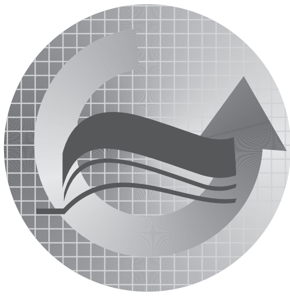

CA Rutvik Sanghvi

Taxation of Capital Gains earned by Non-residents

Since the opening up of the economy almost two decades back, many non-residents have found favour with investments in India. This article aims at discussing the various provisions and issues related to taxation of capital gains earned by non-residents in India.

The broad outline of this article is as follows:

1. Taxability in India of capital gains earned by Non-residents.
2. Computation of taxable capital gains.
3. Applicable Tax Rates for capital gains under the Act.
4. Taxability of capital gains under the DTAAs.
5. Special provisions for gains earned by Non-resident Indians.
6. Taxability of gains earned by FIIs.
7. Taxability of gains on transfer of bonds and GDRs.
8. Taxability of gains earned by QFIs.
9. Taxability of gains earned by FVCIs.
10. Taxability of gains earned by Offshore Funds.
11. "Indirect transfers" – taxability and issues.
12. Deductibility of tax at source from capital gains.

1. Taxability in India of capital gains earned by Non-residents

1.1 Scope

Section 5 of the Income-tax Act ("the Act") provides for the scope of income taxable in India for non-residents. Section 5(2) of the Act provides that income which is received; accrues or arises; or is deemed to accrue or arise to a non-resident in India is taxable under the Act.

1.2 Charge of tax

Section 45 of the Act provides that any profits or gains arising from the transfer of a capital asset effected in the previous year shall be chargeable to tax under the head "Capital gains" and shall be deemed to be income of the previous year in which the transfer took place.

1.3 Source of income

A cumulative reading of the above provisions results in capital gains arising in the hands of a non-resident in India if the **transfer** of the capital assets happens **in India**.

1.4 Deeming Provision

Section 9 of the Act further extends this scope by deeming certain incomes to arise in India. Capital gains that would be deemed to arise in India under Section 9 would be all income arising, whether directly or indirectly, through the **transfer of a capital asset situate in India.** It envisages taxability in a case where income may arise outside India due to transfer happening outside India, but is still deemed to arise in India if the capital asset transferred is situated in India.[1]

For example, take a case where an Indian house property is transferred by one non-resident to another non-resident outside India, i.e., the contract for sale is executed outside India and full price is paid outside India. As per Section 5, tax on gain would not be chargeable to tax in India as transfer happens outside India. However, as per Section 9 as the property is situated in India, the gain is deemed to arise in India.

1.5 Indirect transfers

Till the enactment of Finance Act 2012, Sections 5 & 9 did not bring to tax gains earned by a non-resident on transfer outside India of an asset situated outside India. In the recent decision of Vodafone International B.V.[2] the Hon'ble Supreme Court has dealt with an important jurisdictional issue where:

– the transfer happens outside India,

– of an asset situated outside India, but

– which derives its substantial value

– from capital assets situated within India.

This decision held that income earned on such a transfer does not lead to taxation within India. This has resulted in amendments to Section 9 – not only to counter the Supreme Court's decision but also the various factors cited by the Hon'ble Judges which led to such a decision. These amendments were made retrospectively with effect from 1st April 1962. This has in turn brought about controversial issues regarding taxability in India of overseas transfers. Now an indirect transfer is taxable in India if it satisfies the conditions laid down in section 9. A detailed discussion on 'indirect transfers' is made in Para 11.

1.6 Taxability under the Double Tax Avoidance Agreements

India has entered into Double Tax Avoidance Agreements (DTAA) with several countries. As per Section 90(2), taxability for non-residents is determined as per the provisions of the Act or the applicable DTAA, whichever are more beneficial. Capital gains under the DTAA are generally taxed in a different manner than other incomes. The provisions are discussed in Para 4.

1.7 Exemption from tax

A substantial benefit available to both residents and non-residents is exemption from income-tax under Section 10(38). Long-term capital gains earned on transfer of equity shares or units of an equity-oriented fund on which securities transaction tax (STT) is paid at the time of sale, are exempt. This provides a major relaxation in the taxation of capital gains in the hands of non-residents. Quite a few older provisions providing reduced rates of tax for long-term capital gains have been rendered largely ineffective due to this exemption.

2. Computation of taxable capital gains

Once the gains are determined to be taxable in India, as per the Act or the DTAA, computation of such gains would be determined as per the provisions of the Act. Computation mechanism for capital gains is not provided under the DTAAs. Section 48 provides the mechanism to compute capital gains earned in India.

1 Kanga & Palkhivala's The Law and Practice of Income-tax, Seventh Edition, Page 205.

2 Vodafone International Holdings BV vs. Union of India [2012] 341 ITR 1 (SC)

2.1 Base provision

As per Section 48, the full value of consideration received on transfer is to be reduced by the expenditure on transfer and the cost of acquisition or improvement. However, this computation is to subject to certain adjustments as required by the provisos to Section 48.

2.2 Foreign Exchange Fluctuation Adjustment:

The first proviso to Section 48 provides for adjustment of foreign exchange fluctuations in the value of rupee. This provision is applicable to:

– capital gains – short-term or long-term;
– arising on transfer by a non-resident;
– of shares or debentures of an Indian company;
– purchased out of foreign currency.

In such a case, capital gains shall be computed by converting the amount of sale consideration into the same foreign currency as was used at the time of purchase. Thus the proviso, in essence, prescribes computation of capital gain in foreign currency. Such conversion neutralises the impact of any fluctuation in the value of rupee.

For example, an investor has invested USD (US Dollars) 1,000 at a rate of ₹ 45 per USD in 2011, i.e., ₹ 45,000. If the value of his investment appreciates to ₹ 60,000 by 2013, he would earn ₹ 15,000 in Rupee terms on sale of the securities. However, in USD terms, he would not have earned any gain.

Sr. No.	*Particulars*	*In Rupees*	*In USD*
a.	Cost (at ₹ 45 per USD)	45,000	1,000
b.	Sale consideration (at ₹ 60 per USD)	60,000	1,000
c.	Gain in respective currency (b – a)	15,000	Nil
d.	Taxable gain on account of application of first proviso to Section 48	Nil	

As per this provision, taxable gains would be computed in the same currency as was utilised at the time of purchase. Hence, the non-resident's capital gains would be converted into USD. This would result in nil taxable gain for the non-resident.

There are certain issues to the above computation which are mentioned below:

2.2.1 Does the tax payer have an option to choose applicability of this provision?

The objective to introduce this provision was to provide protection to non-residents from devaluation of the rupee. However, it applies also when the rupee appreciates in value.

In such a case, the taxable gain would increase. Modifying our earlier example, if on the date of sale, the Rupee is valued at ₹ 30 per USD, the non-resident stands to earn taxable gain in the following manner:

Sr. No.	*Particulars*	*In Rupees*	*In USD*
a.	Cost (at ₹ 45 per USD)	45,000	1,000
b.	Sale consideration (at ₹ 30 per USD)	60,000	2,000
c.	Gain in respective foreign currency (b – a)	15,000	1,000
d.	Gain on account of application of first proviso to Section 48 (USD 1,000 at ₹ 30)	30,000	
e.	Additional Gain taxable on account of appreciation in value of Rupee (d - c)	15,000	

Therefore, on application of the first proviso to Section 48, the non-resident stands to pay tax on foreign exchange gain earned on appreciation in value of Rupee.

One view is that this provision is a relief giving provision. Hence if there is an increase in the taxable gains, the provision does not apply.

The Central Board of Direct Taxes (CBDT) has issued a circular at the time of enactment of this provision[3]. It states that – *"The non-resident Indians who invest in shares and debentures of Indian companies have been representing that due to the fall in the value of the Indian rupee vis-a-vis the foreign currency in which the investment is made by them, they are adversely affected when they sell such shares or debentures. In order to overcome this situation, sub-section (1) of section 48 of the Income-tax Act has been amended …"*. The intention may have been to give relief only in case of fall in the rupee value. On rupee appreciation, no adjustment may be required.

While the provision would have been brought into law with the above intention, the language does not support any option for the tax payer. It merely states that capital gain is to be calculated in foreign currency. It does not mention that the conversion is to be done only in case of devaluation of rupee.

This may also be right as practically any non-resident would calculate the gains in his home country's currency, and not in Indian rupees. The provision in that manner neither benefits him, nor puts him at any disadvantageous position when computed in foreign currency. In my view, this is a mandatory provision.

2.2.2 Is this benefit available to shares or debentures gifted or inherited?

Assume a case where shares or debentures purchased out of foreign currency are acquired by the non-resident seller on account of gift or inheritance. In such a case, the seller has not himself purchased the assets out of his own foreign currency. Can the benefit be denied in such a case?

The proviso does not lay down any condition for purchase of the shares or debentures, except for the fact that it should be out of utilisation of foreign currency. If the shares or debentures are purchased out of foreign currency by the original owner, in my view, capital gains earned by a non-resident would be covered within the provision for foreign exchange fluctuation adjustment.

2.2.3 Whether adjustment is from date of investment or date of remittance?

In a case where the foreign exchange funds are remitted to India, but are used for purchase of shares or debentures much later, there is a chance that the value of rupee has depreciated even before purchase.

For example, the non-resident investor has remitted USD 1,000 into India and the foreign exchange rates applicable are:

Date	Foreign Exchange Rate	Amount in Rupees
On date of remittance – 1st April 2011	₹ 45 per USD	45,000
On date of purchase of shares – 31st December 2011	₹ 50 per USD	50,000
On date of sale – 1st February 2013	₹ 60 per USD	60,000

Whether the non-resident seller can claim adjustment for the devaluation of ₹ 5,000 incurred between the date of remittance and date of purchase?

The provision states that conversion has to be done for the cost of acquisition. As per the Rules[4], the prescribed date for conversion of cost is the date of purchase. Therefore, protection against devaluation between date of remittance and date of purchase may not be available to the non-resident.

2.2.4 Difficulties in respect of reinvestment of sale proceeds

The provision states that *"the aforesaid manner of computation of capital gains shall be applicable in respect of capital gains accruing or arising from every reinvestment thereafter …"*

3 Circular No. 554 dated 13th February 1990 183 ITR St 138.

4 As per Rule 115A

How does one apply this condition? What is the meaning of reinvestment thereafter? What should be the rate of foreign exchange for converting the cost of shares? Should we take the rate as on the date of re-investment, or should we take the original rate when funds were first invested?

For example, the non-resident investor has reinvested the sale proceeds of ₹ 60,000 from the example above in 2013. The cost of such shares was ₹ 45,000 when purchased in 2011.

In the above example, the amount of reinvestment is ₹ 60,000. However, the amount which had been invested out of foreign currency is only ₹ 45,000. Does the computation as per this provision apply to reinvestment of the original amount of ₹. 45,000, or the sale proceeds of ₹ 60,000? The excess over ₹ 45,000 (i.e., 15,000) comprises of rupee funds earned in India. There is no foreign currency utilisation at all.

In my view, one may take a logical view. The objective is that for non-residents, the gain should be computed in foreign currency. In case the initial remittance was from foreign currency, adjustment can be done for the subsequent reinvestment out of the initial investment. Therefore one should convert the whole amount of reinvestment for such adjustment; and the rate to be applied should be the rate of foreign currency as on the date of reinvestment.

2.3 Adjustment for inflation

The second proviso to Section 48 provides protection from inflation in India. This enables the assessee to compute gains after increasing the costs by prescribed indexation factors. The loss on account of inflation is offset to a limited extent in this manner.

Provisions of 'indexation benefit' and 'foreign exchange fluctuation adjustment' are mutually exclusive. Therefore, indexation benefit applies to non-residents only for capital assets other than those for which foreign exchange fluctuation adjustment applies (for example, for house properties, etc.). CBDT[5] has been clear in its view that as protection is already provided for forex fluctuation under the first proviso to Section 48, which takes into account inflation, further relief under the second proviso will not be available.

Indexation benefit is available for both residents and non-residents. However, unlike the first proviso, the benefit is restricted only to long-term capital gains, and not short-term capital gains.

3. Applicable tax rates for capital gains under the Act

3.1 Tax liability in the hands of non-residents on capital gains is determined by Section 111A, Section 112 and the 'rates in force' as prescribed under the Finance Act. Surcharge and education cess, as applicable, are added to these rates.

3.2 Short-term capital gains

Short-term gains are taxable in like manner for residents and non-residents. The below table summarises the rates of tax applicable for short-term gains:

Type of asset	Rate of tax	Legal provisions
Equity Shares or units of an equity-oriented fund, on which STT is paid	15%	Section 111A
Capital assets other than those mentioned above including off-market sale of listed equity shares and units of equity-oriented fund	a. Slab rates for individual & HUF b. 40% for foreign companies c. 30% for those not covered above	'Rates in force' as per Part I to the First Schedule of the relevant assessment year's Finance Act

5 Circular No. 636, dated 31-8-1992

It should be noted that under Section 111A, marginal relief is not available for non-resident individuals or HUFs. Further, beneficial slab rates applicable for senior citizens or very senior citizens as per the 'rates in force' are not available for non-residents.

3.3 Long-term capital gains

Section 112(1)(c) read with proviso to Section 112(1) and Section 10(38) provide the tax rates applicable for long-term gains earned by a non-resident.

Type of asset	Applicable tax rates
Unlisted Securities	Up to A.Y. 2011-12: 20% From A.Y. 2012-13: 10%
Listed securities on which STT is not paid on transfer (Lower rate of tax as per Proviso to Section 112(1))	Lower of: 10% tax before availing 'indexation' benefit; or 20% tax after availing 'indexation' benefit.
Listed securities on which STT is paid on transfer	Exempt from tax as per Section 10(38)

Marginal relief available for resident individuals and HUFs is not available for non-residents.

3.4 Lower rate of tax available for "foreign currency" securities?

3.4.1 Proviso to Section 112(1) states that where long-term gains are earned on sale of listed securities or units, the tax rate applicable would be restricted to 10%. This lower rate of tax is applicable on gains computed "before giving effect to the provisions of the second proviso to Section 48", i.e., on gains earned before taking indexation benefit.

The proviso to Section 112(1) has led to a controversy with regard to sale of listed securities or units purchased in foreign currency. As discussed in Para 2.3 above, in case of shares purchased out of foreign currency, adjustment for foreign exchange[6] is applicable and not the indexation adjustment[7].

The controversy

The view taken by the taxpayer is that as such gains are computed after foreign exchange fluctuation adjustment, and without taking indexation benefit; the taxability should be restricted to 10%. In this manner, benefit of both the lower rate of tax, as well as the forex fluctuation adjustment, is obtained.

The tax department's view is that the lower rate of 10% applies only for capital gains where indexation benefit is applicable and can be obtained. If indexation benefit is not available, such long-term gains would be taxable at 20%, and not at a lower rate of 10%.

3.4.2 The above differing stands have led to litigation. Taxation at the lower rate of 10% after foreign exchange fluctuation adjustment has been upheld in quite a few decisions[8] of the Authority for Advance Ruling (AAR) as well as the Income Tax Appellate Tribunal (ITAT).

This view has been upheld by the Hon'ble Delhi High Court in Cairn UK Holdings Ltd.[9] The decision was based on a literal interpretation of proviso to Section 112(1) as against its purposive interpretation. It held that in case the legislature did not intend to provide dual benefits of foreign exchange fluctuation adjustment and

6 As per first proviso to Section 48.

7 As per second proviso to Section 48.

8 Timken France, In re [2007] 164 Taxman 354 (AAR); McLeod Russel India Ltd., In re [2008] 168 Taxman 175 (AAR); Compagnie Financiere Hamon, In re [2009] 177 Taxman 511 (AAR); Alcan Inc. v. DDIT (16 SOT 8).

9 Cairn UK Holdings Ltd. v. Director of Income-tax [2013] 38 taxmann.com 179 (Delhi)

the lower rate of tax, it could have done so by explicitly stipulating the same in the Act. Certain inconsistencies in this interpretation were also held not to be a ground for reading Section 112 differently.

This decision has reversed the ruling of the AAR[10] in the same case, wherein it was held that the words "before giving effect to" used in proviso the Section 112 can come into play only if the assets sold are first qualified for indexation benefit. Thus, the beneficial rate of 10% tax is not applicable for foreign currency securities to which the indexation benefit is not available. This view was also supported in a decision of the ITAT[11].

While the High Court has laid down the favourable position for the taxpayer, one should be careful while obtaining benefit under both provisions. Such an interpretation can lead to litigation.

4. Taxability of Capital Gains under the Double Tax Avoidance Agreements

4.1 Fundamental principles

Capital Gain is discussed in Article 13 of the OECD & UN Models[12]. 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 the right to tax gains from the sale of such assets.

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[13].

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

If the DTAA 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.

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

4.2 Immovable property:

4.2.1 Basic rule as per Article 13(1) - Capital Gain earned by a resident of a Foreign Country on sale of immovable property (situated in India), can be taxed in India. The Foreign Country can also tax the Capital Gain.

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.

4.2.2 As per Article 13(4), if a non-resident 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 COS, the COS can tax the gains. COR 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 is owned by an Indian entity or a foreign entity; then on sale of shares or interest in the entity, India can tax the income.

10 AAR No.950 of 2010,[2011] 12 taxmann.com 266 (AAR - New Delhi)

11 BASF Aktiengesselschaft vs. DDIT (293 ITR 1)

12 Organisation for Economic Cooperation & Development and United Nations Model Tax Conventions

13 There are however a few old DTAAs where the right to tax Capital gain is only with the Country of Source, e.g., Bangladesh, Greece and Egypt.

India did not tax gains if the shares or interest were outside India as there was 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.

4.3 Movable property owned by a Permanent Establishment or a Fixed Base [Article 13(2)]

Capital Gains earned by a resident, arising from sale of movable property, which is a part of the business property of a permanent establishment (PE) or a fixed base (FB) in India, can be taxed in India. It can also be taxed in the COR. The property would usually be equipments, computers, furniture and other assets used in the business. Most of the assets would form a part of "block of assets" under the Act. Gain would be taxable as short-term gain under section 50 of the Act.

4.4 Ships and Aircraft [Article 13(3)]

Basic rule – If a non-resident 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. India CANNOT tax the Capital Gain. This is in line with the taxation of income earned from operating ships and aircraft in international traffic which are taxed only where effective management is situated.

However, immovable property pertaining to operation of ships or aircraft (e.g. office premises in source country), can be taxed under Article 13(1) in COS.

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

4.5.1 Basic rule – If a resident of Country A sells share of an Indian company, and the shares exceed a certain minimum percentage of investee's capital, then India can tax the gains. Country A can also tax the gains.

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

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

Example

A resident of, say, Country A owns shares equal to 20% of the Indian company's shares. The shareholding prescribed in the DTAA with Country A 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 DTAA 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, whatever may be the number of shares sold.

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

4.5.2 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 criterion 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.

4.5.3 Some DTAAs have a slightly modified clause. As per the India-Netherlands DTAA, *"alienation of shares…which 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 that other State."* Therefore, when a sale takes place of even one share of an Indian company, which forms part of at least a 10% holding, India can also tax such transfer. However, such gain is taxable in India only if sale is to a resident of India.

4.6 Other property [Article 13(6)]:
Basic rule – If a resident of a foreign country sells any property other than those mentioned in the above paras, it is taxable only in that foreign country. India cannot tax the same. This is the residuary clause. Some assets which can fall under the residuary clause are know-how, units of a mutual fund, bullion, etc. Sale of these assets will not be taxable in India.

This residuary clause in Mauritius, Singapore and some other DTAAs has been used to claim relief from taxation on Capital Gain in India on sale of shares, as shares in general fall under the residuary clause in these DTAAs.

4.7 Issues under some Indian DTAAs

4.7.1 Situation where there is no Article for Capital Gains in a DTAA
The DTAA 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 DTAAs – specially the new ones (including the India-Malaysia DTAA 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.

4.7.2 Mauritius DTAA
India's DTAA with Mauritius has led to several controversies. As per Article 13(4) of the DTAA, the right to tax capital gains derived by a resident of Mauritius is only with Mauritius. India does not have a right to tax such gains. Further, capital gains are not taxable in Mauritius as per its domestic tax laws and thus, a Mauritius tax resident earning capital gains in India does not have to pay tax in either country. For example, shares of an Indian company sold by a Maurtian tax resident would not suffer any tax in either country. Therefore, Mauritius has been a preferred tax jurisdiction for inbound investments.

There has been considerable litigation on this benefit of **double non-taxation** enjoyed under this DTAA. The tax authorities have alleged that investors using the India-Mauritius DTAA are indulging in **treaty shopping** as they lack commercial substance in Mauritius. The CBDT in its Circular No. 789 stated that wherever a Tax Residency Certificate is issued by the Mauritian Revenue Authorities, it will be sufficient evidence for residence and beneficial ownership for applying the provisions of the DTAA. The Supreme Court in Azadi Bachao Andolan[14] upheld the validity of this circular.

However, in the recent case of **Aditya Birla Nuvo**[15], the Bombay High Court has held that, based on the facts of the case, even though the Mauritian company was the registered owner of the Indian company's shares, it could not be regarded as the legal/beneficial owner of the

14 Union of India vs. Azadi Bachao Andolan (2003) 263 ITR 706 (SC)

15 Aditya Birla Nuvo Ltd vs DDIT 342 ITR 308 (Bom)

income accruing thereon. The Court further held that both the circular and the Supreme Court decision in Azadi Bachao Andolan are not applicable to the facts of the case as the gains may not have arisen to a Mauritius taxpayer.

Therefore, the issues under the Mauritius DTAA stay alive and clarity may come only once the DTAA is revised.

4.7.3 Singapore DTAA

Singapore DTAA has a 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[16]. I understand that it was brought about at the request of Singapore Government as Mauritius DTAA has a similar benefit.

There is however a **Limitation of Benefits** clause (LOB clause) which was also brought about at the same time[17]. The LOB clause applies to sale of other assets (which include shares) not covered in Articles 13(1) to 13(3) of the main DTAA. The LOB clause provides for the certain tests, which are discussed below:

As per clause (1) of the LOB clause, 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 (2) of the LOB clause 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 deeming a company as a shell company. These are given in clauses (3) and (4) of the LOB clause.

Clause (3) provides that the entity will be a shell company if its total annual expenditure on operations in Singapore is less than S$ 200,000 in Singapore. 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. 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.

Clause (4) provides that the entity will not be a shell company if:

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

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

Explanation provided at the end of the LOB clause provides that the case of entities not having *bona fide* business shall be covered by clause (1) mentioned above. As discussed earlier, clause (1) provides for the test based on "**affairs**" of the person. Thus, even if the company is not a shell company (as it satisfies the tests laid down in clauses (2) to (4) of the LOB clause), it could still be considered as a company whose **affairs** are arranged to take advantage of the capital gain tax relief. Hence, LOB clause can be applied, resulting in denial of the DTAA benefit.

16 Article 1 of the Protocol signed between India and Singapore on 29th June, 2005 with effect from 1st August 2005.

17 Article 3 of the Protocol signed between India and Singapore on 29th June, 2005.

4.7.4 Cyprus DTAA

The India-Cyprus DTAA also provides for similar benefits on capital gains as the India-Mauritius DTAA. Therefore, no tax is payable in India on sale of shares in an Indian company by a tax resident of Cyprus.

However, recently, the CBDT has notified Cyprus as a **"Notified Jurisdictional Area"** under Section 94A[18]. In other words, Cyprus has been listed as a non-co-operative jurisdiction and the applicable anti-tax avoidance provisions come into effect from the date of this notification, i.e, from 1st November, 2013 on all transactions with Cyprus. The implications of this notification have been summarised in a Press Release[19]. Provisions relevant for capital gains are:

– All parties to transactions with a person in Cyprus shall be treated as associated enterprises and the transfer pricing provisions will accordingly apply. Additional documentation as prescribed will be required to be maintained.

– Any payment on which tax is deductible at source and made to a person located in Cyprus, will be liable for deduction of tax at source as per the rates under the Act or 30%, whichever is higher.

Impact on gains not taxable under the DTAA?

Section 94A prescribes additional requirements to be applied on transactions with Notified Jurisdictional Areas. However, it does not deny the benefits available under the DTAA. As mentioned earlier, capital gains earned in India will not be taxable in India as per the DTAA with Cyprus.

Therefore, the above provision for deduction of tax at source at higher rate will not apply to such capital gains. In my view, while this stand is correct, it should be noted that once these anti-tax avoidance provisions are enforced, the transactions will be scrutinised thoroughly. An Indian resident must obtain and maintain all required details for even tax exempt transactions.

4.7.5 UAE DTAA

The India-UAE DTAA 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 DTAA has been amended by a protocol. As per the protocol, capital gain earned on sale of shares will be taxable in India.

4.8 Overall, the DTAAs generally do not give any benefit for immovable properties situated in India, or for properties of PEs in India. However, significant benefits may be available for capital gains on sale of shares under certain DTAAs.

Impact of DTAAs on taxation of FIIs is dealt with in para 6.2 and their impact on taxation of 'indirect transfers' is discussed in detail in para 11.7.

5. Special provisions for gains earned by Non-resident Indians

Non-resident Indians (NRIs) have enjoyed a beneficial tax treatment in India as compared to other non-residents. While the general provisions explained above are equally applicable to NRIs, special provisions of Chapter XII-A – Sections 115C to Section 115-I – are applicable for taxation of certain incomes earned by NRIs.

5.1 Applicability of Chapter XII-A:

Assets covered	Incomes covered	Tax rate
'Specified assets' if purchased, acquired or subscribed to in convertible foreign exchange: a. Shares in an Indian company; b. Debentures in or deposits with an Indian company which is not a private company; and c. Specified Government securities.	a. Investment income which is defined as income derived from the specified assets, but excluding dividends referred to in Section 115O	20%
	b. Long-term capital gains	10%

18 Notification No. 86/2013 dated 1st November, 2013

19 Press Release issued by the Ministry of Finance dated 1st November 2013

5.1.1 As discussed in the preceding paragraphs, long-term capital gains earned on sale of listed securities where STT is paid are exempt from tax under Section 10(38). Long-term gains earned on transfer of unlisted securities are taxable at 10% as per Section 112. Further, benefits of slab rates are not available under both Section 115E and Section 112.

Therefore, Chapter XII-A benefits are now restricted to a narrow range of long-term gains – those earned on listed securities which are not exempted under Section 10(38), i.e., which are not traded on a stock exchange. As per Section 112(1)(c)(ii), such gains are taxable at 20% as compared to 10% under Section 115E.

5.2 Issues

5.2.1 Deposits held with banking companies

There is an issue on whether specified assets being 'deposits with an Indian company' include deposits held with banking companies. Under Chapter XII-A deposits with companies other than 'private companies'[20] are covered. Banks are companies, though regulated under the Banking Regulation Act. Further, most Indian banks are public companies. They are not private companies as per the definition under the Companies Act. Therefore, deposits with banking companies should be covered under Chapter XII-A. Judicial precedent[21] in this matter also supports this view.

However, deposits with branches of foreign banks would not get covered under the above definition as these foreign branches are not 'Indian companies'.

5.2.2 Are short-term gains covered?

There is a controversy on whether 'investment income' includes short-term gains earned on sale of specified assets. As per a judicial precedent[22] short-term gain falls within the definition of 'income' as per the Act, and hence would be covered under the definition of 'investment income'.

However, the Mumbai Tribunal in *Sunderdas Haridas v. ACIT*[23] has held that 'investment income' does not cover short-term capital gains. The reasons for such a decision are:

a. 'Investment income' is to be considered as a phrase distinct from the definition of 'income' in the Act. While the 'income' definition covers capital gains, the same cannot be covered under the phrase 'investment income'.

b. If benefit was to be provided to short-term capital gains, the same would have been specified in the Act clearly as is done in other sections.

c. The exclusion of short-term gains from the benefits of Section 112 is with the specific purpose to restrict the outflow of hot money. The concessional tax rate is extended to traders or investors who are dedicated to the Indian market for a sufficiently long time thus deriving income like dividends, interest, or long-term capital gains.

d. "Income derived from any asset" should flow from the use of the asset, and not from capital realisation on sale of the asset. The legislature did not intend to give benefit to short-term capital gains although short-term capital gains for the purposes of the Act remains part of 'total income' within the meaning of Section 2(45).

In my view, the decision of the Mumbai Tribunal is correct. If benefit of lower rate of tax was to be provided to short-term capital gains too, it should have been specifically mentioned in the Section.

20 As defined under the Companies Act
21 V. Ravi Narayanan, In re [2008] 168 Taxman 65 (AAR).
22 Smt. Trishla Jain [1990] 34 ITD 523 (Delhi)
23 [1998] 67 ITD 89 (Mum.)

6. Taxability of gains earned by FIIs

Foreign Institutional Investors (FIIs) have had a chequered past with the Income-tax authorities in India. While the Income-tax Act has provided for streamlined provisions for taxation of FIIs, there have been several attempts to bring to tax the incomes earned by FIIs to tax at higher rates. There has been a "tug-of-war" between the FIIs and the tax department.

6.1 Taxability under the Income-tax Act

Under the Income-tax Act, taxation of FIIs is governed by Section 115AD. Sub-accounts of FIIs would also get covered under Section 115AD.

As per the Advance Ruling in Universities Superannuation Scheme Ltd.[24], Section 115AD is a self-contained code for purposes of determining computation and taxability of incomes of FIIs. FIIs cannot opt for being taxed under the normal provisions of the Income-tax Act.

6.1.1 Tax rates for Capital Gains

This Section provides tax rates for capital gains which are largely in line with the general provisions.

Type of asset	Short-term Gains	Long-term Gains
Equity shares or units of an equity-oriented fund, on which STT is paid, i.e., which are sold on the stock exchange	15%	Exempt u/s. 10(38)
Capital assets other than those mentioned above. Off-market sale of listed equity shares and units of equity-oriented fund are also covered here	30%	10%

The major difference in the above tax rates is for short-term gains on which STT is not paid. While for foreign companies the tax rate for such gains would be 40%, FIIs are taxable only at 30%.

It should be noted that as per Section 115AD(3), the computation of capital gains has to be done without taking into effect the first and second provisos to Section 48.

6.2 Taxation under the treaties

FIIs which are tax residents of countries with which India has signed DTAAs can take benefit of the provisions of the DTAAs or the Act whichever are more beneficial. The benefits generally available to FIIs under the treaties are:

6.2.1 If the income is considered as Capital Gain, then the same may be taxable in India according to most of the DTAAs. However as per some of the DTAAs like Mauritius, Singapore and Cyprus, the Capital Gain will be taxable only in those countries as COR. As these countries have no tax on Capital Gains under their respective domestic tax laws, the gains can be earned tax free.

6.2.2 If the income is considered as Business Income, then in absence of a PE in India, India cannot tax the income. 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.

Different FIIs have taken different stands – Capital Gains or Business income – and succeeded to have tax free incomes under both claims.

6.3 Deductibility of tax at source

While Section 195 is applicable for all payments to non-residents, Section 196D specifically deals with deduction of tax at source from incomes

24 275 ITR 0434

earned by FIIs. Therefore, for incomes covered under Section 196D, deduction of tax at source will not be determined as per Section 195.

Section 196D provides that no tax is required to be deducted at source from capital gains earned by FIIs. Therefore, short-term capital gains or long-term capital gains, which may otherwise be taxable in India, can be paid to an FII without deduction of tax at source.

However, it should be noted that FIIs are still responsible for paying any tax on such incomes in their own capacity by filing their tax returns.

6.4 Capital Gains vis-à-vis Business Income

6.4.1 The major issue that arises in taxation of incomes earned by FIIs is whether the income is in the nature of capital gains or business income. As tax rates applicable can be quite different for business incomes as compared to capital gains, there is litigation on this issue.

6.4.2 The determination of the issue - whether incomes earned are business income or capital gains is based on the intention of the assessee at the time of investing in capital asset. If the investment was in the nature of trade, it is considered as business income. If the intention was to hold on and earn income and appreciation, it is considered as investment. The determination of the intention is largely based on facts and conduct of the income earner. There are a number of decisions[25], including those of the Supreme Court, which have brought out the factors on which this demarcation needs to be done. The CBDT has also issued a circular[26] supplementing its earlier instruction[27] bringing out these factors. The main factors are:

– Whether the activities are regular and allied; or occasional and incidental?

– Whether the number of transactions is substantial?

– Whether the intention to invest is to earn dividends or profits on sale?

– Whether the treatment in books is as investments or stock-in-trade?

– Whether own funds are utilised or borrowed funds?

It should be noted that there can be a number of other factors; and that this issue needs to be decided based on a cumulative reading of all the factors and not any one of them.

6.4.3 The decisions which have dealt with this issue in relation to FIIs have brought out **additional factors** that can determine the nature of income earned.

In the case of Fidelity Advisors[28] and XYZ/ABC Equity Fund[29], the Authority ruled that the transactions by the FIIs amounted to business income. Article 7 of the relevant DTAA will apply. In absence of a PE in India, the income cannot be taxed in India. Similar view was adopted in a few other decisions[30].

However subsequently in the advance ruling of Fidelity North Star Fund[31], it has been held that the income on sale of securities will be considered as Capital Gain. The reason was that the under SEBI[32] Regulations, an FII can only 'invest' and not do 'business'. Hence, FIIs can only earn dividend and capital gain. One

25 Sarder Indra Singh & sons Ltd. v. CIT (1953) (24 ITR 415); G.Venkata Swami Naidu &Co. vs. CIT (1959) (35 ITR 594);Karam Chand Thapar and Brothers (P) Ltd vs. CIT (1971) (83 ITR 899); Commissioner of Income Tax vs. Associated Industrial Development Company (P) Ltd (82 ITR 586); Commissioner of Income Tax, Bombay vs. H. Holck Larsen (160 ITR 67).

26 Circular No. 4/2007 dated 15th June 2007

27 Instruction No. 1827 [F. No. 181/1/89-IT(AI), dated 31-8-1989

28 271 ITR 1

29 250 ITR 194

30 General Electric Pension Trust (280 ITR 425), Royal Bank of Canada (323 ITR 380)

31 288 ITR 641

32 Securities Exchange Board of India

cannot presume that FIIs took approvals with an intention to violate the laws by trading in securities.

In *L.G. Asian Plus Ltd. vs. ACIT*[33], the Mumbai ITAT has provided the same reasoning as in Fidelity North Star Fund to hold that income earned by FIIs on transfer of securities would be taxable as capital gains under Section 115AD. However, it has proceeded further to state that in a hypothetical case where an FII does earn 'business income' it would be taxable under the general provisions only if such income was earned on transfer of assets other than 'securities'. Therefore, as per the ITAT, in case of transfer of securities held as stock-in-trade or investments, income would be taxable as capital gains under provisions of Section 115AD.

In my humble view, with respect, tax laws and regulatory laws have different objectives. Approval obtained under regulatory laws does not impact taxation of income. One has to ultimately look at the facts. If the transactions are 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 in nature. 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.

6.4.4 Taxation of gains on derivatives

While the above paragraph dealt with income earned on sale of capital assets like shares and units; taxation of income on transfer of derivatives has brought out a slightly different issue. Trading in derivatives was covered under 'speculative transaction' as per Section 43(5) of the Act. An amendment was brought in from 1st April, 2006 excluding transactions in respect of trading in derivatives from 'speculative transactions'. This resulted in income earned on trading in derivatives to form part of 'business income'.

In quite a few cases, FIIs had submitted income on trading in derivatives under the head 'Capital Gains' instead of 'Business Income'. The tax department had contested these claims.

In the recent decision of Platinum Asset Management Ltd.[34], the ITAT held that as derivatives are covered within the definition of 'securities' mentioned in Section 115AD, the income would be determined as per Section 115AD, and not as per the general provisions. As Section 43 defines terms used under the head 'Incomes from Business or Profession', the definition of 'speculative transaction' therein would not be applicable for transactions of derivatives covered under Section 115AD. The ITAT took support of its earlier decision in *L.G. Asian Plus Ltd. v. ACIT*[35] mentioned above. A similar decision was provided for the same assessee for a different assessment year[36]. Further, the judgement of the Bombay High Court[37] on derivatives being taxed as "business income" was not relied upon by the ITAT as its ratio could not be applied in case of an FII.

Therefore, the legal position presently is that income on transfer of derivatives would be brought to tax under Section 115AD as capital gains and not as business income under Section 28.

33 [2011] 11 taxmann.com 414
34 I.T.A.No.2787/M/2012
35 [2011] 11 taxmann.com 414
36 ITA No.3598/Mum/2010dated 5th December 2012.
37 CIT v. Bharat R. Ruia (HUF) 337 ITR 452 (Bom)

7. Taxability of gains on transfer of bonds and GDRs

7.1 To enable foreigners to invest in Indian companies without having to be involved with the Indian capital market, the Government has come out with a scheme[38] under which the Indian company issues shares or convertible debentures / bonds in foreign currency. The shares / bonds are issued in the official name of an Indian depository / custodian. Under a back-to-back arrangement, an overseas depository issues Global Depository Receipts (GDRs) to the non-resident investors. GDRs include American Depository Receipts (ADRs). These receipts are tradable on an overseas exchange.

In essence the investment is in shares or bonds of an Indian company, but through GDR mechanism. However as they are independently tradable, they are like simple derivative instruments.

In 2008, the Government came out with "Foreign Currency Exchangeable Bonds Scheme 2008" (FCEB). Under this scheme, the FCEBs are issued by the Indian company to non-residents under the GDR mechanism. The non-resident can exchange the bond, with the equity shares of a listed company, which is held by the FCEB issuing company (the issuing company and the listed company have to belong to the same group). Thus bonds are "exchanged" for shares. The strength of the listed company is used to raise funds by a group company.

7.2 Section 115AC deals with taxation of incomes earned on bonds of Public Sector Undertakings (PSUs), and GDRs purchased by non-residents out of foreign currency. The incomes covered are dividend (other than on which Dividend Distribution Tax (DDT) has been paid), interest and long term capital gain. **Long Term Capital Gain is taxable @ 10%.**

Practically there are not many issues regarding taxation of income on GDRs. The section and the scheme grant certainty. The tax regime of GDRs is running smoothly.

7.3 Capital gains related to GDRs

There can be three taxable events in case of GDRs. The taxability which can arise at each event is mentioned below:

7.3.1 On trading in GDRs

If the transfer happens outside India, there is no tax, provided that the transaction is between two non-residents. The scheme and Section 47(viia) clearly state this. Long-term gain & short-term gain – both are exempt from tax – on transfer of GDRs.

7.3.2 On conversion of GDR into underlying share

If the GDR is converted into shares by the investor, then it may amount to a gain on exchange. But the scheme is silent. It in fact proceeds on the assumption that only when the converted shares are sold, there is a tax. The appreciation or depreciation before conversion is ignored. Please refer para 7.5 below.

7.3.3 On sale of underlying shares

General provisions of the Act would apply in this case.

7.4 What happens if GDRs are transferred to Indian residents?

Earlier GDRs could not be sold to residents due to regulatory issues. However, under the Liberalised Remittance Scheme of FEMA[39], an Indian resident can now buy foreign securities up to the prescribed limit. Even Indian mutual funds have been recently permitted to buy the GDRs.

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38 "Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993"

39 Foreign Exchange Management Act

The scheme and section 47(viia) of the Act exempt gains on transfer of GDR from one non-resident to another non-resident. Does it mean that a transfer to a resident is taxable?

If the non-resident sells the shares to an Indian resident, there can be a tax issue if we consider the GDR to represent Indian securities. As STT would not have been paid, there can be a tax on it.

If GDR is considered to be an independent security, there should be no tax, as the transaction takes place outside India.

The problem is if the GDR was sold on the overseas stock market, how will the non-resident investor know who is the buyer! From the buyer's angle, how will he know who is the seller! Can the Indian department state that the Indian buyer is the agent of the non-resident u/s. 163? The answer is yes. It has also been confirmed in the Advance Ruling of Trinity Corporation[40].

If yes, how would he know who is the seller? Which DTAA is to be considered? Is it long-term gain or short-term gain? What is the cost, etc.?

In my view, the entire scheme is such that GDRs are considered as independent of the underlying securities. They are foreign securities, traded outside India. Hence there should be no tax payable by a non-resident on sale to an Indian resident.

However, due to the recent amendment in Section 9, shares traded outside India, which derive their substantial value from assets located in India, would be deemed to be situated in India. This can lead to taxation of GDRs, even if they are considered to be an independent security. However, in my view, as there is a specific exemption for trading in GDRs by non-residents, there should be no tax liability due to the amended provision of Section 9 also.

40 AAR No. 740 of 2006.

7.5 Cost and the period of holding of shares obtained on conversion of GDRs

GDRs can be converted in to their underlying shares. On eventual sale of such shares, there is an issue of what should be the cost and period of holding of such shares.

7.5.1 *Cost of underlying shares:*

Section 49 strictly does not apply to conversion of GDRs. Section 55 also does not refer to such conversions. Clause 7 of the scheme states as under:

> *"(3) On redemption, the cost of acquisition of the shares underlying the Global Depository Receipts shall be reckoned as the cost on the date on which the Overseas Depository Bank advises the Domestic Custodian Bank for redemption. The price of the ordinary shares of the issuing company prevailing in the Bombay Stock Exchange or the National Stock Exchange on the date of the advice of redemption shall be taken as the cost of acquisition of the underlying ordinary shares.*
>
> *(4) For the purposes of conversions of Foreign Currency Convertible Bonds, the cost of acquisition in the hands of the non-resident investors would be the conversion price determined on the basis of the price of the shares at the Bombay Stock Exchange, or the National Stock Exchange, on the date of conversion of Foreign Currency Convertible Bonds into shares."*

Thus the cost has to be considered as the price on the date on which the GDRs or FCCBs are converted. If the shares are sold immediately on conversion, then there may hardly be any capital gain. **In other words, the appreciation or depreciation while the security is a GDR, is ignored.**

The overall scheme is that as long as GDRs are not converted into underlying securities, they remain outside the tax net. Therefore to take the view that cost of share should be the cost of GDR will not be possible.

7.5.2 Period of holding:

For the purpose of determining the period of holding of shares, clause 9 states as under:

> *"(4) If any capital gains arise on the transfer of the aforesaid shares in India to the non-resident investor, he will be liable to income-tax under the provisions of the Income-tax Act. If the aforesaid shares are held by the non-resident investor for a period of more than twelve months from the date of advice of their redemption by the Overseas Depository Bank, the capital gains arising on the sale thereof will be treated as long-term capital gains and will be subject to income-tax at the rate 10 per cent under the provisions of Section 115AC of the Income-tax Act. If such shares are held for a period of less than twelve months from the date of redemption advice, the capital gains arising on the sale thereof will be treated as short-term capital gains and will be subject to tax at the normal rates of income-tax applicable to non-residents under the provisions of the Income-tax Act."*

The date of holding is considered to be from the date of redemption advice by the overseas depository.

7.6 Capital gains on sale of PSU Bonds

On sale of bonds of PSUs, if there is a long-term gain, the tax is 10%. On short-term gains, the tax is 30% / 40%.

If the bonds are listed, then the period of holding should be more than 12 months to qualify as long-term. If the bonds are unlisted, the period is 36 months.

8. Taxability of gains earned by QFIs

8.1 Qualified Financial Investors are a new category of foreign investors, recently permitted under SEBI and RBI[41] to invest in the capital market in India. The definition of 'QFIs' under the SEBI Regulations includes all 'persons' as defined in the Income-tax Act and FEMA. Further such person needs to be a non-resident of India as per the Income-tax Act and FEMA; and a 'resident' of a country specified in these Regulations as per its domestic tax laws. It specifically excludes FIIs, their sub-accounts and FVCIs.

8.2 The Income-tax Act has not provided any relaxation or special provisions for incomes earned by QFIs. Hence, QFIs would be taxable as per the general provisions depending on the type of investor. This results in a significant difference in taxation, as FIIs are taxed at a lower rate, as also enjoy exemption from deduction of tax at source. QFIs do not have any such relief.

8.3 The CBDT has released FAQs on various aspects related to QFIs. It provides the procedure by which taxes are required to be deducted at source on incomes earned by QFIs. QFIs are to operate in India through their Qualified Depository Participants (QDPs) – a financial intermediary registered with the SEBI. The QDPs have been assigned the responsibilities regarding deduction of tax at source from amounts remitted to the QFIs. QDPs will be treated as a representative assessee / agent of the QFI. The QDP must ensure that the broker deducts appropriate tax, failing which the QDP must deduct the taxes.

The FAQs provide the manner in which incomes are to be computed at the time of deduction of taxes at source. The QFIs will be required to file a tax return to claim the benefits as per the Act.

9. Taxability of gains earned by FVCIs

9.1 Foreign Venture Capital Investors (FVCIs) are registered under the SEBI Regulations for investment in securities of

41 Reserve Bank of India

Indian companies. FVCIs enjoy relaxed pricing norms and lock-in period as compared to other investors.

9.2 Like QFIs, FVCIs also do not enjoy any special taxation policies or rates. Incomes earned by them are subject to tax rates as per the type of income and the nature of entity through which they are investing in India.

However, for investments made by them in Domestic Venture Capital Companies (DVCCs) or Domestic Venture Capital Funds (DVCFs), FVCIs can earn incomes without taxation at two levels. This is because DVCCs and DVCFs are treated as pass-through entities for incomes earned by them from investment in a Venture Capital Undertaking (VCU) as per Section 10(23FB) of the Act. Therefore, capital gains earned by DVCCs and DVCFs on sale of shares in VCUs would directly be taxable in the hands of FVCIs.

This also entails on them a responsibility to pay appropriate taxes on such gains in India. Further, as per Section 10(23FB), FVCIs need to pay tax on income earned by the DVCF or DVCC on an accrual basis, irrespective of when the income is received by the FVCI.

9.3 FVCIs which invest through tax efficient jurisdictions, avail of the benefits of tax treaties signed by India with such countries.

10. Taxability of gains earned by Offshore Funds

Income of Offshore Fund is entitled for special tax treatment on Mutual Fund Dividend & long-term Gain on units of mutual funds as per Section 115AB.

10.1 An Offshore Funds is an "overseas financial organisation" - a fund, institution, association or body, whether incorporated or not, established under the laws of a country outside India. It should have entered into an arrangement for investment in India with any public sector bank or public financial institution or a mutual fund specified under section 10(23D). The arrangement should be approved by the SEBI.

10.2 Applicability of Section 115AB to capital gains

Investments covered	Incomes covered	Tax rate
The investments covered are in units of a mutual fund as specified under section 10(23D) or of the Unit Trust of India; and should be in foreign currency	Long-term capital gains	10%

10.2.1 Long-term gains are exempt from tax under section 10(38), if the units are of "equity oriented mutual fund" and STT is paid. Therefore the relief granted by this section is redundant in case of such gain.

However, long-term capital gain on units of "non-equity oriented mutual fund", are taxable under this section @ 10%.

Other incomes like short-term capital gains are taxed as per normal provisions.

No deduction of expenses and no deduction under Chapter VI-A is allowed.

10.3 Applicability of Section 112

Long term capital gain on listed units of "non-equity oriented mutual fund" are taxable under this section @ 10%. The second proviso to section 48 is not applicable, i.e., inflation adjustment provisions do not apply[42].

Under section 112, the tax on Long Term Capital Gain on such units is 20%. Compared to a tax of 20% under section 112, the tax under section 115AB is 10%. But if the tax @ 20% after inflation adjustment is less than tax @ 10%, without

42 As per Section 115AB(2). First proviso to section 48 (foreign exchange fluctuation adjustment) does not apply to units in any case.

inflation adjustment, can the offshore fund pay lower of the two?

In my view, the answer is no. This is a specific section and overrides the general section. The principle laid down in Advance Ruling (that specific sections override general provisions) referred to in para 6.1 can equally apply here.

10.4 Therefore, in conclusion, there do not seem to be any benefits to offshore funds which are covered under Section 115AB. However, as there is no provision for these funds to opt out of this Section, taxability of gains earned by such funds will be determined as per Section 115AB.

11. "Indirect transfers" – Taxability and issues

11.1 'Indirect transfers' are used to describe transactions where overseas assets are transferred leading to a transfer in value of the underlying Indian capital assets. While in form there is no transfer in India, in substance there is a transfer. These transfers can lead to taxation in India as per recent amendments.

11.2 The reason for such amendments was the Supreme Court's decision in favour of Vodafone International Holdings B.V.[43]. In this decision the Supreme Court held that Hutchison's sale of one share of a Caymans Island company outside India, which led to transfer of its entire Indian telecom business to Vodafone B.V., will not be liable to tax in India. The Supreme Court's decision was based on the reasoning that in a transfer of an overseas asset outside India, one cannot adopt a 'look through' approach to tax the underlying assets in India. Based on several factors, it also upheld the transfer as genuine and not as a colourable device used to avoid tax.

11.3 The Government came out with a slew of amendments to counter this decision. As the Supreme Court held that such income was not within the scope of taxable income under the Act, the Government amended the scope itself.

Section 9(1)(i) lays down that income arising or accruing, directly or indirectly, **through** the **transfer** of a **capital asset situated in India** would be deemed to accrue or arise in India.

The enabling provision to tax income on such transfers was brought through Explanation 5 to Section 9(1)(i) which stated that:

Any share or interest in a foreign company was deemed to be situated in India if the share or interest derives, directly or indirectly, its value substantially from assets located in India.

Further, amendments in the expression "through" used above; in the definition of 'capital asset' under Section 2(14); and in the definition of 'transfer' under Section 2(47); were also made to enable the above deeming provision; and to counter some other rulings laid down by the Supreme Court.

All the above amendments were brought in with retrospective effect from 1st April, 1962 and as 'clarifications' to existing law.

11.4 "Assets" deemed to be situated in India:

The important distinction to be noted in this amendment is that instead of deeming the **capital gains** that would be earned on such 'indirect transfers' to be within the scope of the Act, the overseas assets which would get transferred are itself deemed to be situated in India. This leads to a change in the fact pattern itself, though of course only for tax purposes. This can lead to a number of issues, some of them probably unintended.

If tax is payable in the foreign country on such transfer, there can be double taxation. Tax credit may not be available for such double taxation as both countries would claim a right to tax such income.

43 Vodafone International Holdings BV vs. Union of India [2012] 341 ITR 1 (SC)

Further, while the provisions are aimed at taxation of capital gains, any other incomes earned on such assets may also be taxable within India. For example, dividends declared on such foreign shares can be taxable in India, as the shares will be deemed to situated within India.

11.5 There are several other concerns raised on certain aspects of these amendments. Particularly, clarity is desired on the following aspects:

- What does one mean by 'substantial' value. Is it more than 50% or is it something close to the entire value?
- In case tax is levied on such overseas transfers, what would be the taxation when the underlying Indian capital assets are sold? Whether credit would be available for taxes already paid?
- There are ambiguities on how computation would be done for such gains in India, especially where the assets sold overseas represent both Indian and foreign assets, and value is not ascribed separately.
- This provision is aimed at restructuring exercise or outright sale. However, technically this provision applies to even one share sold by a retail investor outside India which has it values based on Indian capital assets. How can a person operationally comply with such a provision?
- Group reorganisations can also lead to taxation under Section 9 even though Indian capital assets are transferred as part of overseas assets.

11.6 A Committee under the Chairmanship of Dr. Shome was established to deal with these issues. The Committee has submitted its final report recommending several changes in these amendments. In its draft report, the Committee has suggested that:

- A threshold of 50% should be applied for the word 'substantially'.
- The phrase 'directly or indirectly' should be applied as a 'look through' approach, whereby all intermediaries should be ignored.
- Investments made by non-residents through FIIs should be exempted from such a tax.
- Transfer of shares on approved stock exchanges where such shares are frequently traded should also be exempted from these provisions.

11.7 Relief available under the DTAA?

Unlike certain other provisions[44], the amendments made in Section 9 are not 'non-obtstante' provisions. In other words, they do not override the DTAA. Therefore, wherever the DTAA provides a benefit, as per Section 90(2) the taxpayer can still opt for taxation under the DTAA. As seen in Para 4 above, transfer of shares (not otherwise covered) are taxable only in the COR. In certain DTAAs this results in double non-taxation. This benefit can be availed by non-residents taxed on their indirect transfers too.

In Sanofi Pasteur Holding SA[45], two French companies (MA & GIMD) had sold the shares of another French company (ShanH) to a third French company (Sanofi Pasteur Hoding). ShanH in turn held shares of the Indian company Shantha Biotechnics Ltd.

As per Article 14(5) of the DTAA, capital gains on such transfers outside India were not liable to tax in India. Upholding the principle in Section 90(2), the Andhra Pradesh High Court has held that in absence of a non-obstante clause,

44 Like Section 206AA of the Act with regard to holding of PAN.

45 Sanofi Pasteur Holding SA vs. Department of Revenue[2013] 30 taxmann.com 222

the retrospective amendments under Section 9 cannot override provisions of the DTAA.

Therefore, the impact of these amendments to Section 9(1)(i) will be limited wherever a beneficial DTAA is available.

12. Deductibility of tax at source from capital gains

As per Section 195, tax is required to be deducted at source from "sums chargeable to tax" before making the payment to a non-resident. Deduction has to be only on "sum chargeable to tax". Therefore, where the payment does not include any income chargeable to tax, no deduction of tax at source is required. While there are many issues related to deduction of tax at source, the main points in relation to capital gains earned by non-residents are as follows:

12.1 Deduction of tax on capital gain or gross consideration?

There is a concern whether tax is required to be deducted under Section 195 only on the capital gain, or on the whole amount of consideration paid to a non-resident. This issue has come up time and again before judicial authorities. The Karnataka High Court in Samsung Electronics Co. Ltd.[46] held that deduction of tax at source was required on each remittance on the gross sum payable. It incorrectly applied the Supreme Court ruling in Transmission Corpn. of AP Ltd.[47] that at the time of deduction of tax at source, the taxpayer needs to obtain an order under Section 195(2) to determine the amount of taxable income forming part of a composite payment.

The Supreme Court in GE India Technology Cen. (P.) Ltd.[48] has corrected this ruling and held that ***"The obligation to deduct tax at source is, however, limited to the appropriate proportion of income chargeable under the Act forming part of the gross sum of money payable to the non-resident."***

However, there are a couple of recent decisions of the Bengaluru Tribunal which have not applied the above Supreme Court ruling. In Syed Aslam Hashmi[49], the ITAT taking support of the Karnataka High Court decision in Samsung Electronics, has held that tax needs to be deducted at source on the whole of the consideration.

In R. Prakash[50] the ITAT has upheld the computation of interest under Section 201(1A) on tax payable on the whole amount of consideration instead of on the amount of gain.

In my humble view and with respect, both the above decisions of the Bengaluru Tribunal are not correct in law as they have not considered the decision of the Supreme Court in GE Technology Cen. P. Ltd., which has clearly stated that deduction of tax at source is required only on the portion of income embedded in the payment.

12.2 Can the payer himself determine the amount of tax to be deducted at source?

The payer needs to determine the amount of capital gains earned by the payee and deduct appropriate tax at source. Determination can be difficult in certain cases, especially where capital gains are earned. However, the payer can, if proper details are available, compute the gain and deduct the taxes on his own. Approaching the tax officer for an order u/s. 195(2) is not required in every case.

This seems to be the department's stand too, which has in the FAQs prepared for QFIs mentioned at number 22 that the payer need not

46 CIT (International Taxation) vs. Samsung Electronics Co. Ltd. [2009] 185 Taxman 313
47 Transmission Corpn. of A.P. Ltd. vs. CIT [1999] 239 ITR 587
48 GE India Technology Cen. (P.) Ltd. vs. CIT [2010] 193 TAXMAN 234 (SC)
49 Syed Aslam Hashmi vs. ITO [2013] 55 SOT 441
50 R. Prakash vs. ITO [2013] 38 taxmann.com 123 (Bangalore - Trib.)

approach the tax department in every case of deduction of tax under Section 195.

The Supreme Court in GE India Technology Cen. (P.) Ltd. also held that *"….where a person responsible for deduction is fairly certain then he can make his own determination as to whether the tax was deductible at source and, if so, what should be the amount thereof."*

There are concerns whether a Chartered Accountant (CA) can issue certificate in cases of capital gains, especially where sale of properties are concerned. As an extension of the above principle, a CA can also issue a certificate in Form 15CB determining the amount of tax deducted at source. There is no bar on issuance of such certificates by CAs. However, as a practice, and to avoid unnecessary risk of incorrect computation of tax payable, deductors tend to approach the income-tax department for a certificate in such cases.

12.3 Applicability of Tax Residency Certificate and Section 206AA

Before finalising the deductibility of tax at source from capital gains, a deductor must take care of the provisions of Tax Residency Certificate and Section 206AA:

12.3.1 Tax Residency Certificate

It should be noted that, with effect from 1st April 2013, as per Sections 90(4) & 90(5), in case a tax payer wants to take benefit of a DTAA, it must obtain a Tax Residency Certificate (TRC) of the country of which it is resident for tax purposes. The TRC is required to be obtained at the time of availing the benefit of the DTAA. Further, it needs to contain the prescribed particulars, failing which the details need to be submitted under a self-declaration in Form 10F. In case no benefit of the DTAA is adopted, a TRC is not required.

12.3.2 Section 206AA

Section 206AA provides for deduction of tax at source at higher rates in case Permanent Account Number (PAN) is not available. In case a non-resident earning income from India does not provide a valid PAN, the tax rate applicable would the rates as per the Act, the DTAA or 20%, whichever is higher.

This provision is a non-obstante provision, superseding all other provisions under the Act. Therefore, even if tax is required to be deducted at a lower rate under any of the beneficial provisions of a DTAA, it may be deducted at a rate of 20% in case he does not obtain a PAN. However, it should be noted that a non-resident whose income is not taxable in India would not be covered by these provisions.

13. Closing note

In conclusion, taxation of capital gains for non-residents can raise tricky issues. However, the lower rates of tax now applicable (especially for long-term capital gains) has resulted in many special provisions to be largely ineffective in providing any further tax benefit.

Indirect transfer provisions recently introduced can lead to unintended taxation. However, clarity may come only after the provisions are suitably explained or amended. Existence of a DTAA can help mitigate the double taxation.

With GAAR coming into effect from 1st April, 2015, investment through offshore centres may not give any tax benefit.

> There's nothing more important than our good health – that's our principal capital asset.
>
> — *Arlen Specter*