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# Capital gains earned by an Indian resident on sale of shares of a Sri Lankan entity not taxable in India

## In brief

Recently, in the case of Apollo Hospital Enterprises Ltd.[1] (the assessee), the Chennai Income-tax Appellate Tribunal (the Tribunal) held that as per Article 13(4) of the India-Sri Lanka double tax avoidance agreement (the tax treaty), the capital gains earned by an Indian resident on the sale of shares of a Sri Lankan company are taxable only in Sri Lanka. Further, Notification No. 90 of 2008, dated 28 August, 2008, issued under section 90A of the Income-tax Act 1961 (the Act), is relevant only for interpreting private agreements entered between 'specified associations' (as specified under section 90(A) of the Act) and not for tax treaty between the two countries (which is governed by section 90 of the Act).

[1] Apollo Hospital Enterprises Ltd. *v.* DCIT [TS-609-ITAT-2012(CHNY)]

## Facts

- The assessee, an Indian resident, sold its share in a Sri Lankan company, The Lanka Hospitals Corporation Ltd. (Lanka Co), and earned capital gains.
- The sale of such shares is subject to share transaction levy in Sri Lanka. Therefore, it is exempt from Sri Lanka income tax as per the country's tax laws.
- The assessee excluded the capital gains from its taxable income in India by relying on Article 13(4) of the tax treaty.
- As per Article 13(4) of the tax treaty, *"Gains from alienation of stocks/shares of a company* ***may be taxed*** *in the contracting state in which they have been issued".*

- However, the assessing officer (AO) included the income in the capital gains on the following basis:
  - As per section 5 of the Act, entire income of an Indian resident (incurred in India as well as abroad) is taxable in India. Since the assessee was a resident in India, its income from the sale of shares of Lanka Co is taxable in India.
  - However, the assessee can opt for benefit under the tax treaty which provides two methods for elimination of double taxation--income exclusion method (IEM) and tax credit method (TCM).
  - As per Notification No. 90 of 2008, if an agreement between 'specified associations' provides that income of an Indian resident 'may be taxed' in the other country, then such income shall be included in the assessee's income taxable in India. Also, the double taxation relief shall be granted in accordance with the method of elimination provided in such an agreement.
  - As Article 13(4) of the tax treaty uses the expression 'may be taxed', both India and Sri Lanka have the right to tax the arising capital gains.
  - Under the TCM, tax credit is given to the assessee for tax paid in Sri Lanka. Since in this case, no tax was paid, there is no scope for tax credit and the entire capital gains were subject to tax in India.
- The Commissioner of Income-tax (Appeals) upheld the assessee's claim and held that as per Article 13(4) of the tax treaty, capital gains on sale of shares of Lanka Co. were not taxable in India.

## Issue

- Whether capital gains arising out of the sale of shares of a Sri Lankan company by an Indian resident company will be taxable in India as per Article 13(4) of the India-Sri Lanka tax treaty

## Revenue contentions

- The term 'may be taxed' used in Article 13(4) of the tax treaty cannot be interpreted to exclude the power of India to tax a long-term capital gain arising to an Indian resident on the sale of shares of a Sri Lankan company.
- Notification No. 90 of 2008 interpreting the words 'may be taxed' clearly states that the income covered by Article 13(4) of the tax treaty (i.e. capital gains) has to be included in the total income taxable in India.
- As per section 5 of the Act, capital gains in the hands of an Indian resident on account of transaction arising outside India have to be considered as part of its total income.
- Relying on the decision of the Chennai Tribunal in the case of Data Software Research Co. Ltd.[2], it was contended that relief can be granted to the assessee for tax paid in Sri Lanka using TCM, but since no tax was paid in Sri Lanka, no tax credit was available to the assessee.

## Assessee's contentions

- Relying on the decision of the Supreme Court in Azadi Bachao Andolan[3], it was contended that the provisions of the tax treaty override the provisions of the Act (i.e., section 5).
- The term 'may be taxed' used in Article 13 (4) of the tax treaty gives exclusive power to Sri Lanka to tax the gains on the sale of shares of the Sri Lankan company.
- Relying on the decision of the Supreme Court in the case of PVAL Kulandagan Chettiar[4], it was contended that the terminology 'may be taxed' used in the tax

[2] CIT *v.* Data Software Research Co. Ltd [2007] 288 ITR 289 (Mds)

[3] UOI *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

[4] CIT *v.* P.V.A.L. Kulandagan Chettiar [2004] 267 ITR 654 (SC)

treaty with Malaysia was interpreted to prevail over section 4 and 5 of the Act. Thus, the residency in India will become irrelevant when the tax treaty is applied.

- Relying on the decision of the Madhya Pradesh High Court[5] and the Indore Tribunal[6] in the case of Turquoise Investment and Finance Ltd. (later affirmed by the Supreme Court[7]), it was contended that:

  - The TCM for the elimination of double tax will be applicable only if tax was payable in both countries.

  - Article 13(4) of the tax treaty clearly establishes that capital gains arising on the sale of shares are to be taxed in the contracting state in which such stocks or shares were issued (Sri Lanka in the instant case).

  - As the income is taxable only in Sri Lanka, the IEM for elimination of double tax must be given preference over the TCM.

- The Notification No. 90 of 2008 defining the expression 'may be taxed' was issued specifically with reference to section 90A of the Act (and not section 90 of the Act) and will be applicable on the agreement between 'specified associations' only. It will not be applicable while interpreting the provisions of the tax treaty (which are separately covered under section 90 of the Act).

## Tribunal ruling

- The Tribunal relying on the decision of the Mumbai Tribunal in the case of Pooja Bhatt[8], which in turn relied on the decision of Supreme Court in PVAL Kulandagan Chettiar (above) and the Madras High Court in Vr. S.R.M. Firm[9] held the following:

  - By using the expression 'may be taxed in the other state', the contracting parties (i.e. India and Sri Lanka) permitted only that state, from where the income is sourced, to tax the income and consequently, the state of residence was precluded from taxing such income.

  - The tax treaty clearly specifies instances where both the countries have the right to tax a particular income like in the case of dividend (Article 11) etc.

  - Hence, the contention of the revenue authorities that the expression 'may be taxed in the other state' gives the option to both the states to tax such an income cannot be accepted.

- The assessee can choose to be taxed as per the provisions of the domestic law or the applicable tax treaty, whichever is more beneficial to him. Thereby, the assessee can escape the provision of section 5 of the Act.

- The Notification No. 90 of 2008, defining the expression 'may be taxed', was issued specifically with reference to section 90A of the Act. It can only affect agreement between 'specified persons' and cannot be expanded or interpreted to define terms in a tax treaty entered between two countries (which is governed by section 90 of the Act).

## Conclusion

The Tribunal, relying on the decision of PVAL Kulandagan Chettiar (above), concluded that the expression 'may be taxed' used in Article 13(4) of the India-Sri Lanka tax treaty, implies exclusion of India's right to tax the capital gains arising on sale of shares of a Sri Lankan company by an Indian resident. Further, Notification No. 90 of 2008 (above), issued under section 90A of the Act, is relevant only for interpreting private agreements entered between 'specified

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5 DCIT *v.* Turquoise Investment & Finance Ltd [2008] 299 ITR 143 (MP)

6 ACIT *v.* Turquoise Investment & Finance Ltd [2004] 89 ITD 155 (Indore)

7 DCIT *v.* Turquoise Investment & Finance Ltd [2008] 300 ITR 1 (SC)

8 Pooja Bhatt *v.* DCIT [2009] 22 DTR 458 (Mum)

9 CIT *v.* Vr. S.R.M. Firm [1984] 208 ITR 400 (Mds)

associations' (as specified under section 90(A) of the Act) and not for tax treaty between the two countries (which is governed by section 90 of the Act).

It is worthwhile to note that as per Notification No. 91 of 2008 (dated 28 August 2008) issued under section 90 of the Act, where a tax treaty between two countries provides that income of an India resident "may be taxed" in the other country, then such income shall be included in his income taxable in India and double taxation relief shall be granted in accordance with the method of elimination provided in such an agreement. It appears that instead of this Notification (i.e. No. 91 of 2008 issued under section 90 of the Act), the Notification issued under section 90A of the Act was brought to the attention of the Tribunal.

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