Tax alert: Mumbai ITAT explains difference in tax treatment of sale of shares of Indian companies holding real estate as investment vis-à-vis those engaged in development of real estate

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Summary

The Mumbai bench of Income Tax Appellate Tribunal (ITAT), in a recent ruling[1], held that capital gains arising to a non-resident taxpayer on sale of shares of Indian companies engaged in real estate development activity would not be taxable under the India-Spain tax treaty since the transfer of shares does not result in transfer of the rights or control over the underlying immovable property held by the Indian company.

Facts of the case

- During the year, the taxpayer earned capital gains from sale of shares held by it in six Indian companies engaged in the business of real estate development (classified under the BSE Realty Index) in India.
- The issue relates to the taxation of such income under the capital gains provisions i.e. Article 14(4), of the India-Spain tax treaty (tax treaty).
- The provision of article 14(4) of the tax treaty provides that gains from alienation of shares of a company, the property of which consists directly or indirectly, principally of immovable property situated in a jurisdiction will be taxable in that jurisdiction.
- The Commissioner of Income-tax (Appeals) decided the matter in favour of the taxpayer. He observed that the value of shares is based not just on the extent of the immovable property held as stock-in-trade, but on several other factors such as capital adequacy, projects in the pipeline, current profits and future prospects.
- His view was that as the taxpayer's shareholding in these companies was well under 7%, with such miniscule holdings, the taxpayer cannot be treated as having any rights in the immovable property of the companies.
- Revenue challenged the matter before the ITAT.

Revenue's contentions

- The investee companies were dealing in the real estate sector including the development of immovable properties and the value of the shares of such companies is derived 'principally' from the immovable properties held by these companies.
- It is immaterial whether the properties are held as stock-in-trade or as investments. Capital gains arising to the taxpayer would be taxable in India under article 14(4) of the tax treaty.
- Provisions of UN Model treaty on capital gains and tax treaty are not same and thus commentary of UN Model treaty cannot be applied to interpret its provisions.

Taxpayer's contentions

- As per the commentary on UN Model treaty, the provisions of a tax treaty come into play only in the case of indirect transfer of ownership of the immovable properties resulting by the transfer of shares in a company.

ITAT's ruling

- The capital gains article in the tax treaty provide taxing right to source jurisdiction (as an exception to general rule of providing taxing

[1] JCIT v Merrill Lynch Capital Market Espana SA SV [ITA No. 6108/Mum/2018]

rights to residence jurisdiction) in two cases, namely

(a) Capital gains on sale of immovable property; and

(b) Gain on sale of shares of a company, property of which principally consists of immovable properties. Such holding may be direct or indirect.

- The second exception takes colour from first exception. It is widely known that at times companies are floated mainly to hold immovable properties, as transfer of ownership of company, is far easier than transferring the ownership of underlying immovable property.
- Article 14(4) is only an extension of article 14(1). Hence, if the immovable property is held by the taxpayer on its own or through web of corporate structures, the gains on account of value appreciation of such immovable property must be taxed in source jurisdiction as well.
- The wordings of UN and OECD Model Convention differ from the tax treaty under consideration, however, the intent and purpose for which article 14(4) was introduced is not any different.
- The common thread in the UN and OECD model convention commentary is that the threshold to trigger taxation on alienation of shares of a company where underlying asset constitutes immovable property is of 51% or more of the aggregate value of assets.
- The expression 'principally' is not specifically defined in the tax treaty under consideration; however, the threshold test can be safely applied at 51% of total assets.
- The scope of article 14(4) of the tax treaty must essentially remain confined to the shares which, taken on standalone basis or as a cumulative effect of the related transactions, lead to the control of the company or, in any other way, give right to enjoy or occupy the underlying immovable property owned by the company in question and such property must be what the company in question principally holds. Alienation of shares, directly or indirectly results in the control and enjoyment, of the underlying property, changing hands too.
- In the instant case, the taxpayer sold not more than 2% shares in any of the six companies, as an investor. There is no question of holding any controlling interest or even significant interest in these companies.
- All these companies are engaged in the business of real estate development rather than holding real estate as an investment. The business model of realty companies is focused on gains from real estate development rather than gains from holding immovable property.
- The tax officer has not examined the facts but proceeded on an incorrect presumption that the property of every company listed on BSE realty index principally consists of immovable properties.
- Finally, it was held that in this case the gains from sale of shares was not taxable in India.

Our comments

The ITAT dwelt upon and clarified the taxation of disposal of investment in an Indian company deriving value principally from immovable property situated in India, whereby capital gains which are otherwise taxable in country of residence are taxable in India.

This ruling brings out a distinction in the business models focused on gains from real estate development vis-à-vis gains from holding immovable properties as investments. It clarifies that in such cases, for the purpose of taxing the capital gains on sale of shares in India, the following conditions have to be fulfilled:

(a) The non-resident should have substantial interest in the Indian company making real estate investments in India; and

(b) The real estate company in addition to the principally deriving value from the property in India should be deriving income from the real estate held as investments and not from real estate development activities.

This decision would also be useful in interpreting other tax treaties having similar provisions such as the Spain, Korea, Luxembourg, Ireland tax treaties.

Contact us

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NEW DELHI National Office Outer Circle L 41 Connaught Circus, New Delhi 110001 T +91 11 4278 7070	**NEW DELHI** 6th floor, Worldmark 2, Aerocity, New Delhi – 110037 T +91 11 4952 7400	**AHMEDABAD** 7th Floor, Heritage Chambers, Nr. Azad Society, Nehru Nagar, Ahmedabad - 380015	**BENGALURU** 5th Floor, 65/2, Block A, Bagmane Tridib, Bagmane Tech Park, C V Raman Nagar, Bengaluru – 560093 T +91 80 4243 0700	**CHANDIGARH** B-406A, 4th Floor, L&T Elante office Industrial area, Phase-I, Chandigarh 160002 T +91 172 4338 000
CHENNAI 7th Floor, Prestige Polygon 471, Anna Salai, Teynampet Chennai - 600 018 T +91 44 4294 0000	**DEHRADUN** Suite 2211, Michigan Avenue, Doon Express Business Park, Saharanpur Road, Dehradun – 248002 T +91 135 264 6500	**GURGAON** 21st Floor DLF Square, Jacaranda Marg, DLF Phase II, Gurgaon 122002 T +91 124 462 8000	**HYDERABAD** 7th Floor, Block III White House Kundan Bagh, Begumpet Hyderabad 500016 T +91 40 6630 8200	**KOCHI** 7th Floor, Modayil Centre Point, Warriam road junction, M.G. Road, Kochi 682016 T +91 484 406 4541
KOLKATA 10C Hungerford Street 5th Floor, Kolkata 700017 T +91 33 4050 8000	**MUMBAI** 16th Floor, Tower II Indiabulls Finance Centre SB Marg, Prabhadevi (W) Mumbai 400013 T +91 22 6626 2600	**MUMBAI** Kaledonia, 1st Floor, C Wing (Opposite J&J office) Sahar Road, Andheri East, Mumbai 400069	**NOIDA** Plot No. 19A, 7th Floor Sector – 16A, Noida 201301 T +91 120 4855 900	**PUNE** 3rd Floor, Unit No 309 to 312, West Wing, Nyati Unitree, Nagar Road, Yerwada Pune- 411006 T +91 20 6744 8800

For more information or for any queries, write to us at **contact@in.gt.com**

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