Deloitte.

Tax Alert | Delivering clarity

26 June 2020

Transfer of shares, deriving value from immovable property, not taxable in India under unamended India-Cyprus tax treaty

The Delhi Bench of the Indian Income-tax Appellate Tribunal has rendered its decision that capital gains derived by a Cyprus entity on sale of shares of an Indian company (deriving value from immovable property in India), are not chargeable to tax in India, under the unamended India-Cyprus tax treaty provisions.

Facts of the case:

- Narmil Infosolutions Pvt Ltd (the taxpayer)[1] is an Indian company engaged in the business of providing information technology enabled services.
- During the Financial Year (FY) 2009-10, corresponding to the Assessment Year (AY) 2010-11, the taxpayer purchased shares of Unitech Info Private Limited (UIPL) from Vectex Limited (Seller). The Seller is a company incorporated in Cyprus and held more than 95% shares of UIPL.
- UIPL is an Indian company, engaged in the business of real estate development. It is the developer of an information technology software-exporting zone proposed to be developed on a parcel of land situated in Chennai.
- During the course of audit of the income-tax return of the taxpayer, the taxpayer submitted the following contentions in support of its position for non-withholding of taxes (from payment made to the Seller):
  - The Seller was a tax resident of Cyprus and did not have any permanent establishment (PE) or fixed place of business in India.
  - The transaction was covered by Article 14(4) of the India-Cyprus tax treaty (Tax Treaty), dealing with taxation of capital gain on transfer / alienation of property other than covered under Articles 14(1), (2) and (3) of the Tax treaty, as per which capital gain was to be taxed in Cyprus and not in India.
  - Accordingly, since the transaction was not taxable in India as per the provisions of Article 14(4) of the Tax treaty, tax was not deductible.
  - Further, substitution of market value of land for valuation purposes (adjusted by book assets and liabilities) in the valuation report did not mean that the taxpayer had purchased an immovable property.
- The AO did not agree with the contentions of the taxpayer and held the following in his order:

[1] DCIT v. Narmil Infosolutions Pvt. Ltd. ITA No. 1152/Del/2016

©2020 Deloitte Touche Tohmatsu India LLP

- Based on the valuation report of UIPL shares, it was apparent that the value of UIPL shares was calculated solely based on the immovable property (i.e. land). Therefore, the transfer of shares resulted in effective change in ownership of the immovable property (i.e. land).
- Capital gains earned by the Seller were from alienation of an immovable property situated in India and thus, taxable in India as per Article 14 (1) of the unamended India-Cyprus tax treaty (Tax treaty).
- Considering that the capital gain of the Seller was taxable in India, the taxpayer was required to withhold tax while making payment of sale consideration to the Seller. However, since the taxpayer did not withhold tax at source, the taxpayer was in default.
- Further, since the taxpayer had entered into a transaction by making payment of sale consideration for UIPL shares, the taxpayer qualified as an agent of the Seller.

In view of the above, the AO subjected the capital gains to tax in the hands of the taxpayer.

- Aggrieved by the AO's order, the taxpayer filed an appeal before the Commissioner of Income-tax Appeals [CIT(A)].
- The CIT(A) deleted the addition made by the AO and held that capital gains earned by the Seller were not chargeable to tax in India as per Article 14(4) of the Tax treaty. Since the capital gain was not chargeable to tax in India, the taxpayer was not required to withhold tax.

  Further, the CIT(A) held that the AO was first required to pass a separate appealable order treating the taxpayer as an agent of the Seller, and only then the taxpayer could be considered to be an agent of the Seller.
- Aggrieved by the CIT(A)'s order, the tax authorities filed an appeal before the Delhi Bench of the Income-tax Appellate Tribunal (ITAT).

Decision of the ITAT:

- The ITAT noted that the only issue for its consideration was whether the sale of UIPL shares (holding immovable property as its only asset) was taxable in the hands of the Seller as per the provisions of the Tax Treaty.
- The ITAT noted that the Seller was a tax resident of Cyprus, holding a valid tax residency certificate (TRC) and therefore, was eligible to take the benefit of the Tax treaty.
- The ITAT held that the transaction of sale of UIPL shares was covered under Article 14(4) of the Tax Treaty, because:
  - The UIPL shares were not covered under Article 6(2) of the Tax treaty (which defines the term immovable property) and therefore, Article 14(1) of the Tax treaty (relating to transfer of immovable property) did not apply.
  - The Seller did not have any PE or fixed base in India and therefore, Article 14(2) of the Tax treaty was not applicable;

©2020 Deloitte Touche Tohmatsu India LLP

- The capital gains were not for alienation of any ship or aircraft or movable property pertaining to the same and therefore, Article 14(3) of the Tax treaty was not applicable.
- Accordingly, the transaction of sale of UIPL shares was covered under Article 14(4) of the Tax treaty relating to taxation of property other than that covered under Articles 14(1) / (2) / (3) i.e. it related to gains on alienation of UIPL shares in the current case.

- The ITAT held that as per Article 14(4) of the Tax Treaty, any gain arising from the alienation of property (i.e. shares of an Indian company in the case under consideration) was taxable only in the Contracting State in which the alienator was resident (i.e. Cyprus in the case under consideration). Since the alienator was a tax resident of Cyprus, the capital gains arising on sale of shares of an Indian company were chargeable to tax only in Cyprus and not in India.
- The ITAT observed that the Tax Treaty was amended in November 2016 to specifically include a paragraph dealing with gains from the alienation of shares of a company, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State. The transaction may have been taxable as per the amended Tax Treaty. However, since the amendment was subsequent to the transaction date, it did not apply.
- In view of the above, the ITAT held that the transaction was not taxable in India as per the unamended Tax Treaty and accordingly, the taxpayer was not required to withhold tax from the payment made to the Seller.

Comments:

This ruling lays down the principle that in the absence of a specific Article dealing with capital gains on alienation of shares of a company whose only asset is an immovable property, the taxability of the same should be covered under the Article dealing with alienation of shares of a company.

©2020 Deloitte Touche Tohmatsu India LLP

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