Tax alert: Exemption for small shareholders for indirect transfer provisions, to apply retrospectively

21 March 2024

The Delhi High Court has rendered its decision that Explanations 6 and 7 to section 9(1)(i) of the Income-tax Act 1961 (ITA) [relating to exemption provided to small shareholders from applicability of indirect transfer provisions], inserted vide Finance Act 2015, would apply retrospectively i.e. from 1 April 1962.

In a nutshell

Explanations 6 and 7 alone would have no meaning if they were not read along with Explanation 5 of section 9(1)(i) of the ITA. Therefore, if explanations 6 and 7 have to be read along with explanation 5, which concededly operates from 1 April 1962, they would have to be construed as clarificatory and curative.

Although Explanations 6 and 7 were indicated in FA 2015 to take effect from 1 April 2016, they could be treated as retrospective, having regard to the legislative history which led to the insertion of Explanations 6 and 7 to section 9(1)(i) of the ITA.

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Background:

- The taxpayer[1] is a company incorporated under the laws of Singapore.
- During Financial Years (FYs) 2012-13 and 2013-14, corresponding to Assessment Years (AYs) 2013-14 and 2014-15, the taxpayer invested in equity and preference shares of, say S Co, a company incorporated in and a resident of Singapore. The taxpayer's investment in S Co comprised of 0.05% of the equity capital and 2.93% of the preference share capital of S Co.
- During the year under consideration, i.e. FY 2014-15, corresponding to AY 2015-16, the taxpayer sold its investment in S Co to an Indian company (I Co) and earned capital gains on sale of such shares. However, the taxpayer filed its return of income declaring its income as 'Nil' on the basis that the taxpayer had no right of management and control concerning the affairs of S Co. Hence, the capital gains arising on account of transfer of shares was not taxable in India.

  The same was on the basis that Explanation 7 to section 9(1)(i) of the Income-tax Act, 1961 (ITA) [giving exemption to shareholders holding less than 5% of shareholding from applicability of indirect transfer provisions] ought to have been given retrospective effect. The Explanations 6 and 7 clarified Explanation 5 to section 9(1)(i) of the ITA, which was introduced via Finance Act (FA), 2012.
- During the course of audit proceedings, the Assessing Officer (AO) did not accept the taxpayer's contentions and held that the capital gains earned by the taxpayer on sale of S Co's shares, had deemed to accrue or arise in India under Explanation 5* to section 9(1)(i) of the ITA. Accordingly, the AO passed a draft assessment order proposing addition towards capital gains.

  Explanation 5.—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**:*
- Aggrieved, the taxpayer filed objections against the draft order of the AO with the Dispute Resolution Panel (DRP) which rejected the taxpayer's objections. The taxpayer filed an appeal against the final order of the AO (passed, based on DRPs directions) with the Delhi Bench of the Income-tax Appellate Tribunal (ITAT). The ITAT held that the Explanations 6 and 7 to section 9(1)(i) of the ITA operated retrospectively.
- Aggrieved, the Revenue filed an appeal before the Delhi High Court (HC).

Relevant provisions in brief:

Extracts of section 9(1)(i) of the ITA:

"Section 9 - Income deemed to accrue or arise in India.

(1) The following incomes shall be deemed to accrue or arise in India :—

***(i) all income accruing or arising, whether directly or indirectly,** through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or **through the transfer of a capital asset situate in India**.*

……………..

*Explanation 4.—For the removal of doubts, it is hereby clarified that the expression **"through"** shall mean and include and shall be deemed to have always meant and included "by means of", "in consequence of" or "by reason of".*

[1] CIT, International taxation-1 vs. Augustus Capital Pte Ltd. [2024] ITA No. 405/2022 (Delhi- HC)

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Explanation 5.—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****:………..*

Explanation 6.—For the purposes of this clause, it is hereby declared that—

(a) the share or interest, referred to in Explanation 5, shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if, on the specified date, the value of such assets—

(i) exceeds the amount of ten crore rupees; and

(ii) represents at least fifty per cent of the value of all the assets owned by the company or entity, as the case may be;

Explanation 7.— For the purposes of this clause,—

(a) no income shall be deemed to accrue or arise to a non-resident from transfer, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, referred to in the Explanation 5,—

(i) ***if such company or entity directly owns the assets situated in India*** *and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer,* ***neither holds the right of management or control in relation to such company or entity, nor holds voting power or share capital*** *or interest* ***exceeding five per cent of the total voting power or total share capital*** *or total interest, as the case may be, of such company or entity; or*

(ii) ***if such company or entity indirectly owns the assets situated in India*** *and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer,* ***neither holds the right of management or control in relation to such company or entity, nor holds any right in, or in relation to, such company or entity which would entitle him to the right of management or control in the company*** *or entity that directly owns the assets situated in India,* ***nor holds such percentage of voting power or share capital*** *or interest in such company or entity which results in holding of (either individually or along with associated enterprises)* ***a voting power or share capital or interest exceeding five per cent of the total voting power or total share capital*** *or total interest, as the case may be, of the company or entity that directly owns the assets situated in India;*

…………..”

Decision of the HC:

The HC noted that the question for their consideration was whether Explanations 6 and 7 to section 9(1)(i) of the ITA were clarificatory and curative and, therefore, to be given retrospective effect.

In this regard, the HC noted / observed as follows:

- Section 9(1)(i) of the ITA, *inter alia*, seeks to impose tax *albeit via* a deeming fiction qua all income accruing or arising, whether directly or indirectly, through or from any property in India or through or from any asset or through transfer of asset situate in India, or the transfer of a capital asset situated in India.
- In an earlier ruling[2], the Supreme Court had excluded from the scope and ambit of section 9(1)(i) of the ITA, gain or income arising from the transfer of shares of a company **located outside India**, although the value of the shares was dependent on assets which were situated in India.

  It was to address this gap in the legislation, explanations 4 and 5 to section 9(1)(i) of the ITA were introduced via FA 2012, which were given retrospective effect from 1 April 1962.

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

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- Explanations 4 and 5 to section 9(1)(i) of the ITA presented difficulties; the expressions **'share and interest'** and **'substantially'** were vague, resulting in undue hardship for transferors/taxpayers where the percentage of share or interest transferred was insignificant.

  Hence, the legislature took a curative step regarding the vague expressions used in Explanation 5, i.e., 'share/interest' and 'substantially'.

- Explanations 6 and 7 alone did not have meaning if they were not read with Explanation 5. Therefore, if Explanations 6 and 7 had to be read along with Explanation 5, which operated from 1 April 1962, they had to be construed as clarificatory and curative.
- If Explanations 6 and 7 were not read along with Explanation 5, no legislative guidance was available to the AO regarding what meaning to give to the expression 'share/interest' or 'substantially' found in Explanation 5.
- In an earlier ruling[3], which was rendered before the insertion of Explanations 6 and 7 to section 9(1)(i) of the ITA vide FA 2015, the Delhi HC had taken the view that Explanation 5 had to be construed narrowly and restrictively. It had held that gains arising from sale of a share of a company incorporated overseas, which derived less than 50% of its value from assets situated in India, was not taxable under section 9(1)(i) of the ITA, read with Explanation 5 thereto.

In view of the above, the HC concluded that although Explanations 6 and 7 were indicated in FA 2015 to take effect from 1 April 2016, they could be treated as retrospective, having regard to the legislative history which led to the insertion of Explanations 6 and 7 of the ITA.

Accordingly, the HC concurred with the ITAT's order and directed the AO to delete the additions made on account of capital gains on sale of S Co's share from the taxpayer's total taxable income in India.

Comments:

The provisions of section 9(1)(i) of the ITA deal with, *inter alia*, cases of income deemed to accrue or arise in India, whether directly or indirectly, through or from, amongst others, any transfer of a capital asset situate in India.

The FA 2012 had introduced certain amendments to section 9 of the ITA (to include indirect transfer provisions) which, amongst others, included insertion of Explanation 5 to section 9(1)(i) with retrospective effect from 1 April 1962 – to provide that a capital asset, being any share in a company registered or incorporated outside India shall be deemed to be situated in India if the share derives, directly or indirectly, **its value substantially from the assets located in India**.

Further amendments were brought to section 9(1)(i) of the ITA vide FA 2015 which, amongst others, included insertion of Explanations 6 and 7 to section 9(1)(i) of the ITA with effect from 1 April 2016.

The HC in this ruling, while specifically dealing with applicability of provisions of indirect transfer under section 9(1)(i) of the ITA, held as follows:

- Explanations 6 and 7 alone would have no meaning if they were not read along with Explanation 5 of section 9(1)(i) of the ITA. Therefore, if Explanations 6 and 7 have to be read along with Explanation 5, which operates from 1 April 1962, they would have to be construed as clarificatory and curative.
- Although Explanations 6 and 7 were indicated in FA 2015 to take effect from 1 April 2016, they could be treated as retrospective, having regard to the legislative history which led to the insertion of Explanations 6 and 7 to section 9(1)(i) of the ITA.

Taxpayers with similar facts may want to evaluate the impact of this ruling to the specific facts of their cases.

[3] DIT v Copal Research Ltd. Mauritius (2014) taxmann.com 125 (Delhi - HC)

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