www.pwc.com/in

Sharing insights

News Alert
21 August, 2012

pwc

Transfer pricing, minimum alternate tax and filing of return applicable to capital gains earned by foreign company eligible for exemption under tax treaty

In brief

The Authority for Advance Rulings (AAR), in a recent ruling in the case of Castleton Investment Ltd[1], disregarding the theory of precedents, has held that the provisions pertaining to transfer pricing and filing of return of income are applicable even if the income (capital gains) is not liable to tax. The AAR has further held that even a foreign company would be covered under the minimum alternate tax (MAT) provisions of the Income-tax Act, 1961 (the Act).

Facts

- Castleton Investment Ltd (the applicant), a company incorporated in Mauritius, holds shares in an Indian listed company (Indian company).
- The applicant proposes to transfer its investment in the Indian company at fair value to an associated enterprise in Singapore (Singapore AE), through an off-market transaction.
- The applicant, the Indian company and the Singapore AE are all part of the same group.

[1] Castleton Investment Ltd, *In re* [TS-607-AAR-2012]

Key issues raised before the AAR

1. Will the investment held by the applicant in the Indian company be considered as a capital asset under section 2(14) of the Act and will capital gains arising on transfer of shares be taxable in India?

2. Will transfer pricing (TP) provisions be applicable, even if the transfer of shares by the applicant to Singapore AE is not taxable in India?

3. Should taxes be withheld on the consideration paid to the applicant for transfer of shares?

4. Is the applicant required to file any return of income under section 139 of the Act, if the transfer of shares is not taxable in India?

5. Will the MAT provisions under section 115JB of the Act be applicable to the applicant?

AAR ruling

Characterisation of Indian company's shares as capital assets and taxability of capital gains

- The AAR characterised the shares of the Indian company as capital assets, relying upon the contention of the applicant that the shares were held for long-term benefit as investment and it did not wish to trade in those shares.

- Any income generated through the sale of a capital asset would be taxable under capital gains under the Act.

- In view of the above, the AAR held that the transfer of shares of the Indian company by the applicant would be liable to capital gains tax in India.

- However, as per the provisions of Article 13(4) of the Double Tax Avoidance Agreement (tax treaty) between India and Mauritius, capital gains arising in the hands of a Mauritian resident on transfer of shares in an Indian company would be only taxable in Mauritius.

- The AAR, relying upon the ruling of Supreme Court in the case of Azadi Bachao Andolan[2], held that the applicant can claim exemption under the beneficial provisions of the India-Mauritius tax treaty on capital gains arising on the transfer of shares.

Applicability of transfer pricing provisions

- Section 92 of the Act reads as "*Any income arising from an international transaction shall be computed having regard to the arms length price*." Going by the general meaning and by the defined meaning of "income" under the Act and also from a reading of sections 92A to 92C of the Act, there is no need to restrict the scope of the expression "income" appearing in section 92 of the Act. The AAR ruling in the case of Vanenburg Group BV[3] did not discuss this aspect.

- Even if section 92 to sections 92F of the Act are machinery provisions, capital gains cannot be determined without resorting to them. Only on determining whether capital gains have arisen, would the question of its chargeability arise[4]. The question of chargeability to tax would arise only at a later stage. Therefore, whether ultimately the gain or income is taxable in the country or not, sections 92 to 92F of the Act would apply if the transaction is one coming within those provisions. Applicability of section 92 of the Act does not depend on the chargeability under the Act. Where there is no liability, the purpose of

[2] UOI *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC)
[3] Vanenburg Group BV *v.* CIT.,[2007] 289 ITR 464 (AAR)
[4] As per the AAR, in cases governed by the Act alone, they would be chargeable to tax. Where benefits under a tax treaty are opted, then the question would arise whether the gain is taxable in this country and if yes, to what extent.

undertaking a TP exercise is not a question that would affect the operation of a statutory provision.

- Therefore, the provisions of sections 92 to section 92F of the Act are applicable. The aspect that the exercise may not be fruitful in this case, cannot affect the applicability of the statutory provisions.

Applicability of withholding tax

- The AAR, relying upon the decision of the Supreme Court in the case of GE Technology Centre Pvt Ltd[5], ruled that there is no obligation to withhold tax, if such income is not chargeable to tax under the provisions of the Act.

Filing of return of income

- The applicant contended that filing a return of income under section 139 of the Act is not obligatory as the income on the transfer of shares is ultimately not taxable in India.

- Agreeing with the contention of the revenue department, the AAR held that the applicant is bound to file a return of income to claim the benefit under the tax treaty.

- Hence, the obligation under section 139 of the Act cannot simply disappear on account of the non-taxability of the income under the beneficial provisions of the tax treaty.

Applicability of MAT

- The applicant relying upon the ruling in the case of Timken Co[6] argued that the provisions of section 115JB of the Act are applicable only to domestic companies.

- Deviating from its earlier ruling in the case cited by the applicant, the AAR held that the term 'company' as referred to in section 115JB of the Act would not limit its applicability to domestic companies.

- In view of the above, the AAR ruled that the provisions of section 115JB of the Act are *prima facie* applicable to 'every company' and the definition of a company[7] under the Act includes a foreign company.

- Further, the fact that the foreign company had no permanent establishment in India makes no difference to the applicability of MAT provisions.

- The AAR also held that there is no reason to limit the applicability of the provisions of section 115JB of the Act owing to the practical difficulties for foreign companies to prepare their accounts in terms of Schedule VI to the Companies Act, 1956.

Theory of precedents

- On the issue whether the AAR is bound by its own earlier rulings, the AAR held that the theory of precedents does not have a strict application to it.

- The AAR is only bound by the decisions of the Supreme Court (SC) and the decisions of High Courts only have persuasive value.

[5] GE Technology Centre Pvt. Ltd. *v.* CIT [2010] 327 ITR 456 (SC)

[6] Timken Co., *In re* [2010] 326 ITR 193 (AAR)
[7] section 2(17) of the Income-tax Act, 1961

- Further, while the AAR should be slow in disagreeing with its earlier rulings, it should not avoid taking a different view, if it is convinced that the earlier view is not correct.

PwC's observations

Recently, in the case of Columbia Sportswear Company[8], the SC observed that the AAR ought to follow its own earlier rulings. However, in the instant case, the AAR has deviated from its past ruling in the case of Vanenburg Group BV (above), on the questions of applicability of TP provisions and requirement to file return of income, in the absence of liability to pay tax.

In the case of Vanenburg Group BV (above), the AAR held that there was no requirement to file a return if capital gains arising from transfer of shares are exempt from tax. However, in the instant case, the AAR has emphasised that if exemption benefit has to be claimed before the assessing officer, then return has to be filed in the first place.

Further, regarding applicability of TP provisions, the AAR had held, in case of Vanenburg Group BV (above), that these provisions would not apply in the absence of liability to pay tax. However, in the instant case, the AAR has emphasised on the statutory applicability of TP provisions, and has held that these provisions do not automatically become inapplicable if there is no liability to pay tax. Yet, at the same time, the AAR appreciates that applying the TP provisions may not eventually be fruitful, i.e., if capital gains itself are not liable to tax, then the arm's length determination thereof, even if undertaken, would have no revenue consequences.

Accordingly, taxpayers may consider incorporating a note in the income tax return explaining why TP provisions, though statutorily applicable, need not be applied. Also, it is always advisable to maintain the underlying documentation relating to valuation of the shares, which would anyway typically exist when a transfer of shares is executed.

[8] Columbia Sportswear Company *v.* DIT [TS-549-SC-2012]

Our Offices

For private circulation only

Ahmedabad President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	**Bangalore** 6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	**Bhubaneswar** IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	**Chennai** 8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006 Phone +91-44 4228 5000	**Hyderabad** #8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-33 2357 9101 / 4400 1111 Fax: (91) 033 2357 2754	**Mumbai** PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com