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EY Tax Alert

AAR rules that non-resident is not entitled to concessional rate of 10% on capital gains



Executive summary

This Tax Alert summarizes a recent ruling of the Authority for Advance Rulings (AAR) in the case of Cairn UK Holdings Ltd. (Applicant) [AAR No. 950/2010] on the issue of whether a non-resident (NR) is taxable in India at the concessional rate of 10%, as provided under proviso to Section 112 of the Indian Tax Laws (ITL), in respect of long-term capital gains arising from the sale of shares of an Indian company in off-market mode. On interpretation of the provisions of ITL, the AAR held that proviso to Section 112 does not apply to NR taxpayers which are eligible to claim benefits of foreign exchange fluctuation under the computation provision of capital gains under the ITL. Accordingly, the Applicant is not entitled to claim the benefit of the concessional rate of 10% under proviso to Section 112 of the ITL.

Background and facts

- ▶ The Applicant, a company incorporated in Scotland, acquired shares of Cairns India Ltd. (CIL), an Indian listed company, in three tranches: (i) By way of initial subscription (ii) By way of allotment of fully paid up equity shares (iii) Pursuant to a share purchase agreement (SPA). Subsequently, some shares of CIL were sold to another Indian company. The shares transferred were held for a period exceeding 12 months and, consequently, were treated as a long-term capital asset. This transaction of sale took place in an off-market mode and was not transacted through a recognized stock exchange in India.

- ▶ The Applicant was of the view that gains arising on the above sale of such shares are eligible for concessional rate of tax at 10% under the proviso to Section 112(1) of the ITL. Accordingly, it filed an application before the Tax Authority, requesting for a certificate for withholding tax at the rate of 10% on the gains made on the sale of such shares. However, the Tax Authority rejected the Applicant's claim and passed an order for withholding tax at the rate of 20%. Aggrieved, the Applicant filed an application before the AAR to determine the withholding tax rate.
- ▶ Section 112 provides concessional tax rate on long-term capital gains to residents as well as NRs. The proviso to Section 112 provides that tax on capital gains derived from transfer of listed securities/units/zero coupon bonds (ZCBs) would not exceed 10% of the capital gains computed before giving benefit of indexation in terms of the second proviso to Section 48.
- ▶ Section 48 lays down the computation mechanism of capital gains:
 - ▶ The first proviso to Section 48 (applicable only to NRs) provides the mode of computing capital gains from transfer of shares/debentures of an Indian company by determining gain in the currency in which the shares/ securities were initially acquired.
 - ▶ The second proviso to Section 48 (applicable to both residents and NRs) grants benefit of indexation i.e. cost inflation index (CII) while determining taxable capital gains. In the case of NRs, the second proviso to Section 48 is limited to capital assets other than shares/debentures in an Indian company.

- ▶ The third proviso to Section 48 restricts the benefit of indexation to bonds and debentures other than indexed bonds.
- ▶ Considering the above, the issue before the AAR was whether NRs (who are covered by the first proviso to Section 48 of the ITL) can avail the benefit of concessional rate of tax of 10% on capital gains on transfer of listed securities under the proviso to Section 112 of the ITL.

Tax Authority's contentions

- ▶ The Mumbai Tribunal in the case of BASF Aktiengesellschaft^[1] held that proviso to Section 112 would not apply to an NR and, consequently, the rate of tax would be 20%. It was observed that the expression in the proviso to Section 112 'before giving effect to the provisions of the second proviso to Section 48' presupposes the existence of a case where computation of capital gains is to be made in accordance with the second proviso to Section 48. In other words, the Legislature never intended to give benefit of the proviso to Section 112(1) to those cases where long-term capital gains are required to be computed under the first proviso to Section 48 of the ITL.
- ▶ The first and the second provisos to Section 48 are 'mutually exclusive' as they provide distinct

^[1] [293 ITR 1]

modes of computation of capital gains to two different sets of persons i.e., a resident and an NR. Consequently, an NR cannot claim double benefit of protection against foreign exchange fluctuation, as also the CII benefit. This is further fortified by certain other provisions of the ITL which specifically prohibits application of the first and second provisos of Section 48. It would not be a logical interpretation that the Legislature's intention is that, while non-residents have to forego the benefit of CII, they would be granted the benefit of lower rate of 10%, even when nothing is mentioned about it in the proviso to Section 112(1).

- ▶ The Applicant's claim that it cannot be barred from claiming double benefits, one on account of foreign exchange fluctuation and the other on account of lower rate of 10%, is not valid. The Applicant cannot presuppose the existence of double benefit unless so provided by the Legislature.

Applicant's contentions

- ▶ The proviso to Section 112 was enacted with a view to provide lower rate of tax of 10% on long-term capital gains in respect of listed securities or units or ZCBs. What is relevant are the capital gains arising from transfer of the above mentioned specified securities and it is immaterial whether the taxpayer who has earned the capital gains is a resident or an NR. If the Legislature intended to restrict applicability of the

proviso to residents only, specific language would have been incorporated to that effect.

- ▶ In the case of BASF Aktiengesellschaft (*supra*) the Mumbai Tribunal's conclusion that that the eligibility to avail benefit of CII is essential to avail the benefit of the concessional rate of 10% does not appear to lay down the correct principle. The phrase used in proviso to Section 112 i.e., 'before giving effect to provisions of second proviso to Section 48' has been misinterpreted by the Mumbai Tribunal.
- ▶ The benefit of concessional rate of proviso to Section 112 was extended to ZCBs vide Finance Act 2005. The third proviso specifically excludes the CII benefit for bonds while computing capital gains on bonds under Section 48. Hence, ZCBs are not eligible for the CII benefit but are specifically included under proviso to Section 112. If it is accepted that the eligibility of CII benefit (under the second proviso to Section 48) is a precondition for availing the benefit of concessional rate then, ZCBs would go out of the purview of Section 112 and this would lead to unintended results. Such interpretation which gives rise to unintended results or renders a word redundant should be avoided.
- ▶ Reliance was placed on an earlier decision of the AAR in the case of Timken France [294 ITR 513] wherein it was held that the proviso to Section 112 applies to all clauses of Section 112 covering both residents as well as NRs. The same view has been taken by the Mumbai Tribunal in BASF Aktiengesellschaft (*supra*).

- ▶ The benefit of the proviso to Section 112 could not be denied to NRs who were also entitled to relief from foreign exchange fluctuation in terms of first proviso to Section 48. Clear words would have been deployed if one particular category i.e., NRs were to be excluded from benefits of proviso to Section 112. Merely because a resident can have one of the benefits (either CII or 10% rate), NRs cannot be denied benefit of concessional rate as also benefit of computation of gain by conversion into foreign currency.
- ▶ The AAR in Timken's case also held that double benefit/additional relief was not a taboo under the law and merely because the NRs were protected from foreign exchange fluctuation, it did not follow that they should not avail of the benefit of 10% rate which the residents were permitted to avail of. Protection on account of fluctuation made available to NRs could be a justification to deny the benefit of CII, but, the same could not be said to apply to the lower rate of 10%.

AAR ruling

- ▶ While interpreting a taxing statute, the duty of the Court is to give effect to the intention of the Legislature, which can be gathered from the language employed and the context.
- ▶ The ambit of proviso to Section 112 extends to all sub-clauses to Section 112 i.e., it covers residents as well as NRs.

- ▶ Computation of capital gains under Section 48 is done after giving effect to the three provisos which have following coverage:
 - ▶ In case of NRs, the first proviso requires computation of capital gains arising on transfer of shares/debentures by considering the foreign exchange fluctuation. This benefit is available as a hedge to inflation.
 - ▶ Under the second proviso, all taxpayers can avail the CII benefit which is also a benefit against inflation except: (i) For NRs in respect of shares and debentures for which benefit is available under the first proviso; (ii) For debentures and bonds specifically excluded by the third proviso.
 - ▶ The third proviso denies the benefit of CII in respect of bonds and debentures except capital indexed bonds.

- ▶ A ZCB is a separate and distinct in nature from a bond, as understood in common parlance. The third proviso to Section 48 which restricts the benefit of CII to bonds and debentures does not cover ZCBs. Hence, a ZCB is eligible for CII benefit under the second proviso to Section 48. Even if there is a second view on the eligibility of ZCBs to the CII benefit, the explicit reference of ZCBs in the proviso to Section 112 confirms that the CII benefit should be available to ZCBs.

- ▶ Proviso to Section 112 requires determination of the amount of liability which exceeds, by comparing the tax payable at the rate of 20% on capital gains computed from transfer of listed securities, units or ZCBs and 10% of capital gains computed before giving effect to CII. The proviso requires integrated approach and cannot be read in isolation. Stated alternatively, proviso to Section 112 has two limbs:

- ▶ Determine the tax payable on the capital gains arising from the transfer of long-term capital asset on the income computed as per Section 48 of the ITL, including CII benefit, if available.
- ▶ Determine 10% of the capital gains arising from the transfer of long-term capital asset before giving effect to CII provisions.

If the value of (a) is greater than (b), ignore the excess.

The indexation formula under the second proviso to Section 48 enters into the computation in the limb (a) to Section 112 mentioned above. The scheme of the provisions thus requires that limb (b), mentioned above, is restricted to assets and taxpayers who are entitled to the CII benefit. Any other meaning would result in rewriting of the provisions of the statute.

- ▶ The phrase 'before giving effect to' connotes that the effect has otherwise to be given. Hence, for application of proviso to Section 112, the asset must be one qualified for CII benefit under the second proviso to Section 48 of the ITL. If proviso to Section 112 was supposed to apply also to the first proviso to Section 48 which gives benefit of exchange fluctuation protection to NR taxpayers, specific provision to that effect would have been made.
- ▶ The AAR ruling in the case of Timken France (*supra*) had not considered the legal proposition that ZCB are entitled to the CII benefit under the second proviso to Section 48. Also, in the said ruling, proviso to Section 112 was regarded as applicable to all taxpayers, rather than only those taxpayers who are entitled to CII benefit. Each ruling is confined to the facts and law projected in

the application leading to the ruling and binding only to the parties to the transaction. In a case where certain aspects germane to the issue are not examined by the Authority in the earlier ruling, subsequently, the AAR is not hampered from taking a fresh look at the issue.

- ▶ Application of proviso to Section 112 is based on capital assets (being units, securities and ZCBs) to which the provisions of second proviso to Section 48 apply and they do not apply to taxpayers which are not entitled to benefit of the CII. The NRs which are given protection against inflation in respect of shares/debentures of an Indian company and which are kept out of CII benefit in respect of such assets, are not eligible for benefit of 10% under Section 112 of the ITL.

Comments

The question of availability of concessional rate of tax of 10% on capital gains to an NR has not been free from doubt. Various Courts in the past have tried to interpret the provisions of the ITL in this regard. The view emerging from the earlier rulings (which includes rulings of the AAR, Tribunal) had largely been favorable to taxpayers and the issue is currently pending before the Supreme Court which would finally settle the matter.

This AAR ruling gives an unfavorable view by giving a varied interpretation of the provisions of the ITL and also by distinguishing its earlier ruling in the case of Timken France (*supra*). Though an AAR ruling is binding only on the Applicant and on the Tax Authority in respect of transaction in relation to which the ruling

is sought, however, it does have persuasive value. NRs would need to take note of this development. It is pertinent to note that Foreign Institutional Investors, which essentially have income from long-term capital gains, are, in any case, taxed at the rate of 10% under the ITL.

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