High Court interprets words 'substantially'; lays down 50% threshold for indirect transfer of capital assets

Summary – The High Court of Delhi in a recent case of Copal Research Ltd., Mauritius., (the Assessee) held that There can be no recourse to Explanation 5 to enlarge scope of section 9(1) so as to bring to tax gains or income that may arise from transfer of an asset situated outside India, which does not derive bulk of its value from asset situated in India. Gains arising from sale of a shares of a company incorporated overseas, which derives less than 50 per cent of its value from assets situated in India would not be taxable under section 9(1)(i) read with Explanation 5 thereto.

Facts

- CRL, CRIL and Copal-Jersy were companies belonging to the 'Copal Group'. 'CRL' was a company incorporated under the laws of Mauritius, CRIL was an Indian company.
- CRL was holding entire sharecapital of the CRIL.
- However, Copal-Jersey was, at the material time, the ultimate holding company of the Copal Group including shares of CRL and CRIL and its certain shareholders held approximately 67 per cent of the issued and paid-up capital of the company.
- Copal Group Shareholders entered into a Share Purchase Agreement with Moody-UK for sale of approximately 67 per cent of the shares of Copal-Jersy to Moody-UK for an aggregate consideration of USD 92,509,220.
- The AAR held that the capital gains arising out of the sale of shares of an Indian Company - CRIL, sold by a company incorporated in Mauritius to a UK based company were not liable to tax, in India, in the hands of the seller companies and, consequently, the purchasing company had no obligation to withhold tax under section 195 from the consideration payable to the sellers - the Mauritius companies.
- On writ:

Held

- The question, which, arises for consideration is whether the sale of shares of an overseas company which derives only a minor part of its value from the assets located in India could be deemed to be situated in India by virtue of *Explanation* 5 to section 9(1)(i). This question can be answered by reference to the express language of section 9(1)(i) as well as by applying the principle that income sought to be taxed under the Act must have a territorial nexus with India. By virtue of section 9(1)(i) all income arising from transfer of a capital asset situated in India would be deemed to accrue or arise in India and would thus be exigible to tax under the Act. A share of a company incorporated outside India is not an asset which is situated in India and, but for *Explanation* 5 to section 9(1)(i), the gains arising out of any transaction of sale and purchase of a share of an overseas company between non-residents would not be taxable in India. This would be true even if the entire value of the shares of an overseas company was derived from the value of assets situated in India. This issue arose in the case of *Vodafone International Holdings BV* v. *Union of India* [2012] 341 ITR 1/204 Taxman 408/17 taxmann.com 202 and the Supreme Court held that the transaction of sale and purchase of a share of an overseas company between two non-residents would fall outside the ambit of section 9(1)(i). Subsequently, section 9(1) was amended by virtue of Finance Act, 2012 by introduction of *Explanations* 4 & 5 to section 9(1)(i).

- The notes to clauses explained the introduction of the *Explanations* 4 and 5 to section 9(1)(i) as being clarificatory. A plain reading of *Explanation* 5 also indicates that the given reason for its introduction was for removal of any doubts. In other words, the language of the said legislative amendment suggests that it was always the intention of the legislature that an asset which derives its value from assets in India should be considered as one which is situated in India. The clear object of section 9(1)(i) is inter alia to cast the net of tax also on income which arises from transfer of assets in India irrespective of the residential status of the recipient of the income. Since the assets are situated in India, the entire income arising from their transfer could be said to arise in India. *Explanation* 5 introduced a legal fiction for the limited purpose of imputing that assets which substantially derive their value from assets situated in India would also be deemed to be situated in India.
- It is trite law that a legal fiction must be restricted to the purpose for which it was enacted. The object of Explanation 5 was not to extend the scope of section 9(1)(i) to income, which had no territorial nexus with India, but to tax income that had a nexus with India, irrespective of whether the same was reflected in a sale of an asset situated outside India. Viewed from this standpoint there would be no justification to read *Explanation* 5 to provide recourse to section 9(1)(i) for taxing income which arises from transfer of assets overseas and which do not derive bulk of their value from assets in India. In this view, the expression 'substantially' occurring in *Explanation* 5 would necessarily have to be read as synonymous to 'principally', 'mainly" or at least 'majority'. *Explanation* 5 having been stated to be clarificatory must be read restrictively and at best to cover situations where in substance the assets in India are transacted by transacting in shares of overseas holding companies and not to transactions where assets situated overseas are transacted which also derive some value on account of assets situated in India. There can be no recourse to *Explanation* 5 to enlarge the scope of section 9(1) so as to cast the net of tax on gains or income that may arise from transfer of an asset situated outside India, which derives bulk of its value from assets outside India.
- It is also relevant to refer to the draft report submitted by the expert committee appointed by the Prime Minister in 2012 to report on the retrospective amendment relating to indirect transfer of assets (Shome Committee). The said Committee had, in its draft report, considered the import of the expression 'substantially' as used in *Explanation* 5 to section 9(1)(i). The Committee considered the submissions of stakeholders that the expression 'substantially' did not have any fixed meaning and was vague. After analysis, the Committee noted that it was necessary to pin down a definition of the

said expression and for that purpose, there were no reason to depart from the Direct Tax Code Bill, 2010 (DTC) that had been put in the public domain. Under the DTC, gains from the sale of assets situated overseas, which derived more than 50 per cent of their value from assets situated in India, were liable to be taxed in India.

- In addition to the above, the 'United Nations Model Double Taxation Convention between Developed and Developing Countries' and the 'OECD Model Tax Convention on Income and on Capital' may also be referred to since the said conventions deal with a regime whereunder the right to tax capital gains can be fairly and reasonably apportioned between contracting States. Since the models propose a regime which is generally accepted in respect of indirect transfers, the same, although not binding on Indian authorities, would certainly have a persuasive value in interpreting the expression 'substantially' in a reasonable manner and in its contextual perspective. The 'United Nations Model Double Taxation Convention between Developed and Developing Countries' and the 'OECD Model Tax Convention on Income and on Capital' provide that the taxation rights in case of sale of shares are ceded to the country where the underlying assets are situated only if more than 50 Per cent of the value of such shares is derived from such property.
- Paragraph (4) of Article 13 of the United Nations Model Double Taxation Convention between Developed and Developing Countries provides that a Contracting State is allowed to tax a gain on alienation of shares of a company or on alienation of interests in other entities the property of which consists principally of immovable property situated in that State. For this purpose, the term 'principally' in relation to the ownership of an immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by such company, partnership, trust or estate. It is also relevant to note that India has signed a treaty with Korea incorporating this clause.
- The 'OECD Model Tax Convention on Income and on Capital' provides a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation. Article 13 of the said Convention deals with the taxes on capital gains. Article 13(1) provides that the gains derived by a resident of a Contracting State from the alienation of immovable property situated in another Contracting State may be taxed in that other State. Article 13(4) of the said Convention provides that the 'gains derived by a resident of a Contracting State from the alienation of shares or comparable interests deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.'
- In view of the above, gains arising from sale of a share of a company incorporated overseas, which derives less than 50 Per cent of its value from assets situated in India would certainly not be taxable under section 9(1)(i) read with *Explanation* 5 thereto.
- Thus, the gains arising to the shareholders of Copal-Jersey from sale of their shares in Copal-Jersey to Moody UK would not be taxable under section 9(1)(i), as their value could not be stated to be derived substantially from assets in India.