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High Court rules India can't tax Dutch company's sale of shares of in Indian company that holds Indian immovable property

Posted on July 25, 2017 in Asia-Pacific, Featured News, India

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The High Court of Andhra Pradesh has concluded in a recent decision that gains arising from a Dutch company's sale of shares of an Indian immovable property company to a Singapore company do not amount to a sale of immovable property situated in India. As such, the transaction is not taxable in India under the India-Netherlands tax treaty, the Court has ruled.

The decision, *Director of Income Tax v. Vanenburg Facilities BV [Income Tax Appeal Nos. 55 & 71 of 2014 w/ Writ Petition No. 41469 of 2015*, published June 28, is significant considering the Netherlands' growing role as the preferred holding jurisdiction for hosting Indian investments.

The facts of the case are fairly straightforward. Vanenburg IT Park Limited ("VITPL") is an Indian company that owned land in Hyderabad and is engaged in the business of development, operation, and maintenance of an industrial park constructed on the land.

The taxpayer, Vanenburg Facilities BV, a Dutch BV company, sold its entire shareholding in VITPL to the Ascendas Property (Fund) India Pte Limited, a private company incorporated in Singapore.

A certain amount of interest was also paid to the taxpayer due to delayed payment of the sale consideration.

The taxpayer made an application to the Indian tax department for a nil withholding tax certificate on the sale consideration and interest; however, the tax authorities denied the request and passed an order directing the buyer to withhold tax on the sale consideration and interest. The taxpayer then claimed a refund of the entire tax withheld on the sale consideration and interest.

Indian immovable property used for business

The assessing officer ("AO") held that the gains arising from the transfer of shares of VITPL were taxable in India. The AO reasoned that the shares of VITPL constituted 'immovable property' under India's domestic tax laws, and therefore, Article 13(1) of the India-Netherlands tax treaty, which specifically provides that gains arising from the transfer of 'immovable property' situated in India may be taxed in India, would apply.

The AO found Article 13(4) of the India-Netherlands tax treaty to be inapplicable in the present case. Article 13(4) provides that gains arising from the transfer of shares constituting more than 25% of the share capital of an Indian company, whose value is derived principally from immovable property situated in India (other than property in which the business of the company is carried on) are taxable in India.

Since, in the present case, the value of shares of VITPL was derived from immovable property used for its business purposes, the AO found Article 13(4) inapplicable.

Since Article 13(1) was applicable, the AO found Article 13(5) to also be inapplicable. Article 13(5) is the residual clause and provides that gains arising from a transfer of shares of an Indian company whose value is not derived principally from immovable property (other than property in which the business of the company is carried on) should be taxable only in the Netherlands, with an exception for transfers to Indian residents (not undertaken in the course of a corporate reorganization).

The taxpayer appealed to the Commissioner of Income Tax (Appeals) (CIT(A)), who upheld the AO's ruling. The taxpayer preferred a second appeal to the Tribunal. Allowing the appeal, the Tribunal ruled that Article 13(1) had no application in the present case and it was Article 13(5) which would be applicable. The tax authorities, however, appealed to the High Court.

High Court ruling

Upholding the Tribunal's ruling, the High Court held that Article 13(5) of the Dutch treaty would be applicable to the gains arising from the sale of shares of VITPL and therefore the gains were not taxable in India.

The High Court upheld the legal principle that a company is a separate legal entity from its shareholders and the fact that all its shares may be owned by one person has nothing to do with its separate legal existence.

The High Court rejected the idea that the definition of immovable property under India's domestic tax law (intended to be used in very specific scenarios) should be regarded as "law of the State" under Article 6 of the India-Netherlands tax treaty, favouring a more traditional definition of immovable property (such as that under India's Transfer of Property Act).

The High Court also refused to allow the tax authorities to apply Article 13(4) of the Dutch tax treaty to the transaction by raising a new argument that the immovable property of VITPL was not actually immovable property in which the business of VITPL was carried on since the tax authorities had failed to raise these arguments either before the CIT(A) or the Tribunal.

Analysis

In concluding that the sale of shares of a company deriving substantial value from immovable property would not be tantamount to a sale of immovable property, the High Court adhered to a longstanding principle of corporate law that the property of a company is not the property of its shareholders.

The shareholders of a company typically neither occupy nor enjoy ownership rights over the property of a company, having no rights in the immovable property of the company but only in an interest in its shares. A shareholders' rights are usually limited to electing directors, participating in profits (dividends) and sharing in the surplus of a company on its winding up.

Interestingly, the litigation strategy of the revenue authorities appears to have been flawed, given their failure to challenge the finding of the AO that VITPL carried on its business from the immovable property.

Had this finding of fact been challenged earlier, it is possible that Article 13(4) of the India Netherlands tax treaty would have applied, leading to taxation of the gains in India.

The wording "property in which the business of the company was carried on" found in the Dutch treaty is similar to the language of Article 13(4) of the UN Model Convention. The Commentary to the UN Model Convention states that the basis for the inclusion of such language was "to exclude from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities." As it stands, we will have to wait for more clarity from the courts on the exact scope of the wording.

India & Netherlands MLI elections

In the context of the OECD/G20 base erosion profit shifting (BEPS) project and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "MLI"), it is worth noting that, pursuant to the provisional notifications submitted by both India and the Netherlands, paragraph 1 of Article 9 of the MLI will be applicable to Article 13(4) of the Dutch tax treaty.

Paragraph 1 introduces a testing period for determining whether the condition on the value threshold is met and expands the scope of interests covered by that paragraph to include interests comparable to shares, such as interests in a partnership or trust.

A question that may arise is whether the requirement of Article 13(4) of the India-Netherlands's tax treaty, that the immovable property should not be immovable property used in the business of the immovable property company, will continue to stand.

Seeing as how the Explanatory Statement to the MLI states that "where Covered Tax Agreements contain exceptions to the application of the existing provisions (for example, some Covered Tax Agreements may exclude gains derived from the alienation of shares of companies that are listed on an approved stock exchange of one of the Contracting Jurisdictions), those exceptions would continue to apply," there appears to be no reason why it should not.

Aggressive tax authorities

Lastly, this case serves as a troubling reminder that the lower level tax authorities often adopt aggressive positions contrary to law, as is evidenced by the initial order requiring that tax be withheld, as well as the later orders of the AO and the CIT(A).

Taxpayer's are frequently required to pursue litigation to the Tribunal or High Court level to obtain a favourable outcome, and even then, the tax authorities often prefer an appeal.

In the backdrop of major legislative changes to India's domestic tax law, like the place of effective management test for corporate residence, the general anti-avoidance rule, and the principal purpose test in the MLI, the current approach of the Indian tax authorities will no doubt result in massive amounts of litigation and will only stymy the Indian government's efforts to improve the ease of doing business.

It is therefore essential to eliminate adversarial approach towards taxpayers, and move to a trust based system of taxation, perhaps by introducing a charter of taxpayer rights which guarantees enforcement of tax laws in a fair, equitable, and non-arbitrary manner, which would also no doubt be well received by taxpayers across the board.

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