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Tax alert: Tax treaty benefit on short-term capital gains, carry forward of long-term capital loss, available at same time

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The Mumbai Bench of the Income-tax Appellate Tribunal has held that the taxpayer is entitled to claim beneficial provisions of the India-Mauritius tax treaty in respect of short-term capital gain and allowed to carry forward long-term capital loss, as per section 74 of the Income-tax Act, 1961.

In a nutshell

Source of income has a direct nexus with the stream from which the income benefits the taxpayer. The heads of income are provided to aggregate similar incomes derived from different sources for deduction and taxation purposes.

While, under the income head, "Capital Gains", short-term and long-term assets are different sources of income, each transaction constituting the short-term and long-term assets are however different sources of income.

- Gains / losses arising from different transactions are distinct transactions and a separate source of income; accordingly, STCG / STCL and LTCG / LTCL are distinct and separate streams of income arising to the taxpayer.
- The provisions of section 90(2) of the ITA would apply to each stream of income and not head of income.

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Background:

- The taxpayer[1] is a company incorporated in Mauritius and is a tax resident of Mauritius under the India-Mauritius tax treaty. It invests in Indian securities directly under the Foreign Direct Investment (FDI) route or indirectly through its subsidiaries.
- During the Financial Year (FY) 2016-17, corresponding to Assessment Year (AY) 2017-18, the taxpayer earned gains and incurred losses on the alienation of shares of Indian companies. The capital gains and losses from transfer/alienation of Indian securities was offered to tax as follows:
  - Long-term capital loss (LTCL) - Carried forward under section 74(1) of the Income-tax Act, 1961 (ITA) for set-off against long-term capital gains (LTCG), if any, earned in eight subsequent years.
  - Short-term capital gains (STCG) - Claimed as exempt from tax in India in accordance with Article 13(4) of the India-Mauritius tax treaty.

  All the purchase and sale transactions giving rise to capital gains were entered before 1 April 2017.
- During the course of audit proceedings, the Assessing Officer (AO) observed the following:
  - Under the head "Capital Gains", the taxpayer had carried forward LTCL on sale / redemption of shares but had claimed the STCL on sale / redemption of shares as exempt under Article 13 of the India-Mauritius tax treaty.
  - Since, the capital gains derived by the tax resident of Mauritius in India was exempt, the question of carrying forward of capital losses from such transactions did not arise.

  Thus, the AO denied carry forward of LTCL incurred during the year under consideration to subsequent years.
- Aggrieved, the taxpayer filed an appeal and in the course of appellate proceedings the matter reached before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Relevant extract of section 74 of the ITA

"(1) Where in respect of any assessment year, the net result of the computation under the head "Capital gains" is a loss to the assessee, the whole loss shall, subject to the other provisions of this Chapter, be carried forward to the following assessment year, and…

…(b) in so far as such loss relates to a long-term capital asset, it shall be set off against income, if any, under the head "Capital gains" assessable for that assessment year in respect of any other capital asset not being a short-term capital asset;

(c) if the loss cannot be wholly so set off, the amount of loss not so set off shall be carried forward to the following assessment year and so on"

Decision of the ITAT:

The ITAT noted that the issue under consideration was whether the taxpayer's claim to carry forward the LTCL was correct or not? The non-taxability of STCG was accepted by the AO and was not in dispute.

In this regard, the ITAT noted /observed the following:

[1] Indium IV (Mauritius) Holdings Limited vs. DCIT (International transaction) [ITA NO.2423/MUM/2022] (Mumbai ITAT)

Provisions of the India-Mauritius tax treaty

- As per Article 13 of the India-Mauritius tax treaty, gains derived by a resident of Mauritius from the alienation of shares shall be taxable only in Mauritius.
- Unlike other Articles, such as Article 10 relating to Dividend, Article 11 relating to Interest or Article 12 relating to Royalty (which are specifically to be taxed on gross basis), Article 13 dealing with Capital Gains only allocates the taxing rights between India and Mauritius and does not regulate the quantification and computation of capital gains. This issue is left entirely to the sovereigns.

Provisions of the ITA

- The provisions of section 48 to 51 of the ITA have laid down the computation mechanism in respect of capital gains for two classes of assets viz long-term and short-term assets. Classification of capital assets between long and short term is determined depending on the period of holding.

  Further, taxation of STCG and LTCG is also governed under different sections being section 111A of the ITA in case of STCG and section 112/112A of the ITA in respect of LTCG. Accordingly, the scheme of the ITA itself recognizes STCG/ STCL and LTCG / LTCL to be separate and distinct sources of income.
- As per section 70 of the ITA, governing intra-head set off of current year losses, the STCL can be carried forward or adjusted intra-head but the LTCL can be carried forward or intra head adjustment cannot be made against the STCG/STCL. Therefore, the legislature has kept the difference in carry forward as well as intra head adjustment separate for LTCG/LTCL and STCG/STCL.

  On perusal of section 70 to section 74 of the ITA, it could be seen that the legislature itself has recognized LTCG/LTCL and STCG/ STCL to be two distinct sources owing to computational dissimilarities.
- Accordingly, by virtue of the provisions of section 90(2) of the ITA, the taxpayer was eligible to claim the beneficial provisions of the treaty in respect of STCG and with regard to LTCL, the taxpayer had the only option to apply provisions of section 74 of the ITA, and accordingly, chose to carry forward LTCL. Reliance was placed on earlier rulings[2] in this regard.

Conclusion

- Source of income has a direct nexus with the stream from which income springs to the taxpayer. The heads of income are provided to aggregate similar incomes derived from different sources for deduction and taxation purposes. While under the head of income, "Capital Gains", short-term and long-term assets are different sources of income, each transaction constituting the short-term and long-term assets are however different sources of income.

  Accordingly, gains / losses arising from different transactions are distinct transactions and a separate source of income; accordingly, STCG / STCL and LTCG / LTCL are distinct and separate streams of income arising to the taxpayer.
- Section 90(2) of the ITA provides the provisions of the ITA or the provisions of the treaty, whichever are beneficial, shall apply to the taxpayer. The provisions of section 90(2) of the ITA would apply to each stream of income and not head of income. Thus, placing reliance on earlier rulings[3], the taxpayer was entitled to claim

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[2] DIT(IT) v. IBM World Trade Corporation [2021] 436 ITR 641 (Karnataka HC), Dimension Data Asia Pacific Pte. Ltd. v. DCIT(IT) [2018] 99 taxmann.com 270 (Mumbai ITAT) and JCIT v. Montgomery Emerging Markets Fund [2006] 100 ITD 217 (Mumbai SB ITAT)

[3] DIT(IT) v. IBM World Trade Corporation [2021] 436 ITR 641 (Karnataka HC), Dimension Data Asia Pacific Pte. Ltd. v. DCIT(IT) [2018] 99 taxmann.com 270 (Mumbai ITAT) and JCIT v. Montgomery Emerging Markets Fund [2006] 100 ITD 217 (Mumbai SB ITAT)

beneficial provisions of the India-Mauritius tax treaty in respect of STCG and allowed to carry forward LTCL as per section 74 of the ITA.

In view of the above, the ITAT allowed the taxpayer's claim of carry forward of LTCL.

Comments:

This ruling has held / upheld the following:

- Source of income has a direct nexus with the stream out of which the income springs to the taxpayer. The heads of income are provided to aggregate similar incomes derived from different sources for deduction and taxation purposes.
- Under the head of income "Capital Gains", short-term and long-term assets are different sources of income. But each transaction constituting the short-term and long-term assets are different sources of income.
- Gains / losses arising from different transactions are distinct transactions and a separate source of income; accordingly, STCG / STCL and LTCG / LTCL are distinct and separate streams of income arising to the taxpayer.
- The provisions of section 90(2) of the ITA would apply to each stream of income and not head of income.

It may be pertinent to note that the India-Mauritius tax treaty has been amended with effect from 1 April 2017 (i.e., AY 2018-19) to tax capital gains from alienation of shares. However, the capital gains exemption under the India-Mauritius tax treaty continues to be available in respect of shares acquired prior to 1 April 2017.

We have provided below link to tax alerts of earlier rulings in connection with set-off and carry forward of losses:

https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert//in-tax-gbt-Brought-forward-capital-losses-not-to-be%20set-off-against-current-year-noexp.pdf

https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/Global%20Business%20Tax%20Alert/in-tax-gbt-alert-taxable-loss-not-to-be-set-off-against-exempt-capital-gains-can-be-carried-forward-noexp.pdf

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