Capital gains on indirect transfer of shares by non-resident not taxable in India since it did not meet the criteria of 'substantial value' as per the Act; Tax treaty benefit available

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In brief

In a recent ruling[1] by the Authority for Advance Rulings (AAR), the transfer of shares in a German company by German residents was held not taxable in India since it did not meet the criteria of "substantial value," as provided under the Income-tax Act, 1961 (the Act). In addition, the said transaction was held not taxable in India under the India-Germany Double Taxation Avoidance Agreement (tax treaty), considering the language employed therein.

In detail

Facts

- The applicant, a German company was engaged in the business of industrial refrigeration.
- The applicant entered into a Share Purchase Agreement (SPA) to acquire an unrelated German company on 31 March, 2011.
- The German company was a family owned company, with all its shareholders being German residents.
- The German company held shares in various entities in different jurisdictions including 100% shares in an Indian company.
- The Indian company was an operating company with its own manufacturing facilities in India. As a result of the aforementioned transaction of acquisition of the German company by the applicant, there was an indirect change in the ownership of the Indian company.
- The applicant filed a report on the fair market valuation (FMV) of shares of the Indian company as well as that of the German company as on 31 December, 2010.

Questions before the AAR

- Taxability of the transfer of shares of the German company in India under the provisions of the Act read with the provisions of the tax treaty.
- Requirement of withholding tax in India for the applicant.

Applicant's contention

- In the present case, as per the FMV report, the ratio of the assets of the Indian company to the assets of the German company was merely 5.40%; therefore, the shares of the German company could not said to have derived their value "substantially" from the assets located in India. Thus, the said transaction of transfer of shares of the German company did not qualify for taxation in India under section 9(1)(i) of the Act.

[1] AAR No. 1232 of 2012

- Further, as per Article 13(4) of the tax treaty, capital gains, if any arising on transfer of shares of a German company was taxable only in Germany.
- In addition, there was no question of transfer of any other asset, *viz.* controlling interest, as it did not constitute a capital asset distinct from the shares. Alternatively, as per Article 13(5) of the tax treaty, even if any such distinct capital asset was being transferred, the same shall be taxable in the country of residence of the transferor, i.e., Germany.
- Therefore, in the absence of any taxability in India on the above transaction, there was no liability to withhold tax relying on the Supreme Court decision in the case of GE India.[2]

Revenue's contentions

While the Revenue did not object to the applicant's contentions under the Act and tax treaty, it was submitted that in case of any discrepancy in the FMV report, the tax officer would appropriately consider the same, as per the provisions of the Act.

AAR's ruling

- Placing reliance on the FMV report from an independent valuer, the AAR agreed that the shares of the German company could not be said to have derived their value "substantially" from the assets located in India. Therefore, the transfer of said shares held was not deemed to have been situated in India, and thus, not taxable in India under section 9(1)(i) of the Act.
- Further, Article 13(4) of tax treaty shall be applicable in the instant case, and therefore, the capital gains, if any, could be brought to tax only in Germany.
- On the transfer of "controlling interest" as a distinct capital asset, the AAR acceded with the decision in the case of Vodafone[3] and held the same to be not taxable in India by virtue of Article 13(5) of the tax treaty.
- In addition, the AAR reaffirmed the position held by the Andhra Pradesh High Court in the case of Sanofi[4] with regard to the taxation of indirect transfer of shares.
- Therefore, the instant transaction of transfer of shares of the German company was held not taxable in India under the Act as well as the tax treaty.
- Further, applying the decision in the case of GE India, tax was not required to be withheld by the applicant in India.

The takeaways

- This ruling recites the condition of "substantial value" for the purpose of taxation pursuant to the indirect transfer of shares.
- In addition, the ruling reaffirms the positions laid down in the case of Sanofi (supra) that the benefit of DTAA has to be given effect while taxing the indirect transfer of shares in India.

Let's talk

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

[2] GE India Technology Cen. Private Limited *v.* CIT [2010] 193 Taxman 234 (SC)

[3] Vodafone International Holdings BV *v.* Union of India [2011] 198 Taxman 418 (SC)

[4] Sanofi Pasteur Holding SA *v.* Department of Revenue [2013] 30 taxmann.com 222 (Andhra Pradesh)

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