

Tax Alert | Delivering Clarity

9 November 2020

Exceptions to indirect transfer provisions introduced by Finance Act, 2015 are applicable retrospectively

The Delhi Bench of the Income-tax Appellate Tribunal held that explanation 7 to section 9(1)(i) of the Income Tax Act, 1961 (introduced by Finance Act, 2015) relating to exceptions to indirect transfer is applicable retrospectively.

Background:

- The taxpayer¹ is a Singapore company engaged in the business of incubation of companies i.e. providing new businesses, with financial support and technical services. The taxpayer had made investment in a Singapore Company (S Co) in the form of equity and preference shares of the said company. The S Co held certain investments in India.
- During Financial Year (FY) 2014-15, corresponding to Assessment Year (AY) 2015-16, the taxpayer sold its entire investment in S Co to an Indian company. The Indian company withheld taxes at source at 43.26% on the entire sales consideration.
- The taxpayer was of the view that the transaction of sale of shares of S Co was not taxable in India in view of the amended provisions of section 9(1)(i) of the Income-tax Act, 1961 (ITA) read with explanations 5, 6 and 7 to the said section.

Explanation 5 to section 9(1) (i) of the ITA was introduced by Finance Act, 2012 (FA 2012) with retrospective effect from AY 1962-63.

Explanation 5 provides as follows: For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

Explanations 6 and 7 to section 9(1)(i) of the ITA were introduced by the Finance Act, 2015 (FA 2015) with effect from AY 2016-17.

Explanation 6 amongst others, provides the threshold for determining (under Explanation 5) whether an interest or share derives value substantially from India. Further, explanation 7 carves out 'exceptions' for applicability of explanation 5 to small investors and lays down criteria for determining a small investor.

- The Assessing Officer (AO) rejected the taxpayer's contention that sale of shares of S Co was not taxable in India on the basis that explanation 7 to section 9(1)(i) of the ITA was applicable from 1

¹ Augustus Capital Pte Ltd v. DCIT ITA no 8084/IDel/2018 (Delhi ITAT)

April 2016 (i.e. AY 2016-17) and therefore, not applicable in the year under consideration viz. AY 2015-16. Accordingly, the AO (in the draft assessment order) subjected the income from sale of S Co shares to long-term capital gains in India.

- Aggrieved by the AO's draft order, the taxpayer filed objections before the Dispute Resolution Panel (DRP). The DRP upheld the AO's order.
- Aggrieved by the AO's final order (passed based on directions from DRP), the taxpayer filed an appeal with the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

The issue which required ITAT's consideration was, whether explanation 7 to section 9(1)(i) of the ITA providing exceptions for applicability of explanation 5 to small investors and laying down criteria for determining a small investor was applicable retrospectively (and thus applicable for the AY under consideration viz. AY 2015-16) or prospectively with effect from AY 2016-17 (and thus not applicable for the AY under consideration viz. AY 2015-16).

Decision of the ITAT:

- The ITAT noted the following:
 - The language of explanation 5 to section 9(1)(i) of the ITA was very clear as it provided, 'For the removal of doubts' which meant that this explanation had clarified as to when any share or interest in a company incorporated outside India should be deemed to be situated in India, when directly or indirectly its value was substantially derived from assets located in India.
 - The Delhi High Court (HC) in an earlier decision², had held that gains arising from sale of shares of a company incorporated overseas, which derived less than 50% of its value from assets located in India would not be taxable under section 9(1)(i) of the ITA, read with explanation 5 thereto (as their value could not be stated to be derived substantially from assets in India).
The said decision of the Delhi HC² was rendered prior to introduction of explanations 6 and 7 to section 9(1)(i) of the ITA (i.e. prior to introduction of the threshold limit to determine whether an interest or share derived value substantially from India and the exceptions to applicability of section 9(1)(i) of the ITA read with explanation 5 thereto).
 - Pursuant to the decision of the Delhi HC, explanations 6 and 7 to section 9(1)(i) of the ITA were introduced.
 - Both explanations 6 and 7 to section 9(1)(i) of ITA started with 'For the purposes of this clause'. Further, explanation 5 to section 9(1)(i) of the ITA started with 'For removal of doubts'.
- Taking note of the above, the ITAT held as follows:
 - The reference to 'this clause' under explanations 6 and 7 was to section 9(1)(i) of the ITA. Further, these explanations 6 and 7 had to be read with explanation 5 to section 9(1)(i) of the ITA to understand the provisions of Section 9(1)(i) of the ITA.

² DIT v. Copal Research Ltd [2014] 49 taxmann.com 125 (Delhi HC)

- Since explanation 5 was given retrospective effect and explanations 6 and 7 had been inserted in furtherance of the object of insertion of explanation 5 to section 9(1)(i) of the ITA, these two explanations could not be read in isolation, but had to be tagged along with explanation 5 so that both the explanations had to be given a retrospective effect.

Accordingly, the ITAT directed the AO to read explanation 7 to section 9(1)(i) of the ITA as applicable for the year under consideration i.e. AY 2015-16.

Comment:

- This ruling lays down an important principle that the provisions of explanation 6 and 7 to section 9(1)(i) of the ITA have to be tagged along with explanation 5 to section 9(1)(i) of the TIA and have to be given a retrospective effect.
- Taxpayers with indirect transfer transactions prior to AY 2016-17, may want to evaluate impact of this ruling to the facts of their case.



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

This material and the information contained herein prepared by Deloitte Touche Tohmatsu India LLP (DTTI LLP) is intended to provide general information on a particular subject or subjects and is not an exhaustive treatment of such subject(s). This material contains information sourced from third party sites (external sites).

DTTI LLP is not responsible for any loss whatsoever caused due to reliance placed on information sourced from such external sites. None of DTTI LLP, Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this material, rendering professional advice or services. This information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser.

No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this material.

©2020 Deloitte Touche Tohmatsu India LLP. Member of Deloitte Touche Tohmatsu Limited