A shell/conduit company (shell company) is any legal entity *"with **negligible or nil business operations** or with **no real and continuous business activities** carried out in that Contracting State."* This test applies to any legal entity and not just a company.

There are tests for determining whether a company is a shell company or not. These are given in clauses (3) and (4) of Article 3 of the Protocol.

Clause (3) provides for a positive test. The entity will be a shell company if its total **annual expenditure** on **operations in Singapore** is less than S$200,000 **in Singapore**. (The test for an Indian company is ₹ 50 lakhs for operations in India.) Thus if the company is to be considered as a *bona fide* company for this clause, it must spend at least S$ 2,00,000 per year on its **operations in Singapore**.

What is the meaning of operations in Singapore has not been explained. One has to consider a normal meaning. If the company spends on office rent, salaries and other costs in Singapore, it will be clearly expenses for Singapore operations.

The expenditure has to be incurred over a period of 2 blocks of 12 months immediately preceding the month in which the Capital gain arises. Thus the period is not a financial year, but a block of 12 months **"immediately preceding"** the **"date"** of Capital gains. For example, if the Capital gain is earned on 15^{th} October 2012, the block of 12 months has to be considered as 15^{th} October 2010 till 14^{th} October, 2011, and 15^{th} October 2011 till 14^{th} October 2012. In each block, a minimum of S$ 2,00,000 should be spent. One cannot take a total for both blocks, incur at least S$ 4,00,000 of expenses, and claim that the entity is not a shell company.

It is debatable if new companies which have not completed at least two years of operations, will be eligible for relief.

The above are technical arguments. Can one argue that the purpose is that if the entity has spent S$ 2,00,000 in two of its preceding financial years, relief should be available? Based on the language, it would not be possible to make such a claim.

Clause (4) provides for a negative test. The entity will **not be** a shell company if:

- it is listed on a recognised stock exchange, and
- the total annual expenditure on the operations is at least $ 2,00,000 in the immediately preceding 24 months.

It will get the benefit of the DTA if these tests are satisfied.

It is a general understanding that if the Singapore company incurs expenditure of S$ 2,00,000 on operations in Singapore, then the DTA should apply. However is that sufficient?

As discussed earlier, clause (1) provides for the test based on affairs of the person. The explanation at the end of Article 3 of the Protocol provides that the case of entities not having *bona fide* business shall be covered by Article 3.1. Thus the company may not be a shell company if it satisfies the tests laid down in clauses (2) to (4) of Article 1. Still it could be considered as a company whose affairs are arranged to take advantage of the capital gain tax relief.

One may argue that is it necessary to split the LOB tests minutely? The interpretation of the DTA should be broader and not technical. Well that is for the courts to decide.

11.6 UAE DTA

The India UAE DTA had a beneficial clause for taxation of shares. If the UAE resident earned capital gain on sale of shares, it was not taxable in India. However in March 2007, the DTA has been amended by a protocol. As per the protocol, capital gain earned on sale of shares will be taxable in India.

12. Some Typical Issues

12.1 Indirect transfers

The Finance Act 2012 has enacted provisions for indirect transfers. This is a fall out of the Supreme Court judgment in the case of Vodafone. There is a separate chapter on this. Hence here I have only discussed very briefly.

12.1.1 Briefly, the facts of the case are that Hutch Hongkong had sold 1 share of a Cayman Island company to Vodafone Netherlands.

Due to the transfer, Hutch had sold the entire interest in the Indian business. The department had argued that based on the facts of the case, and the acknowledgement of the assessee itself, Hutch had sold Indian assets. The Supreme Court held that one has to "look at" the contract and not "look through" the contract. The sale of 1 share of Cayman Island was undertaken outside India by non-residents. Hence it cannot be considered as a transfer in India.

12.1.2 To overcome the effects of the decision, the Government has amended the Income-tax Act with retrospective effect to provide that any transfer outside India whereby Indian assets are transferred, the same will be taxed in India. Subsequently due to outcry from investors, the Government appointed an expert committee headed by Dr. Parthasarathi Shome. The committee has recommended that the tax on indirect transfer be enacted prospectively and not retrospectively. Even if tax has to be imposed retrospectively, several unintended consequences should be taken care of. As on the date of writing this chapter one does not know whether the report will be accepted or not.

12.1.3 Explanation 5 to section 9(1)(i) provides that if the shares of a foreign company are transferred, and if the value of the shares are derived substantially from Indian assets, then the foreign company's shares shall be deemed to be situated in India. What the explanation provides is that the "situs" of the shares shall be deemed to be in India. The shares continue to remain "foreign company's shares".

Normally, as per any DTA, if the shares are Indian company's shares, the same can be taxed in India. In some DTAs, the sale of Indian company's shares cannot be taxed in India. However sale of "foreign company's shares" cannot be taxed in India under a DTA.

Under the clause which deals with indirect sale of immovable property (para 3.4 above), it is only if the principal value is derived due to immovable property in India, that Indian can tax it. There is no provision in case of indirect sale of other assets.

Therefore under a DTA, indirect sale of shares should not be taxable.

12.1.4 Substance over form

Indirect transfer is an issue of substance over form. We have had several decisions on this issue. The Supreme Court in the case of Azadi Bachao Andolan (263 ITR 706) held that if there is no "Limitation of Benefits" clause in the DTA, then the India-Mauritius DTA will apply. It has endorsed treaty shopping.

Capital gains article does not have "beneficial owner" concept. With "Limitation of Benefits" clause & "beneficial owner" clause missing, there is no legal basis for taxing such gain.

The Government has however enacted General Anti Avoidance Rules (GAAR). These will be effective from 1st April 2013. For GAAR rules also, the government has appointed an expert committee. The committee has submitted its report. It has proposed to defer the GAAR by 3 years. The revenue department has opposed the report. Let us see the final outcome.

If GAAR is enacted, then the situation of indirect transfer can be taxed in India if it is considered as an impermissible avoidance transaction. Even if there is a DTA, indirect transfer can be taxed in India.

It will be interesting to note that even without GAAR provisions, the revenue has been arguing the matters based on substance over form. In one such case of E*Trade Mauritius (190 Taxmann 232), the department had analysed fund movement from the bank accounts of the company, the pattern of directorship, etc., and concluded that the real investor was the US company and not the Mauritian company. If US company is the real owner, there is no question of applicability of India-Mauritius DTA. The capital gain will be taxed as per India-US DTA where India can tax the capital gain. The Advance ruling was in favour of the tax payer. Based on the Azadi Bachao decision, if the Mauritian company had a Tax Residency certificate, then it was entitled to the DTA benefit.

GAAR provisions will be effective from 1st April 2013. After that, situations like E*Trade may not get the benefit of DTA.

12.2 Capital Gain in case of Foreign Institutional Investors (FIIs):

An FII can invest in shares and securities as permitted by SEBI and RBI. Several FIIs engage in trading in shares. Will trading in shares be considered as business income or Capital gain?

If the income is considered as Capital Gain, then the same may be taxable in India according to most of the DTAs. However as per some of the DTAs like Mauritius, Singapore and Cyprus, the Capital Gain will be taxable only in those countries.

If the income is considered as business income, then in absence of a PE, India cannot tax the income. FIIs arrange the affairs in a manner, where there is no PE in India. It is an accepted fact that if one conducts the transactions in a manner whereby it amounts to trading, then the income will be considered as business income.

This matter has come up before the Authority for Advance Rulings.

In the case of Fidelity Advisors (271 ITR 1) and XYZ / ABC Equity Fund (250 ITR 194), the Authority ruled that the transactions by the FIIs amounted to business income. Article 7 will apply. In absence of a PE in India, the income cannot be taxed in India.

However subsequently in the advance ruling of Fidelity North Star Fund (288 ITR 641), it has been held that the income on sale of securities will be considered as Capital Gain. The reason was that the under SEBI rules, an FII can only invest. They can earn dividend and capital gain. One cannot presume that FIIs took approvals with an intention to violate the laws by trading. The relevant paragraph is quoted below:

"In our view it will be preposterous to impute an intention to FIIs, who responded to the offer of investment in securities in response to the guidelines, got themselves registered under the SEBI Regulations and undertook to abide by those regulations that they would, in the very first step itself, have intended to violate all the legislative requirements which provided them the opportunity to enter the capital market in India."

In my view, one has to ultimately look at the facts. If the transactions have been conducted in a manner which amounts to trading, it is immaterial as to what kind of approval was obtained. The income should be considered as business income.

However in case of Fidelity North Star Fund, it was the department's stand that the income of the FIIs is Capital gain. Even in the proposed Direct Tax Code, it has been provided that the sale of shares by FIIs will amount to Capital Gain. Thus it appears that the revenue department wants to consider the income of FIIs as Capital Gain.

12.3 Sale of intangible assets – knowhow, brands, etc.

Capital asset includes any asset except stock-in-trade, personal effects, agricultural land outside the city / town limits, and certain bonds. It includes tangible property and intangible property. To determine the situs of tangible assets is relatively easier than intangible assets. Where is an intangible asset situated and where is it transferred? There have been some judicial decisions on this subject. Some of the important issues are discussed below:

12.3.1 In case of outright sale of knowhow, brand, etc., what is the tax treatment?

An Indian resident may purchase technology from a foreign company. The sale is an outright sale, with no rights remaining with the non-resident. In has been held in the Advance Ruling of Pfizer Corporation (271 ITR 101), that sale of knowhow in a form of a dossier becomes a chattel. The dossier was transferred outside India. In that case, it becomes an income outside India for the non-resident. Section 5 does not include incomes outside India. Even under section 9(1), the capital asset is situated outside India. Therefore capital gain cannot be said to be deemed to accrue in India. The Advance Ruling in the case of ABC Ltd. (159 Taxmann 344) also followed the ratio in Pfizer's case.

In Davy Ashmore's case (190 ITR 626), it was held that income on sale of designs and drawings amounts to Capital Gain. In the case of Maggronic Devices (190 Taxmann 382) also, it was held by the Himachal Pradesh High Court that transfer of data, designs and knowhow were a part of plant. As these were transferred outside India, there was no question of the gain being taxed in India.

Thus in case of assets like designs, knowhow, drawings which are transferred outside India, the same are not taxable in India. It is of course necessary that the entire property is transferred. If there is a partial transfer, then the income will be considered as royalty and chargeable to tax accordingly. It may be noted that the definition of "royalty" in Explanation 2 to section 9(1)(vi) excludes amounts paid which would be income under the head capital gain.

12.3.2 However the situation in the case of sale of trademark and brand name is different. In a advance ruling of Foster's Australia (170 Taxmann 341), it distinguished between knowhow and brand name. It has distinguished the ruling in case of Pfizer. The authority has quoted as under:

"There is no legal principle that the situs of intangible assets such as trademark and goodwill would always go with ownership and they have no situs other than the country of fiscal residence of the owner.

On the other hand, there is sufficient authority for the proposition that the intangible assets or incorporeal property can have more than one situs."

The brand name is linked with the place where business is done. The brand name of Foster's was developed due to Indian business. Therefore the situs of brand name was in India also.

Just because the documents pertaining to the brand name were handed outside India, did not mean that the asset was transferred outside India.

An argument was also raised whether the gain can be apportioned between India and the other country as the transfer took place outside India. The Authority denied that and held that once the asset is located in India there is no legal basis for apportioning the income.

Therefore merely because the asset is an intellectual property, it does not mean that the capital gain is not taxable in India.

12.4 Tax rate on Long Term Capital Gain on sale of shares of Indian company

Capital Gain has to be computed under section 48. Under the first proviso, if the non-resident has utilised foreign currency to invest in the shares, he can compute his gain in **foreign currency**. Thus if the rupee has depreciated, he will get relief for the same.

Under second proviso, **inflation adjustment** is available if the shares have been acquired with Indian currency.

The normal tax rate for Long Term gain under section 112 is 20% for a non-resident. However if the tax exceeds 10% of the gain **without the inflation relief**, then it is restricted to 10%. In other words, tax rate is 20% with inflation relief, or 10% without inflation relief, whichever is lower.

There has been a controversy on whether the tax rate of 10% under section 112 can apply to Long Term Capital Gain on shares earned by a non-resident after considering foreign exchange fluctuation relief. The argument is that exchange rate fluctuation provision is applicable. Inflation adjustment provision is not applicable. If Capital gain is computed without considering the inflation adjustment, it means it is computed *"before giving effect to second proviso of section 48"*. Hence the rate of 10% should apply.

This issue has been a matter of appellate proceedings and there are contrary rulings. In the case of Compagnie Financiere Hamon (177 Taxmann 511), Burmah Castrol (AAR 772 of 2008), Mcleod Russel (AAR 299 ITR 79) and Timken France SA (AAR 739 of 2006), the Authority has given a ruling that tax is payable @ 10%. The main ratio was that - it was not necessary for the inflation adjustment proviso to be applicable, for applying the rate of 10%

(without inflation adjustment). The non-resident would get the benefit of exchange rate fluctuation as well as the lower rate of 10%.

Whereas in case BASF AG (293 ITR 1 – Mumbai ITAT) and Cairn UK Holding Ltd. (AAR 950 of 2010), it has been held that the tax is payable @ 20%. The main ratio was that both provisos (exchange rate adjustment and inflation adjustment) are mutually exclusive. If the non-resident is covered by exchange rate fluctuation, then inflation adjustment provision does not apply. The beneficial rate of 10% applies only if inflation adjustment proviso is applicable.

The Finance Act 2012 has amended Section 112(1)(c). It has provided that in case of "unlisted securities", the tax rate will be 10% without considering exchange rate fluctuation and inflation adjustment provision. This is to put the Private Equity Investors on par with FIIs who are liable to pay tax @ 10% on Long Term Capital gain.

However in case of listed securities, there is no amendment. Hence if listed shares are sold in a private deal (not on the stock exchange), then the controversy about the rate of tax survives.

Final note

While capital gain is a relatively simple article compared to other articles, due to different meanings and manner of taxation, there can be several issues. Further in case of capital gain, it may be difficult to plan, as capital assets are not sold frequently. The sale may take place after several years or decades. Laws may change by that time.

Annexure

Hierarchy for taxation considering article 13

The hierarchy is explained in form of a chart. The chart shows hierarchy as per the UN Model, 2011.

Chart – UN Model