Taxation on Foreign Remittances

Capital Gains and Interest

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Capital Gains of Non-residents

- General Perspective
- DTAA Perspective
- Buy Back Tax
- 'Substantial Interest' in India – 2012 amendment
- Loss in a transfer
- How to determine seller in Non-resident
- Certain consequences of shares allotted under ESOP

Capital Gains – general perspective

Capital Gain tax – domestic law

- Tax is to be levied on ‘income’ from any ‘source’
  - Natural meaning of ‘income’ - recurring receipt
  - Transfer of a capital asset – not of recurring nature – no source

- Till 1935 – No tax on gains from transfer of asset

- Post 1935, capital gain to be computed by reducing from the consideration, indexed cost of acquisition of the asset

Capital Gain tax – domestic law … cntd

- Ingredients to tax capital gains
  - Existence of capital asset *in India*
  - Transfer of capital asset
  - Consideration
  - Determinable cost

If any one ingredient fails, the levy fails

- Any person paying consideration to non-resident, is required to withhold taxes at applicable rates.
  - WHT to be applied even when the buyer is a non-resident
  - In cases of failure, WHT can be recovered from the buyer
  - Simultaneous proceedings against seller is also possible, but tax can be recovered only from one person

Capital Gains – DTAA perspective

Treaty benefits in India

- Indian treaties generally provide for taxation of capital gains in the source state
  - Exceptions – Mauritius, Singapore, Netherlands, etc. where gains are taxable in the state of residence

- Considering tax arbitrage, significant investments into India is made through Mauritius and Singapore Investment SPVs

- Eligibility to Treaty – resident of contracting state
  - Investment SPVs eligible only if the subsidiary has substance

Treaty benefits in India … cntd

- Treaties do not define – ‘property’, ‘location of property’, ’transfer’, etc.
- Domestic law contains artificial definition of ‘capital asset’, ‘location of capital asset’, ‘transfer’, ‘cost of asset’, etc.
- Treaty also does not have computation mechanism – domestic law has robust computation scheme with artificial definition for ‘consideration, ‘cost’, etc.

Buy Back Tax

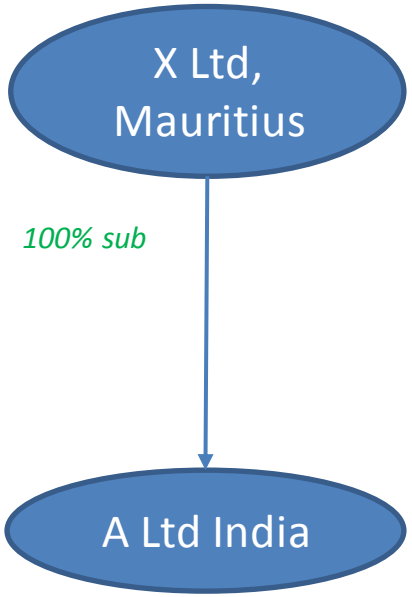
- Background of buy back
- Revenue leakage
- Introduction of buy back tax
- Buy back tax – tax on whose income?
- Buy back tax – availability of Treaty benefit?

Buyback of shares – Background

- Generally companies are not allowed to buy their own shares/ advancing money for buying its own shares
- Exception created by Section 77A of Companies Act, 1956, which provided for buy back of own shares by a company
- Anomaly existed Under IT Act
  - Any distribution by a company to its shares holders will be taxable as *'divided'*
  - Any gain on transfer of capital asset is taxable as '*capital gain'*
- To provide certainty, amendments introduced by FA 1999
  - 46A - Gains on buy back to be taxable as capital gains only
  - 2(22) – Any distribution on buy back will not be treated as dividend

Buyback of shares – issues faced

- A Ltd can distribute its profits by
  - Payment of dividend, subject to DDT
  - Buy-back of shares, treated as capital gains,
- Capital gains earned by a resident of Mauritius/ Singapore/ Netherland, taxable only in the resident state under DTAA
- Consequence of buy back
  - No DDT – as buyback excluded from 'divided'
  - No capital gain tax – where seller resident of countries with beneficial DTAA



Buyback Tax – Section 115QA

- Distributed income by company on buy back shall be charged to tax and the company shall be liable to pay additional income-tax @ 20%
- Distributed income = amount paid on buyback – amount received on issuance of shares
- 10(34A) – Consideration received on buy back exempted from income tax in the hands of the share holder

Buy back tax – tax on whose income?

- Generally, tax liability will only be on the person earning the income
  - But, there is no bar in taxing the income in the hands of any other person, who has some nexus to the income
  - However, the tax can only be on an 'income'
- Buy back tax is a tax on the income of the share holder only, because
  - No income arises to the distributing company on buy back.
  - The only income arising on distribution of profits in buy back is to the share holder.
  - Distributed income has not been deemed to be the income of the distributing company
  - Distributed income has not been deemed to be the income of any particular previous year
- "Tax on distributed income of domestic company " – used to take your mind away and distort the true nature

Buy back tax subject to DTAA?

- For domestic law purposes, BBT is treated to be tax payable by the distributing company,
- This however does not affect treatment under DTAA
  - The income continues to be a tax on alienation of a property – covered by Article 13
  - BBT is a tax on the income of the share holder, collected from the company
- DTAA benefits certainly available
  - Rate of BBT to be restricted to rate of taxation under Article 13/ taxability only in resident state
- The issue will not have practical relevant where underlying tax credit is available under domestic law to the share holder

Retrospective amendment to domestic law

Retrospective amendments to domestic law

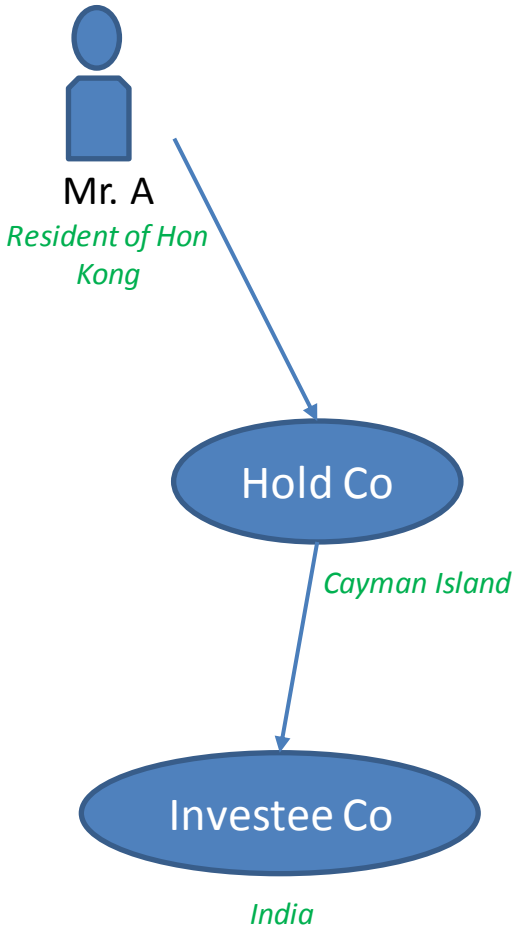
- Shares of a foreign company would be *deemed* to be located in India, if the shares derive their substantial value from India.
- Substantial value would be *deemed* to be derived from India, if more than 50% of the value of the shares of the foreign company is attributable to India.
- Management right/ controlling interest *deemed* to be capital asset
- Artificial computation mechanism introduced to determine value of shares of Indian company and foreign company
- Requirement of Non-resident to apply WHT statutorily provided for

Consequences

- Transfer of shares of any foreign company, having downstream investment in India, would be subject to scrutiny in India
- If more than 50% of the value of the foreign company derives its value from India, the buyer is required to apply WHT.
- Being retrospective from 1976, past transactions can be re-opened upto 16 years. In re-opened scrutiny, liability can be fixed on the seller and not the buyer.
- Despite getting a favorable order from SC, Vodafone has to be pay taxes in India *(Vodafone is separately contesting the tax demand in an international arbitration)*

Consequences … cntd

- Gains derived by Mr. A would be taxable in
  - Hong Kong based on residency
  - Cayman Island based on principal source rule
  - India based on deemed source rule
- Thus, on a single transaction, tax would be levied thrice.



Case study 1

- X Mauritius Ltd is 100% subsidiary of X US Ltd, incorporated in 1995
- X Mauritius Ltd has invested 60% its net worth into X India Ltd and 40% into X Sri Lanka Ltd
- When X US Ltd sells the shares of X Mauritius Ltd in 2019 to Tata Sons India, is Tata Sons required to deduct tax on the payments to be made?
  - US DTAA provides for taxation of capital gains as per domestic law
  - No argument of sham/ eligibility of DTAA questioned

Case study 1 – contention of Tata Sons

- Explanation 5 to 9(1) of the IT Act provides for taxation of indirect transfers in India if foreign asset derive more than 50% of their value from India

- Capital gain is a tax on transfer. Definition of 'location of capital asset' to be seen on the date gains arise.

- Therefore transaction taxable in India

Case study 1 – contention of X Ltd

- When the investment was made in 2000, there was no definition of situs of capital asset in domestic law.

- Subsequent definition to domestic law will not affect treaty interpretation - Situs of asset to be determined as per normal meaning and not as per Explanation 5

- In any case, gains that is attributable to value addition before 2012 cannot be taxable

Case study 1 – possible answers

- Gain from transfer of capital asset arises on the date of transfer. Taxability to be determined based on law applicable on the day of transfer

- Though protection under DTAA is available, full taxing rights have been given to source state. DTAA has not provided for computation mechanism. Hence, Tata Sons required to deduct tax.

- No provision in domestic law to bifurcate gains as taxable and non-taxable gains.

Capital Loss

Loss from Transfer

- Section 45 of IT Act provides for taxation of capital gains. When transaction results in loss, no tax is due

- SC in Transmission Corporation – Payer cannot determine income embedded in a payment, if part of the payment is taxable

- When Indian Co. purchases the share of JV partner at a loss, is there a liability to withhold taxes?

Case Study 2

- TVS Suzuki Ltd was a joint venture of TVS Group and Suzuki Group of Japan.
- Suzuki Group invested into shares of TVS Suzuki @ 100 in 2000, but exited by selling its shares to the TVS Group @ 90 in 2010.
- When TVS group remits the sums to Suzuki, should it deduct tax at source?
- Would the answer be different is the shares are sold @ 110?
- Would the answer be different if Suzuki purchased the shares from Nissan at undisclosed price, but gives a declaration that the transaction results in loss?

Case Study 2 – possible answers

- When purchase price is known to seller and is not subject to any contrary factual determination, no tax is required to be deducted if transaction results in loss
  - Anusha Investment - 378 ITR 621 (Madras)
  - Cannot be taken as general preposition

- When shares are purchased @ 110, claim that tax has to be deducted @ 110 cannot be taken by assessee without a certificate u/s 197 – Transmission Corporation SC

- When purchase price is not know, assessee can still cannot determine rate of TDS without certificate u/s 197

Determination of Residential Status of NR

Case Study 3

- A Ltd purchases a house for using it as its guest house from Mr Y and Mr Z, who inherited the property from their father Mr. X.
- Z executed a power of attorney in favour of Y. Y signed the assignment deed in favour of himself and Z.
- Consideration was thereafter paid into bank accounts of Y and Z in India after deducting tax u/s 194IA
- X and Y, in the agreement, gave their Indian addresses.

Case Study 3 – contd.

- After a lapse of 10 years, AO issues notice to A Ltd stating that Z was a Non-resident for the year in which the asset was transferred and hence A Ltd ought to have deducted tax u/s 195 of the Act.

- Defence for A Ltd?

Case Study 3 – contd.

- P&H HC in Mass Awash (P.) Ltd 397 ITR 305
  - In the absence of statutory time limit, if there is reasonable cause, notice can be issued beyond 8 years
  - The PoA ought to have been looked into by A Ltd, The PoA showed that Y was non-resident. Failure to do due diligence cannot protect assesse.

- A harsh judgment, but the reality
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Transfer of shares allotted under ESOP

Tax on transfer of ESOP share

- Mr X, employee of Tech Mahindra Inc., and resident of USA, allotted shares of Tech Mahindra India under ESOP in 2014
  - Allotment price Rs 20
  - FMV of share on allotment date – Rs 100
  - Mr X paid perquisite tax in USA on Rs 80 @ 30% (tax paid Rs 24)
- Mr X then moved to Tech Mahindra India
- In 2018, Mr X sells the shares at Rs 250 in India
- What will be the capital gains in India
  - Rs 150 (250 – 100)
  - Rs 230 (250 – 20)
  - Rs 206 (250 – 20 – 24)

Legal provisions

- Section 48 provides for computation of capital gains as
  - Consideration less
  - Actual cost of acquisition
- Section 49(2AA)
  - Where shares allotted under ESOP is transferred, FMV considered for perquisite taxation would be regarded as cost of acquisition
  - However, the section refers to perquisite referred to in Section 17(2) only

Consequences

- ITAT Hyderabad in Ramamootrthy Sridharan [ITA 1238/Hyd/2008], on a plain reading of the statute, treated the cost of acquisition to be Rs 206
  - Appeal pending before AP HC
- Correct legal view
  - If entire consideration is brought to tax in India – the value pertaining to remuneration, which under Article 15 is taxable only in USA.
  - Even without 40(2AA) - Once the FMV of the shares allotted under ESOP is taxes, the cost of acquisition shall be value of the shares treated as income
  - Taxing perquisite is a deeming fiction – to be taken to logical conclusion – KP Vargese
  - Taxable capital gains – Rs 150 only

Taxability of Interest earned by NR

SECTION 2(28A): Interest

Interest defined:

'Interest' means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised."

SECTION 2(28A): Interest

- **CIT *v.* Vijay Ship Breaking Corporation [2003] 261 ITR 113 (Gujarat)**

  Facts:

  1. Assessee firm was engaged in ship breaking business and acquired ship from non-resident for demolishing purpose.
  2. Under the agreement, credit for 180 days usance period from date of physical delivery of vessel was allowed at agreed rate of interest.
  3. Amount of interest together with purchase price was to be paid by means of irrevocable 180 days usance letter of credit (L.C.)
  4. Assessee did not deduct tax at source from usance interest, inter alia, on ground that it was part of purchase price of ship.

SECTION 2(*28A*): Interest

- **Issue:** Whether usance interest paid by buyer on unpaid purchase price by means of irrevocable letter of credit would fall within scope of definition of term ‘interest’ under section 2(28A)
- **Held:**
  - It is not the case where the total amount payable under the MOA included a mere estimate of interest loss made as an integral part of the purchase price on incremental basis.
  - There exists a conscious and deliberate stipulations of purchase price of the ship and the interest amount specifically calculated at the agreed rate for the period fixed.
  - Thus, it cannot be said tha the outstanding price of the ship was not a ‘debt incurred’ within the meaning of section 2(28A) or not a ‘debt claim’ under the article concerning taxation of interest in the DTAA.
  - The meaning of the word 'interest' is very wide and would include interest on unpaid purchase price, payable in any manner which would include interest payable by means of irrevocable letter of credit.

SECTION 2(*28A*): Interest

- **Cauvery Spg. & Wvg. Mills Ltd. (In Liquidation) v. Dy. CIT [2011] 238 CTR 55 (Madras)**
- **Facts:**
  1. A mill belonging to the assessee was ordered to be sold in public auction.
  2. The court permitted the successful bidder to pay a portion of the bid amount without interest and the balance amount in instalments with interest.
  3. The amount agreed to be paid by way of interest by the bidder was not on account of any money either borrowed or debt incurred.
- **Held:** In order to call an amount received as interest, the amount should have been received as a due on account of any money either borrowed or as debt incurred. Therefore, the amount in question could not be treated as interest at all.

Interest payments to non-resident HO – Article 7, 11

Interest payments to HO

- Sumitomo Mitsui Banking Corporation v. DDIT (2012) 136 ITD 66 (Mum)(SB)
  - Interest received by HO (Japan) from PE in India not taxable since they're the same legal person – followed Sir Kikabhai Premchand v CIT (1953) 24 ITR 506 (SC)
  - The interest payment is deductible while computing profits of the Indian PE, for the purposes of taxation in India, since the PE has to be treated as a separate and distinct entity (as per Article 7(2))
  - The separate and distinct entity fiction under Article 7(2) does not extend to Article 11 to make the income of the non-resident taxable in India
  - Specific provisions for taxing the interest paid by the PE to HO are absent in domestic law
- Legislative reaction:
  - Explanation inserted in section 9(1)(v) to provide that:
    - Interest paid by the PE to non-resident HO is deemed to accrue or arise in India
    - Such interest is chargeable to tax in addition to any income attributable to the PE
    - PE is a separate and independent person

Interest payments to HO *… contd.*

- Sumitomo saga, continued:
  - No amendment to the definition of income under section 2(24) of the Act – consequence?
  - Exemption under the treaty still available?
  - Interest and penalty not applicable to the HO
  - Effect on previous years and pending litigation?
- TDS provisions to apply?
- Non-resident now required to file two returns – one for the HO and another for the PE in India

Interest payments to HO *… contd.*

- Article 11 – situations:
  i. Bombay branch office of Citibank USA lends money to a Singapore company – whether fully taxable in India?
  ii. Dow Chemicals USA having a factory in India takes a loan for such factory from SBI India
  iii. Bombay branch office Citibank USA lends to Tata Steel India

- Meaning of 'paid' within this context
  - Amount not actually paid by the PE to the HO
  - The term 'paid' has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom. (Para 5, Pg 207 – OECD MC Commentary (2010))

THANK YOU!