

AAR rules on beneficial ownership principles for taxing capital gains under a tax treaty

The Authority for Advance Rulings (“AAR”) has delivered an important ruling on whether a Netherlands company (whose parent company is a German company) is entitled to the capital gains tax exemption under the India – Netherlands Double Taxation Avoidance Agreement (“Treaty”) when it transfers the shares held by it in its Indian subsidiary to another non-resident.

Facts of the case

KSPG Netherlands Holding BV (“Applicant”) is a company incorporated in Netherlands in August 2008. The Applicant was the holding company of Pierburg India (“PG India”), a private limited company in India. The Applicant and PG India were part of the Kolbenschmidt Pierburg Group which had extensive manufacturing operations across the globe. Initially, when PG India was incorporated in October 2006, PG Germany (the parent company) was the sole shareholder and later on in November 2008, all the shares in PG India were transferred to the Applicant by PG Germany. The share transfer from PG Germany to the Applicant was done for a consideration of Rs 100 million, as per the prevailing pricing norms prescribed by the Foreign Exchange Management Act, 1999. After becoming the parent company of PG India, the Applicant had made substantial equity investment in PG India to facilitate PG India’s expansion plans.

Questions before the AAR

Taxability of dividend income

- Whether the Applicant would be liable to tax in India as per the provisions of the Income-tax Act, 1961 (“Act”) on the dividends received by it from PG India?
- Whether the Applicant would be liable to tax in India under the Treaty on the capital gains that may accrue when the Applicant transfers the shares in PG India to another

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non-resident?

- Whether the Applicant would be liable to tax in India as per the provisions of Act on the capital gains that may accrue to the Applicant when PG India does a buy-back of its shares?

Applicant's contentions

Taxability of dividend income

- As per section 10(34) of the Act, if the dividends paid by PG India suffer Dividend Distribution Tax ("DDT") under section 115-O of the Act, then the dividend income is not liable to tax in the hands of the recipient. Assuming that the dividends declared by PG India would suffer DDT, it should not be taxable again in the hands of the Applicant.

Taxability of capital gains at the time of transfer of shares to a non-resident

- Being a "resident" of Netherlands under the Treaty, the Applicant is entitled to invoke the provisions of the Treaty in determining its liability to tax in India.
- As per Article 13(5) of the Treaty where shares of an Indian company are transferred to a non-resident, the gains arising on such a transfer shall be taxable only in Netherlands and not in India.

Taxability of capital gains at the time of buyback of shares by PG India

- Under the Act, a buy-back of shares by PG India will tantamount to "transfer" of shares. Since the "transfer" of shares is between a holding company and an Indian subsidiary, as per the provisions of section 47(iv) of the Act, the "transfer" of shares is exempt from capital gains tax.

Revenue's contentions

Taxability of dividend income

- Applicant's contentions are acceptable, subject to any changes that may be introduced in the Act.

Taxability of capital gains at the time of transfer of shares to a non-resident

- The contemplated transaction of transfer of shares cannot be seen as a proposed transaction by a non-resident and therefore the question is not within the scope of transactions on which an "advance ruling" can be made.

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- Till November 2008, PG India was a direct subsidiary of Pierburg Germany. The Netherlands group company was introduced in between India and Germany, after which the shares in PG India were transferred by Pierburg Germany to the Applicant in November 2008. This transfer of shares was part of the scheme for the avoidance of capital gains tax liability in India.
- Pierburg Germany is the ultimate holding company of PG India. Therefore, the beneficial owner of PG India is Pierburg Germany. Any gains arising to the Applicant at the time of transfer of shares in PG India should therefore, be liable to tax in the hands of the beneficial owner, being Pierburg Germany. Accordingly, the provisions of the India – Germany Tax Treaty will apply in determining the taxability at the time of transfer of shares by the Applicant.

Taxability of capital gains at the time of buyback of shares by PG India

- The transaction of transfer of shares cannot be seen as a proposed transaction by a non-resident and therefore, the question is not within the scope of transactions on which an “advance ruling” can be made

Ruling of the AAR

Taxability of dividend income

- Applicant’s contentions are accepted. Dividend income is not taxable in the hands of the Applicant if DDT is paid by PG India on dividends distributed.

Taxability of capital gains at the time of transfer of shares to a non-resident

- The future transfer of shares in PG India by the Applicant is closely linked to the investments made and proposed to be made in future by the Applicant. Therefore, the contemplated transfer of shares in future cannot be said to be a hypothetical one. The expression tax liability ‘arising out of’ a transaction is wide in its scope and would reasonably encompass the disposal of shares by the Applicant in future, as such a disposal cannot be dissociated and isolated from the Applicant’s substantial equity stake in India. The question posed is therefore within the scope of an “advance ruling”.
- The fact that the Applicant is a “resident” of Netherlands is not being disputed by the Revenue.
- The concept of “beneficial ownership” is not present in Article 13 of the Treaty (capital gains) unlike in the case of Article 10 (dividends), Article 11 (interest) and Article 12 (royalties and fees for technical services). Even assuming that the concept of “beneficial ownership” can be borrowed for the purposes of application of Article 13, there is no

factual or legal basis to conclude that Pierburg Germany is the real and beneficial owner of the shares in PG India and of the capital gains that would accrue.

- The Applicant, although a subsidiary of Pierburg Germany, is a distinct legal entity having its own Board of Directors and management systems.
- Importantly, the Applicant has made significant investments in PG India after it became the shareholder of PG India. The shares in PG India, purchased by the Applicant from Pierburg Germany in November 2008, were also as per the prevailing pricing guidelines.
- At this stage, it would be presumptuous to predicate that the gains accruing to the applicant by the transfer of shares held in PG India would not enure to the benefit of the Applicant or will not enter the profit and loss account of the Applicant or that the gains will be passed on to Pierburg Germany, dictated by its mandate. It is not possible to assume that the Applicant would merely act as a conduit to siphon off the gains to the ultimate holding company by means of a colourable device contrary to its corporate status and the stake in the Indian company.
- It is however, open to the Revenue authorities to look into the facts at the time of the actual transfer of shares in PG India by the Applicant. The Applicant shall provide the information and facts to the Revenue at the time of transfer. However, on principles, based on the facts submitted by the Applicant currently, it cannot be concluded that Pierburg Germany is the beneficial owner of the gains that will arise when shares in PG India are transferred by the Applicant. The proposed transfer of shares cannot be characterized as a device to avoid capital gains tax by unlawful means. Any future examination by the Revenue will therefore be on the basis of the principles discussed here.

Taxability of capital gains at the time of transfer of shares to a non-resident

- A “transfer” of shares pursuant to a buyback of shares by PG India is on a different footing when compared to the transfer of shares by the Applicant in future. The buyback of shares is initiated by PG India and not by the Applicant and therefore any consequent “transfer” of shares in a buyback is dependent on the decision of PG India and not of the Applicant. Moreover, buyback of shares is not integrally connected with the investment made in PG India, in comparison to a future transfer of shares with the investment of the Applicant.
- The AAR therefore held that the Applicant should make an appropriate application as and when there is a buyback of shares by PG India and declined to give an advance ruling on this aspect at this stage.

BMR comments and analysis

The findings on the principles of beneficial ownership for bringing to tax capital gains in a treaty context would be relevant while examining the capital gains tax implications in India for holding structures in other jurisdictions like Mauritius that have similar language in the tax treaties. It may be noted that the source of funds for the investment into India by the Applicant has not been discussed by the AAR in arriving at its conclusions. It is also important to note that the AAR has called upon the Applicant to submit the facts and information when the share transfer is actually done, stating however, that the Revenue's examination and decision would have to be based on the principles decided in the Ruling.

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