

Share transfer by a Netherlands Company in an Indian subsidiary not taxable under the tax treaty provisions

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In brief

In a recent judgement, the High Court (HC) of Telangana and Andhra Pradesh held that alienation of a company's shares could not be equated with alienation of immovable property and taxed under Article 13(1) of the India-Netherlands Double Taxation Avoidance Agreement (tax treaty).

In detail

- The taxpayer company¹ was a tax resident of Netherlands. The taxpayer had a wholly owned subsidiary in India (Ind Co) that was engaged in the business of building, maintaining and operating an information technology park.
- During the financial year (FY) 2004–05, pursuant to share purchase agreement, the taxpayer sold its entire shareholding in Ind Co. to a Singapore based company (purchaser). The purchaser paid the consideration to the taxpayer, after withholding tax in accordance with the order under section 195(2) of the Income-tax Act, 1961 (the Act). Further, the purchaser also paid interest for delay in payment of consideration to the taxpayer, after withholding tax.
- The taxpayer filed the return of income, claiming refund of the entire amount of tax withheld on the premise that the capital gains and interest income was not taxable in accordance with Article 13(5) and Article 11(1) of the tax treaty, respectively.
- During the course of assessment proceedings, the taxpayer contended that Articles 13(4) and 13(5) are specific provisions dealing with capital gains arising out of transfer of shares. In accordance with Article 13(4), the capital gains from the transfer of shares of an Indian company would be taxable in India only if the share derived value from immovable property situated in India. However, in case such immovable property was used in the business of the company the capital gains shall be taxable only in Netherlands.
- In the present case, even though the shares of Ind Co derived value from immovable property, Ind Co used such immovable property in carrying on its business (i.e. business of providing the immovable property on lease). Hence, the capital gains was not taxable under Article 13(4). Therefore, pursuant to Article 13(5) of the tax treaty, the gains was taxable only in Netherlands.
- The taxpayer also made an alternate claim of exemption under section 10(23G) of the Act as Ind Co was notified under section 10(23G) of the Act.

¹ TS-246-HC-2017(AP)

- In the assessment order, the Tax Officer (TO) concurred with the taxpayer's contention on the applicability of Article 13(4). However, the TO held that the shares of the taxpayer partake the character of immovable property. Therefore, the capital gains arising from alienation of such shares was chargeable to tax under Article 13(1) of the tax treaty. Further, the TO denied the alternative claim of the taxpayer that the capital gains was exempt under section 10(23G) of the Act. Moreover, the TO held that interest on delayed payment of consideration was deemed to have accrued or arisen in India under section 9(1)(v) of the Act and, hence, taxable in India.
- The matter was carried to the Tribunal.
- With respect to the issue of taxability of capital gains, the Tribunal held the same in favour of the taxpayer and held that the capital gains was not taxable in India under Article 13(5) of the tax treaty as well as the provisions of section 10(23G). Since the capital gains were not taxable in India, the underlying interest paid on delayed payment of consideration also was held to be not taxable in India.
- The Revenue filed an appeal against the Tribunal's order before the HC. Further, since the refunds were not granted even post issuance of Tribunal order, the taxpayer also filed a writ before the HC for refund of taxes withheld including interest.

Issues before the HC

- Whether the transaction of transfer of shares to the purchaser would fall within the ambit of Article 13(4) of the tax treaty?

- Whether Tribunal was correct in interpreting Article 13(1) and Article 13(4) of tax treaty, as giving the right to tax capital gains to Netherlands and not to the source country India?
- Whether the Tribunal was correct in interpreting the conditions laid out in section 10(23G) of the Act?
- Whether the Tribunal was correct in holding that the interest paid by the purchaser on account of delayed payment of sale consideration was not taxable in India?

Taxpayers' contention

- During the course of assessment proceedings, the TO concurred with the taxpayer's explanation with regard to applicability of Article 13(4). However, the Revenue authorities for the first time has raised the ground that the capital gains are taxable under the Article 13(4) of the tax treaty. It was not open to the Revenue to contend that Article 13(4) of the tax treaty would have applications as it would amount to allowing the Revenue to exercise revisionary jurisdiction under section 263.
- On the issue of taxability of interest income, the taxpayer contended that, as per Article 11(1), the interest paid to taxpayer in Netherlands would normally be taxable in Netherlands. Since both the parties to the sale of shares had mutually agreed to defer the closing date and the purchaser voluntarily agreed to pay interest for such late payment, the interest did not partake the character of penalty charges as referred to in Article 11(6) of the tax treaty.

Revenue's contention

- Article 13(4) of the tax treaty would be applicable to the facts of the present case. Therefore, capital gains on transfer of shares was liable to be taxed in India.
- The issue of applicability of Article 13(4) was not being raised for the first time before the HC. The taxpayer had contended on this issue right from the stage of assessment. The Commissioner of Income Tax (Appeals) [CIT(A)] and Tribunal also took note of the taxpayer's contention on Article 13(4) during the course of appellate proceedings.
- The question of applicability of Article 13(4) of the tax treaty was purely a question of law and not of fact. Therefore, it could be determined by the HC in the present appeal. It was well within the power of the HC to entertain the question of applicability of Article 13(4) by exercising power under section 260A (6) of the Act.
- The interest was taxable in the hands of the taxpayer by virtue of the provisions of section 9(1)(i) of the Act. Article 11(1) of the tax treaty has no application to the interest income earned by the taxpayer since such interest is penal in nature.

High Court's ruling

- The HC noted that the acceptance of the TO that the transaction was not taxable under Article 13(4) was explicit from the assessment order. If the Revenue intended to correct this, it was well within the power of the Commissioner to exercise jurisdiction under section 263

of the Act². However, no such exercise was undertaken by the Revenue.

The HC further noted that neither the TO nor the CIT (A) took remedial steps on the applicability of Article 13(4). Thereafter, it was open to the Revenue to raise the issue before the Tribunal by filing cross-objections, which was not done by the Revenue. It was only before the HC that the question of applicability of Article 13(4) of the tax treaty was raised.

- Further, the HC rejected the revenue contention that the question of applicability of Article 13(4) of the tax treaty was a pure question of law. The HC stated that it was also necessary to factually determine whether the immovable property from which the company's shares principally derived their value was used in the business of Ind Co, which was not done during the assessment/ appellate proceedings.
- Based on the above, the HC concluded that the question of applicability of Article 13(4) of the tax treaty could not be permitted to be raised before the HC. Thus, the appeal would necessarily have to be restricted to the finding of the

Tribunal that Article 13(1) of the tax treaty had no application to the transaction.

- The HC held that the revenue authorities erred in equating the alienation of the company's shares to alienation of its immovable property, disregarding the legal distinction between 'share sale' and 'asset sale' summed up by the Supreme Court³ ruling. Therefore, the Tribunal rightly held that alienation of shares by the taxpayer did not fall under Article 13(1) of the tax treaty and that the residuary clause in Article 13(5) would have application. Pursuant to Article 13(5), the capital gains would not be taxable in India. Since the transaction was not taxable, it was not required to go into the alternate claim of the taxpayer that it was also entitled to exemption from taxation under section 10(23G) of the Act.
- On the issue of taxability of interest income, the HC held that the payment of interest does not partake the nature of penalty charges. Therefore, pursuant to Article 11(1) of the tax treaty, interest was not taxable in India.
- Since the appeals were dismissed, the HC directed the

revenue to issue a refund of taxes to the taxpayer within twelve weeks of the receipt of the HC order.

The takeaways

The following are the key takeaways from the judgement:

- The HC has reiterated the long-standing position that the departmental representative could not be allowed to argue contrary to what has been done by the TO as the same is not permissible within the framework of statutory provisions.
- Further, the HC has laid down the principle that interest on delayed payment of consideration may not necessarily be penal in nature. The characterisation must be done based on the facts of each case.
- The order of the HC in so far as directing the revenue to issue refunds is a breather for taxpayers waiting for refunds from the revenue. Approaching the HC in a writ jurisdiction for grant of refunds could be considered in certain circumstances.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

²ACIT v. Maersk Global Service Centre India Private Limited [2011] 133 ITD 543 (Mumbai)

³ Vodafone International Holdings BV [2012] 6 SCC 613

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