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# TAX ISSUES ARISING OUT OF A SALE OF INDIAN SECURITIES BY A NON-RESIDENT TO A RESIDENT

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One of the fundamental drivers of any transaction involving the sale of securities is the impact of tax laws on such transaction. In a securities sale transaction, if the seller is a non-resident, the complexities increase. This paper delves into the various tax issues that arise when a person resident outside India sells his/her/its stake in an Indian company to a person resident in India.

# 1. Taxability of the Income of a Non-resident:

In India, the taxability of a person's income is dependent on such person's residential status. A person resident outside India is not liable to Indian tax authorities or subject to Indian tax laws unless such non-resident has income arising in India.

### *1.1. Who is a non-resident?*

Section 2(30) of the Income Tax Act, 1961 ("**IT Act**") defines a non-resident to be a person who is not a "resident" and a resident is defined as a person who is resident in India within the meaning of section 6 of the Act.

Section 6 details the criteria of being a resident for (i) individuals and (ii) companies.

1.1.1. For an **individual**, section 6(1) provides as follows:

*"(1) An individual is said to be resident in India in any previous year, if he —*

*(a) is in India in that year for a period or periods amounting in all to one hundred and eighty-two days or more; or*

*(b) having within the four years preceding that year been in India for a period or periods amounting in all to three hundred and sixty-five days or more, is in India for a period or periods amounting in all to sixty days or more in that year."*

1.1.2. For a **company**, section 6(3) provides as follows:

*"(3) A company is said to be a resident in India in any previous year, if —*
*(i) it is an Indian company; or*
*(ii) its place of effective management, in that year, is in India.*

*Explanation — For the purposes of this clause "place of effective management" means a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made."*

Under the Act, a "company" is defined to include, *inter alia*, an Indian company and a body corporate incorporated by or under the laws of a country outside India.

Therefore, individuals and/or companies not satisfying the criteria laid down under section 6(1) and (3) of the IT Act shall be considered to be "non-residents" for the purpose of computation of tax under the Act.

### *1.2. What portion of a non-resident's income is subject to Indian taxation?*

Section 5 of the IT Act explains what constitutes the "total income" of a non-resident. According to section 5(2):

*"(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which —*

*(a) is received or is deemed to be received in India in such year by or on behalf of such person; or*

*(b) accrues or arises or is deemed to accrue or arise to him in India during such year.*

*Explanation 1 — Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.*

*Explanation 2 — For the removal of doubts, it is hereby declared that income which has been included in the total income of a person on the basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India."*

*1.3. When is income deemed to arise in India for a non-resident?*

Section 9 of the IT Act categories income which is deemed to arise in India. The relevant parts of the section are reproduced hereinbelow:

*"(1) The following incomes shall be deemed to accrue or arise in India —*

*(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India."*

*1.4. What is a "transfer"?*

Section 2(47) of the IT Act defines "transfer", in relation to a capital asset to include the following:

a. the sale, exchange or relinquishment of the asset; or
b. the extinguishment of any rights therein; or
c. the compulsory acquisition thereof under any law; or
d. in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment; or
e. the maturity or redemption of a zero coupon bond; or
f. any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882); or
g. any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

*1.5. Transactions not regarded as transfer:*

Section 47 of the IT Act lists transactions which cannot be regarded as a "transfer" for the purposes of the IT Act. The following transactions are particularly noteworthy exclusions:

(i) any transfer of a capital asset by a company to its subsidiary company, if —
(a) the parent company or its nominees hold the whole of the share capital of the subsidiary company, and
(b) the subsidiary company is an Indian company;

(ii) any transfer of a capital asset by a subsidiary company to the holding company, if —
(a) the whole of the share capital of the subsidiary company is held by the holding company, and
(b) the holding company is an Indian company;

Provided that sub clauses (i) and (ii) hereinabove will not be applicable in case of transfer of a capital asset as stock in trade.

(iii) any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company;
(iv) any transfer or issue of shares by the resulting company, in a scheme of demerger to the shareholders of the demerged company if the transfer or issue is made in consideration of demerger of the undertaking.

## 2. Are "Securities" Capital Assets or Stock-in-Trade?

As per section 45(1) of the IT Act, any profits or gains arising from the transfer of a capital asset effected in the previous year shall be chargeable to income-tax under the head "capital gains".

Further, section 28 of the IT Act treats any profits and gains of any business or profession carried on by the assessee in the previous year to be chargeable to income-tax under the head of "profits and gains of business or profession" ("**Business Income**"). While sale of a capital asset could give rise to capital gains, the sale of stock-in-trade could give rise to Business Income. Since Business Income is taxed at a higher rate than capital gains, it would be preferable if the securities that are being sold by a non-resident to a resident are treated as capital assets instead of stock-in-trade.

### *2.1. What is a capital asset?*

Section 2(14) of the IT Act defines a "capital asset" to include:

*"(a) property of any kind held by an assessee, whether or not connected with his business or profession;*
*(b) any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under the Securities and Exchange Board of India Act, 1992 (15 of 1992)."*

Section 2(14) also includes a list of items which are excluded from the definition of a capital asset, which includes, amongst other things, any stock-in-trade other than the securities referred to in sub-clause (*b*), consumable stores or raw materials held for the purposes of his business or profession.

Securities of an Indian company which are not expressly classified as stock in trade, may be regarded as "property" under Section 2(14) (a) of the IT Act and consequently treated as a capital asset. The Central Board of Direct Taxes has issued several circulars (detailed hereinbelow) to help in assessing whether securities should be treated as capital asset or as stock-in-trade.

### *2.2. Classification of capital gains*

The capital gains arising from the transfer short-term capital assets ("**Short-Term Capital Assets")** are charged at a higher tax rate as compared to capital gains arising from the transfer of long term capital assets ("**Long Term Capital Assets**").

Section 2(42A) of the IT Act defines a Short-Term Capital Asset as a capital asset held by an assessee for not more than 36 (thirty six) months immediately preceding the date of its transfer.

Long Term Capital Assets are those capital assets which are held for more than a period of 36 (thirty six) months immediately preceding the date of their transfer.

However, the third proviso to section 2 (42A) of the IT Act provides that in the case of a **share of a company** (not being a share listed in a recognised stock exchange in India), or an immovable property, being land or building or both, an asset held for not more than 24 (twenty four) months qualifies as a short term capital asset.

Therefore, capital gains arising out of the transfer of unlisted shares of Indian companies are chargeable as long term capital gains if such shares are held for a minimum of 24 (twenty four) months before transferring. However, unlisted securities other than shares have to be held for a minimum of 36 (thirty six) months before transferring for the profits to be classified as long term capital gains.

The period of holding of capital assets and the cost of acquisition of the securities is based on *First-in-First-out* method as per Section 45 (2A) of the IT Act. This implies that, for securities that are accumulated over a period of time, if only a portion of the securities held by the transferor are transferred, for the computation of capital gains it would be assumed that transfer pertains to the earliest assets acquired.

*2.3. <u>What is stock-in-trade?</u>*

The IT Act does not define the term stock-in-trade. In case of *H. Mohammad & Co.* v. *CIT*[1], while distinguishing between a capital asset and a stock in trade, the Gujarat High Court observed with following in respect to a stock-in-trade:

"*In view of the generally understood meaning of the words "stock-in-trade" in the commercial world, it is obvious that this phrase "stock-in-trade" means all those goods or commodities in which the particular individual deals in the sense of buying and selling in the course of his business activity and it cannot be said to include a commodity which is acquired for the purpose of being let to hire………*

*…….. these two illustrations of the circulating library and the car-hiring business clearly go to show the essential characteristics of stock-in-trade, viz., that it must be a commodity in which there is a dealing, i.e., which is bought and sold as distinguished from a commodity with which the business is carried on, viz., from the exploitation of which the income is derived. The distinction is between selling outright in the course of the business activity as distinguished from deriving income from exploitation of one's assets*."

Thus, a stock-in-trade is something in which an individual deals, whereas his capital asset is something with which he deals.

*2.4. <u>Guidance provided by CBDT</u>*

2.4.1. The Central Board of Direct Taxes ("**CBDT**") in its circular no. 4/2007, dated June 15, 2007, made a clear distinction between shares held as stock in trade and shares held as investment. The CBDT made references to various judicial pronouncements on the matter, the most notable being the principles formulated by the Authority for Advance Rulings ("**AAR**") in the case of *Fidelity Northstar Fund and others,*[2] based on various Supreme Court rulings. The principles are detailed hereinbelow:

*"(i) Where a company purchases and sells shares, it must be shown that they were held as stock-in-trade and that existence of the power to purchase and sell shares in the memorandum of association is not decisive of the nature of transaction;*

*(ii) the substantial nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and sales and the holding would furnish a good guide to determine the nature of transactions;*

*(iii) ordinarily the purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade/adventure in the nature of trade; but where the object of the investment in shares of a company is to derive income by way of dividend etc. then the profits accruing by change in such investment (by sale of shares) will yield capital gain and not revenue receipt".*

[1] *H. Mohammad & Co.* v. *CIT*, (1977) 107 ITR 637.
[2] *In re: Fidelity Northstar Fund and others,* (AAR) (288 ITR 641).

In the case of *Fidelity Northstar Fund and others,*[3] the AAR held the shares held by the applicant, an FII, to be capital assets and not as business assets.

2.4.2. To guide the assessing officers, the CBDT vide office memorandum dated December 13, 2005 [F. No. 149/287/2005-TPL] laid down the following guidelines to distinguish between shares held as stock-in-trade and shares held as investment:

- Whether the purchase and sale of securities was allied to his usual trade or business/was incidental to it or was an occasional independent activity;
- Whether, the purchase is made solely with the intention of resale at a profit or for long-term appreciation and/or for earning dividends and interest;
- Whether scale of activity is substantial;
- Whether transaction was entered into continuously and regularly during the assessment year;
- Whether purchases are made out of own funds or borrowings;
- The stated objects in the Memorandum and Articles of Association in the case of corporate assessee;
- Typical holding period for securities bought and sold;
- Ratio of sales to purchase and holding;
- The time devoted to the activity and the extent to which it is the means of livelihood;
- The characterization of securities in the books of account and balance sheet as stock-in-trade or investment;
- Whether the securities purchased or sold are listed or unlisted;
- Whether investment is in sister/related concerns or independent companies;
- Whether transaction is by promoters of the company;
- total number of stock dealt in;
- whether money has been paid or received or whether these are only book entries.

2.4.3. CBDT issued a circular 6/2016 dated February 29, 2016 which provided that an assessee who held listed shares for more than twelve (12) months had the option to treat and reflect income from sale of shares either as income from business or as income from capital gains. However, this option could only be availed by a person having such income from listed shares. Further, once an assessee had taken a stand, he/she/it would not be allowed to change his/her/its stand again. CBDT further issued a clarificatory letter [F.NO.225/12/2016/ITA.II] dated May 2, 2016, wherein it stated that the income arising from transfer of 'unlisted shares' would be regarded as income under the head 'capital gains', irrespective of the period of holding of such unlisted shares. However, it would not be necessarily applied in the following cases:

- the genuineness of transactions in unlisted shares itself is questionable; or
- the transfer of unlisted shares is related to an issue pertaining to lifting of corporate veil; or
- the transfer of unlisted shares is made along with the control and management of underlying business.

In such cases, the assessing officer is required to take an appropriate view.

## 3. Place of Effective Management:

3.1. Section 6 of the IT Act sets out the parameters for determining if a person is resident in India in any previous year. Companies which are not Indian companies will also be deemed to be resident in India for any previous year, if in such year its place of effective management ("**POEM**") was in India. Place of effective management ("**POEM**") is the place

[3] *Ibid.*

where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made. POEM is an internationally recognised test for determination of residence of a company incorporated in a foreign jurisdiction. The CBDT issued a circular dated January 24, 2017 ("**January Circular**") wherein it laid down certain guiding principles to be followed for determination of POEM. Some of the relevant guidelines are as follows:

(i) The January Circular clarifies that a company shall be said to be engaged in "active business outside India" if the passive income of such a company is not more than 50% of its total income; and (i) less than 50% of its total assets are situated in India; and (ii) less than 50% of total number of employees are situated in India or are resident in India; and (iii) the payroll expenses incurred on such employees is less than 50% of its total payroll expenditure.

(ii) Any determination of the POEM will depend upon the facts and circumstances of a given case.

(iii) Since "residence" is to be determined for each year, POEM will also be required to be determined on a year-to-year basis. The process of determination of POEM would be primarily based on the fact as to whether or not the company is engaged in active business outside India.

(iv) The POEM in case of a company engaged in active business outside India shall be presumed to be outside India if the majority meetings of the board of directors of the company are held outside India. However, if on the basis of facts and circumstances it is established that the board of directors of the company are standing aside and not exercising their powers of management and such powers are being exercised by either the holding company or any other person (s) resident in India, then the place of effective management shall be considered to be in India.

3.2. The January Circular also laid down guidelines to determine the POEM in cases of companies other than those that are engaged in active business outside India.

3.3. The CBDT issued a supplemental circular dated February 23, 2017, wherein it stated that that the January Circular would not apply to companies having turnover or gross receipts of Rs. 50,00,00,000 (Rupees fifty crore) or less in a financial year. It further clarified that Section 6(3)(ii) of the IT Act shall not apply to a company having turnover or gross receipts of Rs. 50,00,00,000 (Rupees fifty crore) or less in a financial year.

3.4. If any foreign entity is determined to have a POEM in India, it will be considered an Indian resident. If a foreign company selling shares of an Indian company to an Indian buyer is determined to have a POEM in India, it will be taxed as an Indian resident. Therefore, any seller claiming non-resident status should be able to demonstrate that it does not have a POEM in India.

# 4. Computation of Capital Gains:

Section 50CA of the IT Act provides for the computation of capital gains arising from the transfer of shares of an unlisted company.

*4.1. Sale of securities below fair market value*

Section 50CA of the IT Act provides that where shares of an unquoted (unlisted) company are sold below the prescribed fair market value ("**FMV**"), such FMV is deemed to be the sale consideration for the purpose of the computation of capital gains.

Section 50CA of the IT Act reads as follows:

Where the consideration received or accruing as a result of the transfer by an assessee of a capital asset, being share of a company other than a quoted share, is less than the fair market value of such share determined in such manner as may be prescribed, the value so determined shall, for the purposes of section 48, be deemed to be the full value of consideration received or accruing as a result of such transfer.

*4.2. Sale of securities above fair market value*

If securities are sold at a price higher than the fair market value of such securities, the actual sale price of the securities shall be used to compute capital gains arising from such sale.

*4.3. Calculation of FMV*

4.3.1. The IT Rules provide for the calculation of FMV under Rules 11UA and 11UAA of the Income-tax Rules, 1962 (the "**IT Rules**").

4.3.2. The FMV of unlisted equity shares on the date on which shares are transferred ("**valuation date**"), for the purpose of section 50CA of the IT Act is prescribed to be the book valuation of such equity shares subject to certain prescribed adjustments provided under ***Rule 11UAA (1) (c) (b)*** of the IT Rules***.*** The FMV of securities other than equity shares of unlisted companies as per ***Rule 11UAA (1) (c) (c)*** of the IT Rules is provided as the price which such a security would fetch if sold in the open market on the valuation date. The transferor may obtain a report from a merchant banker or an accountant to substantiate the ascertained price.

4.3.3. Rule 11UAA of the IT Rules reads as follows:

*"For the purposes of section 50CA, the fair market value of the share of a company other than a quoted share, shall be determined in the manner provided in sub-clause (b) or sub-clause (c), as the case may be, of clause (c) of sub-rule (1) of rule 11UA and for this purpose the reference to valuation date in the rule 11U and rule 11UA shall mean the date on which the capital asset, being share of a company other than a quoted share, referred to in section 50CA, is transferred.*

*Explanation — For the purposes of this section, "quoted share" means the share quoted on any recognised stock exchange with regularity from time to time, where the quotation of such share is based on current transaction made in the ordinary course of business."*

4.3.4. Rule 11UA (1) (c) (b) and 11UA (1) (c) (c) of the IT Rules referenced in Rule 11UAA provide the detailed calculation formula to ascertain the FMV.

11UA (1) (c) (b)

*"the fair market value of unquoted equity shares shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner, namely—*

*the fair market value of unquoted equity shares = (A+B+C+D - L) × (PV)/(PE)….."*

11UA (1) (c) (b) (c)

*"the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of which such valuation."*

*4.4. Application of Section 281 of the IT Act to securities*

4.4.1. Section 281 of the IT Act seeks to prevent Income tax assesses from alienating their assets in order to avoid paying income tax. This section provides that, if during the pendency of any proceeding under the IT Act or after the completion of proceedings, but before the service of notice for recovery of income tax arrears, any assessee transfers title or possession of any of the assessee's assets to a third person or creates a charge on any of the assessee's assets in favour of a third person ("Transfer"), such Transfer shall be void as against any claim in respect of any tax or any other sum payable by the assessee as a result of the completion of the said proceeding or otherwise, unless it meets one of the following conditions:

- the Transfer was for adequate consideration and without notice of the pendency of such proceeding or, as the case may be, without notice of such tax or other sum payable by the assessee; or
- the Transfer was with the previous permission of the Assessing Officer.

4.4.2. Section 281 defines an "asset" to mean land, building, machinery, plant, shares, securities and fixed deposits in banks, however, it excludes all assets which form a part of stock-in-trade from its ambit. Therefore, if the securities that are to be sold are classified as "stock in trade" and not as a "capital asset" section 281 will not apply.

4.4.3. The impact of Section 281 of the IT Act is that in every transaction for the sale and purchase of securities that are capital assets, buyers seek reassurance that the securities they purchase shall not be taken away from them by the tax authorities on account of the seller's tax liabilities. A sale of securities by a non-resident will also be subject to Section 281.

4.4.4. Buyers usually take one of the following routes to stay safe from the aforesaid Section 281:

4.4.4.1. A buyer may obtain the written consent of the seller's assessing officer prior to the sale. Obtaining such written consent would have the effect of ensuring that the sale transaction is invulnerable to Section 281. However, such a process may take a few months and is not an easy task.

The CBDT, vide a circular no. 4/2011 [F. NO. 402/69/2010-ITCC] dated July 19, 2011 ("**July Circular**") has prescribed guidelines for assessing officers to grant a certificate permitting the transfer under section 281. The seller (taxpayer) is required to apply for the certificate (using a form annexed to the July Circular) at least 30 (thirty) days prior to the proposed date of transaction. As per the July Circular:

- If there is no demand outstanding and there is no likelihood of demand arising in the next 6 (six) months, then the permission should be granted within 10 (ten) working days of the receipt of the application.

- If an undisputed demand is outstanding and there is no likelihood of demand arising in next 6 (six) months, then the seller (taxpayer) should pay the same along with interest due thereon and then permission should be granted within 10 (ten) working days of the payment.

- If a disputed demand is outstanding, then the taxpayer should obtain stay for the same and indemnify the outstanding demand by way of bank guarantee or sufficient assets or by the IT Department retaining the first charge on the assets proposed to be transferred to the extent of such demand. Thereafter, permission under section 281 should be granted by the assessing officer within 10 (ten) working days of the indemnification of the demand.

- If a demand is likely to arise in the next 6 (six) months, then the assessing officer should explore the possibility of taking action prescribed under section 281B[4]. If a demand is likely to arise in the next 6 (six) months and the assessing officer is considering actions prescribed under section 281B for the assets excluding the asset under consideration, then the assessing officer should grant the permission within 15 (fifteen) working days of the receipt of the application.

The validity of the letter granting permission under section 281 would be 180 (one hundred eighty) days from the date of issue of approval, or the service of order of attachment under section 281B whichever is earlier.

4.4.4.2. A buyer may seek a certificate from a chartered accountant who has reviewed the seller's past income tax returns and records of all proceedings under the IT Act, to the effect that that there is little or no possibility of the income tax department appropriating the securities purchased from the seller. Such a certificate would not offer the same degree of protection as getting the written consent of the seller's assessing officer; or

4.4.4.3. A buyer may obtain a representation from the seller to the effect that there are no pending tax proceedings or outstanding demands against the seller initiated by taxation authorities, nor any orders passed by taxation authorities, that prohibit the proposed securities sale by the seller to the buyer or are likely to adversely affect the buyer's title to the securities or likely to render sale of securities to the buyer, void or voidable, under Section 281 of the IT Act. A breach of such a representation would give raise to a claim for damages. A criminal complaint for fraudulent misrepresentation would also lie if the seller had acted fraudulently when giving such representation.

# 5. Minimum Alternate Tax

5.1. Section 115JB of the IT Act provides for the imposition of a Minimum Alternate Tax ("**MAT**") on companies. As per this section, in the event the total income tax payable by an assessee company on its total income (as computed under the IT Act) is less than 15% of its book profit, such book profit shall be deemed to be the total income of the assessee company and be taxed at the rate of 15%.[5] In furtherance of this provision, the assessee company is required to prepare a statement of profit and loss in accordance with the provisions of the Companies Act, 2013, and the IT Act.

5.2. It is noteworthy that MAT applies only to companies. The legislative intent behind this section is to tax companies that earn profits, but show no taxable income.

5.3. A company's "Book profit" is the profit recorded in its books of accounts. Usually a company's book will record profits when any capital asset appreciates in values, though sale of such capital asset would be required to generate capital gains that can be taxed. For example, if in 2010 Company A purchased shares of XYZ Limited for INR. 1 million and in 2021, such shares are worth INR. 10 million, Company A has a book profit of INR. 9 million. However, unless the shares of XYZ Limited are sold by Company A, there would be no taxable capital gains. However, under Section 115JB of the IT Act, MAT would be payable on such book profits if total income tax payable by Company A on its total income (as computed under the IT Act) is less than 15% of its book profit of INR 9 million.

[4] Section 281B, Provisional attachment to protect revenue in certain cases.
[5] The rate of 15% is as applicable from April 1, 2020 and is subject to further revision.

5.4. Explanation 1 of Section 115JB lists out the amounts that should be considered for the calculation of book profit if such amount is debited to the statement of profit and loss and this list includes the amount of income-tax paid or payable, and any provision made for such payment, amounts set aside to meet liabilities, other than ascertained liabilities, provisions made for losses of subsidiary companies, dividends paid or proposed to be paid, depreciation, deferred tax, any provision made for the diminution in the value of any asset, etc.

5.5. When a foreign company sells securities of an Indian company, sub-clause (fb) of Explanation 1 to Section 115JB requires that the expenses relating to the income accruing or arising from the capital gains arising on such sale have to be added to the book profit if such expenses have been debited to the statement of profit and loss of the seller, provided the income tax payable on such capital gains is less than 15%. For example, if the brokerage paid to facilitate the sale of securities has been deducted from the seller's profit and loss statement, such brokerage needs to be added to the book profit, provided the income tax payable on such capital gains is less than 15%. As per sub-clause (iid) of Explanation 1 to Section 115JB, when a foreign company sells securities of an Indian company, if the capital gains arising out of such transaction has been credited to the seller's statement of profit and loss and the income-tax payable on such capital gains is less than 15%, such capital gain has to be reduced from the book profit.

5.6. Consider a foreign company that sells securities of an Indian company for INR 10 Million, has capital gains of INR 8 Million, spent INR. 0.5 million on brokerage, has net capital gains of INR 7.5 Million and whose income tax liability on account of such capital gains is less than 15% of such INR 7.5 Million. If sub-clauses (fb) and (iid) of Explanation 1 to Section 115JB didn't exist, the book profit would include the net capital gains (of INR 7.5 Million) from the sale and the seller would be required to pay 15% of such book profit. Sub-clauses (fb) and (iid) of Explanation 1 to Section 115JB effectively negate the impact of the securities sale transaction on the seller's book profit and loss statement. In other words, a foreign seller's book profit, for the purpose of MAT, has to be calculated by ignoring the securities sale transaction. If total income tax payable by the seller on its total income is less than 15% of its book profit (which shall not include the net capital gains arising from securities sale), such book profit shall be deemed to be the total income of the seller and be taxed at the rate of 15%.

5.7. As per Explanation 4 to Section 115JB of the IT Act, MAT will not be imposed on an assessee that is a foreign company if:

(i) the assessee is a resident of a country or a specified territory with which India has a Double Taxation Avoidance Agreement ("**DTAA**") as specified in Section 90 of the IT Act, or the central government has adopted an agreement with a specified as provided for under Section 90A of the IT Act, provided that the assessee does not have a "permanent establishment" in India in accordance with the provisions of such agreement(s); or

(ii) the assessee is a resident of a country with which India does not have a DTAA, and the assessee is not required to seek registration under any law relating to companies. As per Section 380 of the Companies Act, 2013 ("**Companies Act**") a foreign company shall be required to register itself in India within 30 (thirty) days of establishing a place of business in India.

5.8. A permanent establishment is defined in Section 92F(iiia) of the IT Act as including a fixed place of business through which the business of an enterprise is wholly or partly carried on. Permanent establishments are more expansively defined under DTAAs. For example, the 'Agreement for Avoidable of Double Taxation and Prevention of Fiscal Evasion With

Mauritius', signed by India and Mauritius ("**Mauritius DTAA**") defines the term "permanent establishment" as a fixed place of business through which the business of the enterprise is wholly or partly carried on, which includes a place of management, a branch, an office, a factory, a workshop, a warehouse, and the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise, but only where such activities continue for a period aggregating more than 90 days within any 12 month period. A representative office or a liaison office would not be considered as a permanent establishment if such representative office or liaison office does not undertake any trade, commercial or industrial activities.[6]

The Mauritius DTAA also places limitations on what may be considered a permanent establishment. For example, a permanent establishment shall not be deemed to include the use of facilities solely for the purpose of storage or display of merchandise, maintenance of stock of goods relating to the storage or display of merchandise, maintenance of a fixed place of business for purchase of goods or merchandise, or maintaining a fixed place of business solely for:

(a) for the purpose of advertising,
(b) for the supply of information,
(c) for scientific research, or
(d) for similar activities.

5.9. A 'place of business' is broadly construed by the Companies Act, with Section 2(42) clarifying that a foreign company may have a 'place of business' in India through itself, an agent or through electronic mode, and must conduct business in India to be considered a 'foreign company' for the purposes of the Companies Act. Thus, a foreign company that does not meet the aforementioned criteria under the Companies Act and is deemed to not have a place of business in India will be exempt from payment of MAT, irrespective of whether it is resident of a country that has a DTAA with India.

5.10. The threshold to be considered to have a place of business' in India that requires registration as a foreign company under the Companies Act, is lower than the threshold to be considered to have a permanent establishment in India. However, these two yardsticks are applied by Explanation 4 to Section 115JB to distinct categories of entities. Whether an assessee has a permanent establishment or not is relevant only if it is a resident of a country or a specified territory with which India has a DTAA. If it is a resident of a country with which India does not have a DTAA, the test would be whether it has a place of business' in India that requires registration as a foreign company under the Companies Act,

5.11. Explanation 4A of Section 115JB of the IT Act further clarifies that provisions pertaining to MAT shall not be applicable to a foreign company whose income comprises solely of profits and gains from business referred to in Section 44B (*non-resident's profits and gains from the shipping business*), Section 44BB (*non-resident's profits and gains from business of exploration for mineral oils*), Section 44BBA (*non-resident's profits and gains from the business of operation of aircraft*), and Section 44BBB (*foreign companies' profits and gains from turnkey power projects*).

5.12. Therefore, if a person who is resident outside India sells shares of an Indian company to an Indian resident, MAT would be payable by such company if the following conditions are met for any financial year:

(a) The seller is a company;

[6] *Union of India and Ors.* v. *U.A.E. Exchange Centre*, AIR 2020 SC 2933.

(b) The seller has a permanent establishment or a place of business in India, as the case may be;
(c) The total income tax payable by the company is less than 15% of its book profit, after including the capital gains arising on transactions in securities in its book profit.

# 6. Withholding Tax

6.1. Section 195(1) of the IT Act requires a buyer making a payment that is 'chargeable under the IT Act' to a non-resident seller to withhold tax at the 'rates in force' at the time of the payment on the income arising from the transaction which is chargeable to tax under the IT Act.

6.2. Taxation under Section 195(1) is different from the usual 'tax deductible at source' clauses which mandate a standard deduction at the outset of any transaction. Section 195(1) clearly lays down that withholding of taxes shall only be done for the sum that is chargeable under the IT Act. This implies that if the seller is able to prove that the amount is not taxable under the IT Act, the buyer will not be obligated to and should not withhold taxes.

6.3. An array of judgments including the famous case of *GE (G.E.) India Technology Centre Private Ltd.* vs. *Commissioner of Income Tax and Ors.* [7] have clarified that the taxes are to be withheld by a buyer only if the transaction would result in an income chargeable under the IT Act.

6.4. Section 195 (1) of the IT Act reads as follows:

*Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest (not being interest referred to in section 194LB or section 194LC or section 194LD or any other sum chargeable under the provisions of this Act (not being income chargeable under the head "Salaries") shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force.*

*6.5. <u>Rates in Force</u>*

6.5.1. Section 2(37A) of the IT Act has defined the term 'rates in force' for the purpose of various sections of the IT Act.

6.5.2. Section 2(37A) (iii) defines 'rates in force' for the purposes of deduction of tax under Section 195 of the IT Act as the rate or rates of income tax specified in this behalf in the Finance Act of the relevant year or the rate or rates of income-tax specified as per an agreement (tax-treaty) entered into by the Central Government under Section 90 of the IT Act or a tax treaty notified under Section 90A of the IT Act.

6.5.3. Section 2(37A) (iii) reads as follows:
*for the purposes of deduction of tax under section 194LBA or section 195, the rate or rates of income-tax specified in this behalf in the Finance Act of the relevant year or the rate or rates of income-tax specified in an agreement entered into by the Central Government under section 90, or an agreement notified by the Central Government under section 90A, whichever is applicable by virtue of the provisions of section 90, or section 90A, as the case may be.*

*6.6. <u>Current withholding obligation in respect of a foreign company making long term capital gains under the IT Act</u>*

[7] *GE (G.E.) India Technology Centre Private Ltd.* v. *Commissioner of Income Tax and Ors.* (2010) 10 SCC 29.

6.6.1. At present, the rates in force for withholding tax on long term capital gains arising in accordance with Section 112 (1) (c) (iii) for a company (not being a domestic company) is 10% as per as per Section 195 of the IT Act read with Item 2(b) (vi) of Part II of the First Schedule of the Finance Acts, 2021 read with Section 2 (5) of the Finance Acts, 2021.

6.6.2. In addition to the tax of 10%, Part II also levies a surcharge on the income tax. This surcharge depends on the quantum of the income or aggregates of income paid or likely to be paid to the non-resident company in a year.

a. A surcharge of 2% (two percent) on the withholding tax shall be added by the buyer on an amount ranging between Rs. 1,00,00,000 (Rupees one crore) and Rs. 10,00,00,000 (Rupees ten crore); and
b. A surcharge of 5% (five percent) on the withholding tax shall be added by the buyer on an amount over Rs. 10,00,00,000 (Rupees ten crore)

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