Indirect sale of Indian assets – Capital Gain

This subject was presented as a part of presentation on Capital Gain at the conference of The Chamber of Tax Consultants on 13^{th} January 2017

Naresh Ajwani
Rashmin Sanghvi & Associates
Chartered Accountants

Indirect Transfer

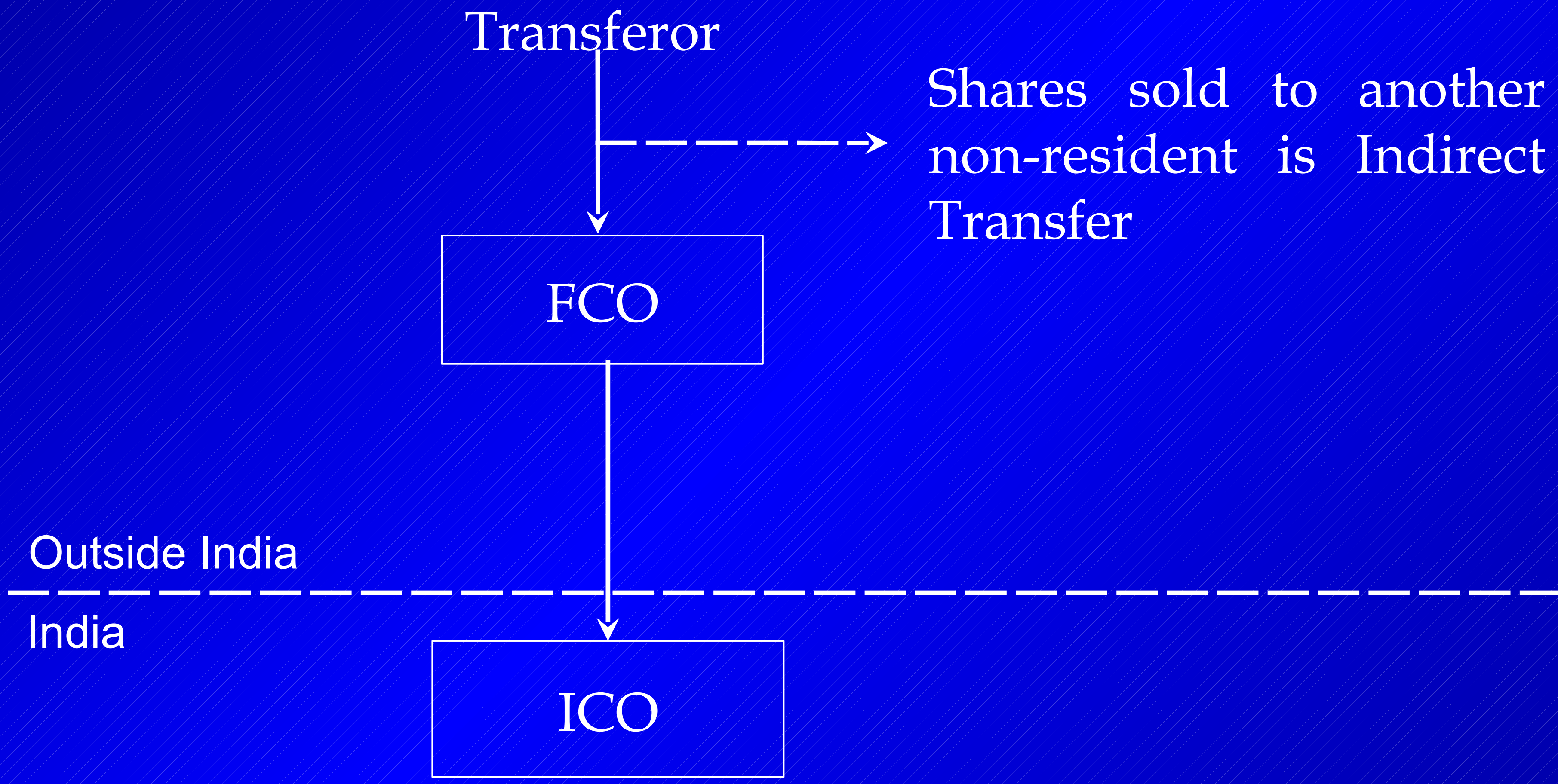
- Indirect Transfer provisions apply when a non-resident of India,

  sells shares or interest in a foreign entity,

  through which it holds substantial Indian assets.

- This is "indirectly" selling Indian assets instead of directly selling the Indian assets. *See next slide…*

Indirect Transfer



Indirect Transfer - ITA

- **Section 9(1)(i), Explanation 5**:

Asset or Capital asset,

being share or interest,

in a company or entity,

registered or incorporated outside India,

shall be deemed to be **situated in India,**

if the share or interest **derives** directly or indirectly, its **value substantially from assets located in India**.

To Check

- Extent of shareholding or voting rights or interest in the entity which holds assets directly in India.
- Existence of management rights or control in investee entity; and entity which holds assets directly in India.
- Value of assets in India of the investee company.
- Value of assets outside India of the investee company.

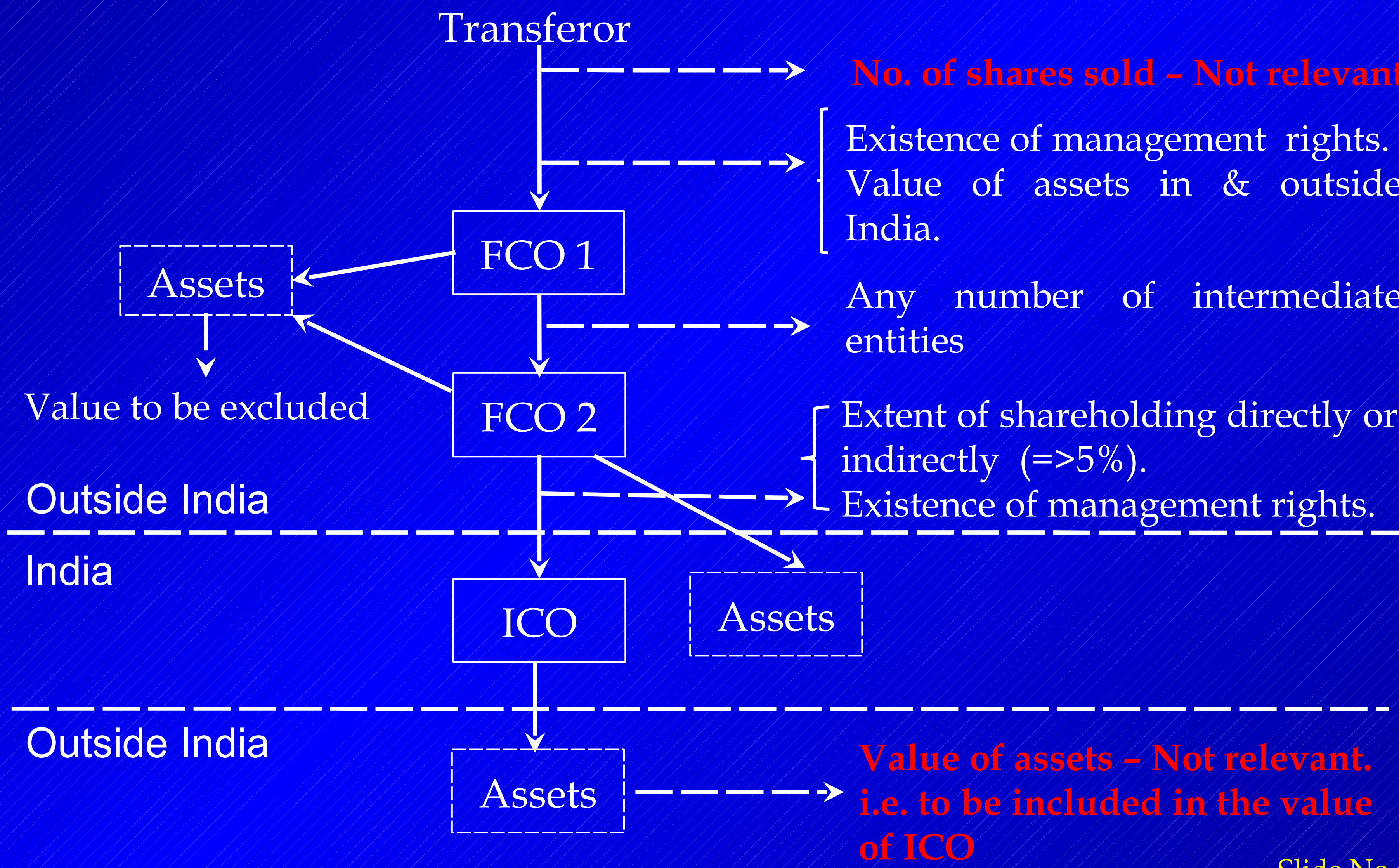
To Check

Not relevant:

- How many shares are sold by the transferor.
- Value of assets outside India of Indian entity.

(Examination stops at Indian company.)

To Check


Transferor
No. of shares sold – Not relevant
Existence of management rights.
Value of assets in & outside India.
FCO 1
Assets
Any number of intermediate entities
Value to be excluded
FCO 2
Extent of shareholding directly or indirectly (=>5%).
Existence of management rights.
Outside India
India
ICO
Assets
Outside India
Assets
Value of assets – Not relevant.
i.e. to be included in the value of ICO

Shareholding & Management

- Provisions apply if:

- Transferor along with AEs holds ≥ 5% of voting rights, or shares or interest directly or indirectly in entity which holds assets directly in India; OR
- Transferor holds management rights in Investee entity; OR
- Transferor holds management rights in entity which holds assets directly in India.

[Above may be held at anytime during the preceding 12 months.]

[S. 9(1)(i), Explanation 7]

Indirect Transfer - ITA

- Sale of shares of foreign entities resident in India covered by these provisions.

(Shares are situated abroad. Hence prima facie source is abroad. Because of residence, gains are taxable in India.)

- Sale by foreign company resident in India:

  Payment to Indian residents – No TDS.

  However payment to foreign entity resident in India – TDS u/s. 195.

Substantial Value

- **Section 9(1)(i), Explanation 6:**

Substantial value in India means Fair Market Value (FMV) of assets in India if it:

- exceed Rs. 10 crores; and

  - represents atleast 50% of the value of all assets owned by company or entity in India.

- Liabilities not to be reduced.

Substantial Value

- Value as on **specified date** – i.e.

  - last date of accounting period preceding the date of transfer; OR

  - date of transfer if the book value of the investee entity on the date of transfer exceeds 15% of the book value as on the accounting period date.

  Rule 11UB for valuation of assets.

  [Specified date is only to determine the FMV of assets in India. Capital gain computation is as per actual transaction values.]

Specified Date – Book Value

- If Book value has increased by more than 15%, FMV has to be considered as on date of transfer.
- Book Value is only to consider **on what date** should the substantial value be considered.
- BV is **not relevant** for determination of income.
- BV is **not relevant** for determining whether substantial value is in India.
- If Book Value falls, or increases by less than 15%, it is **not relevant**. FMV on year end to be considered.

Specified Date – Book Value

As on 31.3.2016	Book Value	FMV
Gross Value	1,000	5,000
Value of Indian Assets	400	3,000
As on date of transfer	**Book Value**	**FMV**
Gross Value	1,500	5,500
Value of Indian Assets	900	3,500
Increase in book value	50%	

- As BV of Global assets of investee company has increased by 15%, specified date is date of transfer.

Specified Date – Book Value

As on 31.3.2016	Book Value	FMV
Gross Value	1,000	1,500
Value of Indian Assets	1,000	1,000 (60%)

By 30.6.2016 foreign investor invests 1,000 in foreign co.

As on 30.6.2016	Book Value	FMV
Gross Value	2,000	2,500
Value of Indian Assets	1,000	1,000 (40%)
Increase in Book Value	100%	

If shares are transferred on 30.6.2016, is it taxable? No.

On date of transfer, FMV of Indian assets < 50%.

Specified Date – Book Value

As on 31.3.2016	Book Value	FMV
Global Value	1,000	1,500
Value of Indian Assets	1,000	500 (33.3%)

By 30.6.2016 foreign investor invests 1,000 in foreign co. Foreign company invests 1,000 in Indian company.

As on 30.6.2016	Book Value	FMV
Global Value	2,000	2,500
Value of Indian Assets	2,000	1,500 (60%)
Increase in B.V.	100%	

If share are transferred on 30.6.2016, is it taxable? Yes.

On date of transfer, FMV of Indian assets ≥ 50%.

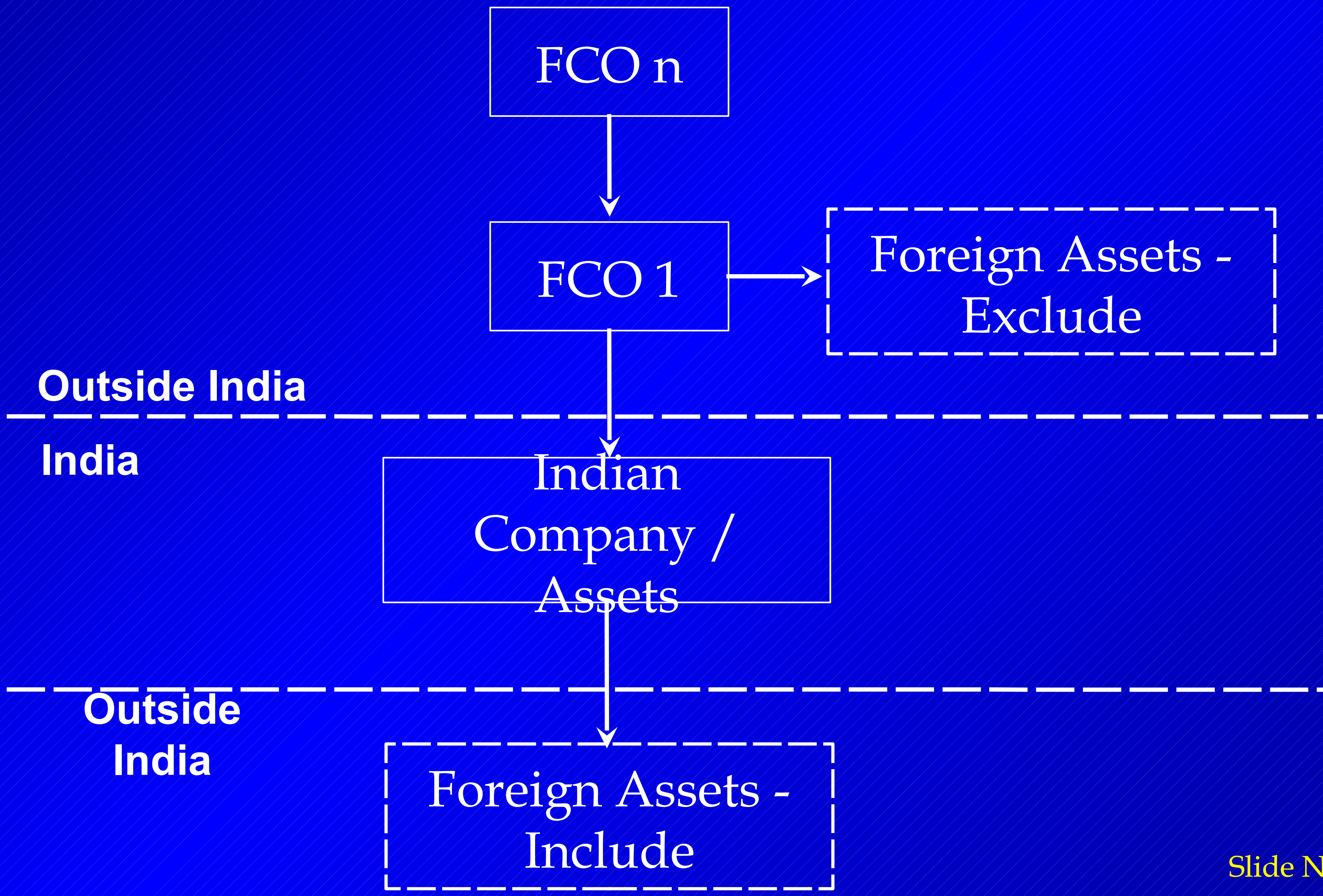
Assets outside India

- Value of assets located outside India of **foreign investee company** has to be **excluded.**

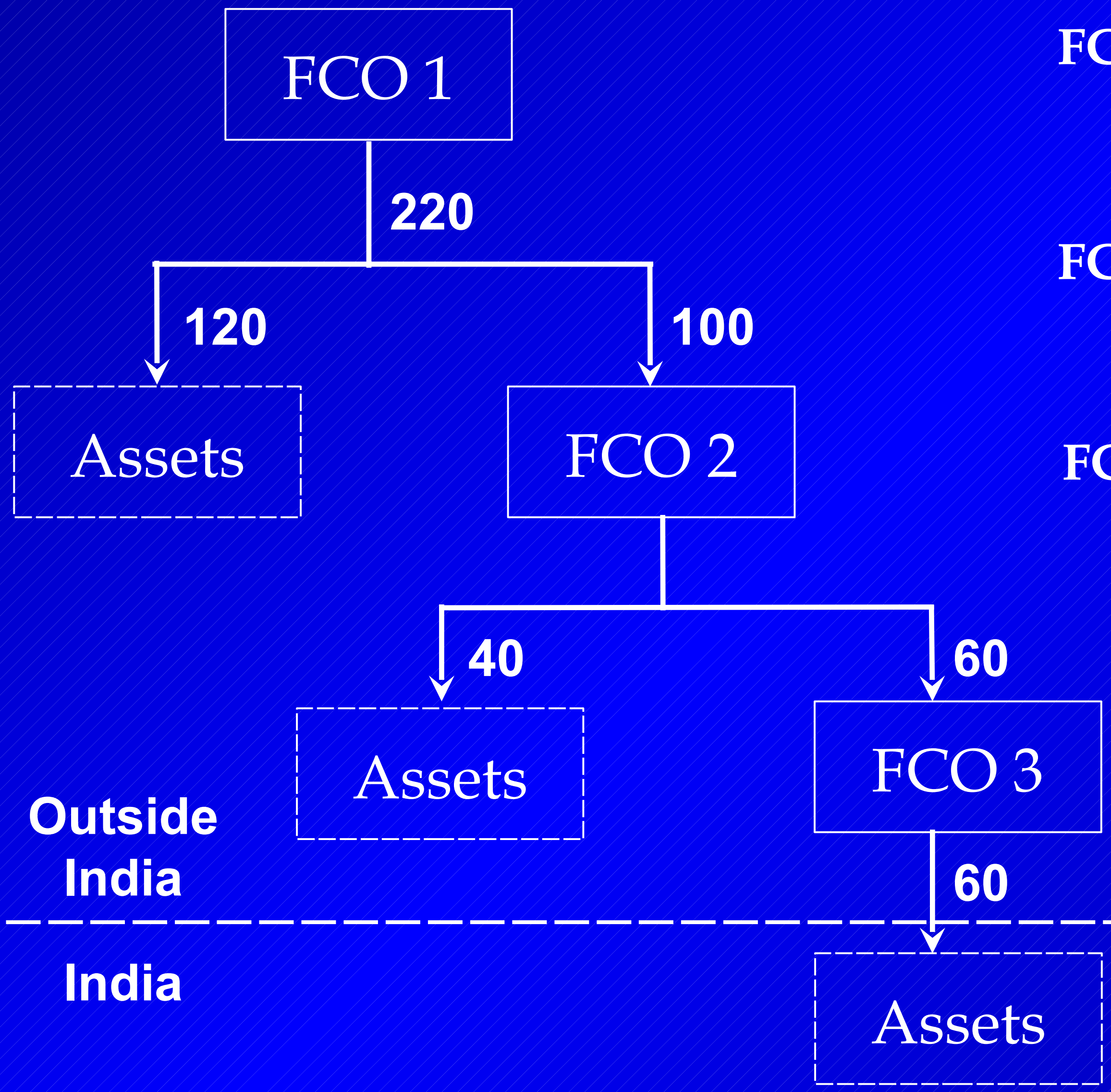
  [Assets held outside India by the **Indian entity** whose shares are transferred indirectly are to be **included**.]

Rule 11UC for income attributable to assets in India.

Assets Outside India



Assets outside India –which entity?



FCO 1 – Substantial value outside India.

FCO 2 – Substantial value in India.

FCO 3 – Substantial value in India.

Summary

- **Summary with reference to the foreign investee company / entity whose shares are sold:**

  \- Value from Indian assets held directly or indirectly exceeds Rs. 10 cr. and is at least of 50% of the total value of assets.

  \- Holding should be 5% or more, or there should be management rights.

  \- Value of assets outside India are to be excluded.

Valuation Rule – R.11UB

- **Listed shares** of Indian co. – Observable share price.

If it includes management rights – FMV = (market capitalisation + BV of liabilities) / total shares.

- **Unlisted shares** of Indian Co. – FMV as per internationally accepted methodology + liabilities if considered for the valuation.

Valuation Rule – R.11UB

- **Interest in partnership** firm or AOP – FMV as per internationally accepted methodology + liabilities if considered for such valuation.

Value to be allocated to partner / member as under:

(i) Upto Capital – in ratio of capital contribution.

(ii) Residual value - in ratio agreed for distribution on dissolution of the entity.

[If there is no agreement for distribution on dissolution, allocation will be as per profit sharing ratio.]

Valuation Rule – R.11UB

- **Other assets** – open market value + liabilities if considered for valuation.
- **Assets of foreign company or entity**.

- In case of transfer between <u>unconnected persons</u> - FMV = value based on full value of consideration + BV of liabilities.

- In case of <u>connected persons</u>,

  For <u>listed company</u> - FMV = observable share price + BV of liabilities.

  For <u>unlisted company</u> - FMV of assets + liabilities if considered.

[Connected person defined in S.102]

Valuation Rule – R.11UB

- The value of Indian entity shall include all its assets and business operations <u>in India and outside India</u>.

- Rate of exchange for conversion of value of Indian assets in INR into foreign currency shall be the TT buying rate on the specified date. [Explanation to Rule 26]

Liabilities

FCO 1 [Investee Co. whose shares are sold]

Liabilities		Assets	
Capital	600	FCO 2 shares	1,000
Loan	400		

FCO 2 [Co. holding assets directly in India]

Liabilities		Assets	
Capital	1,000	ICO	1,500
Reserves	400	Bank outside India	900
Loan	1,000		

Liabilities

ICO

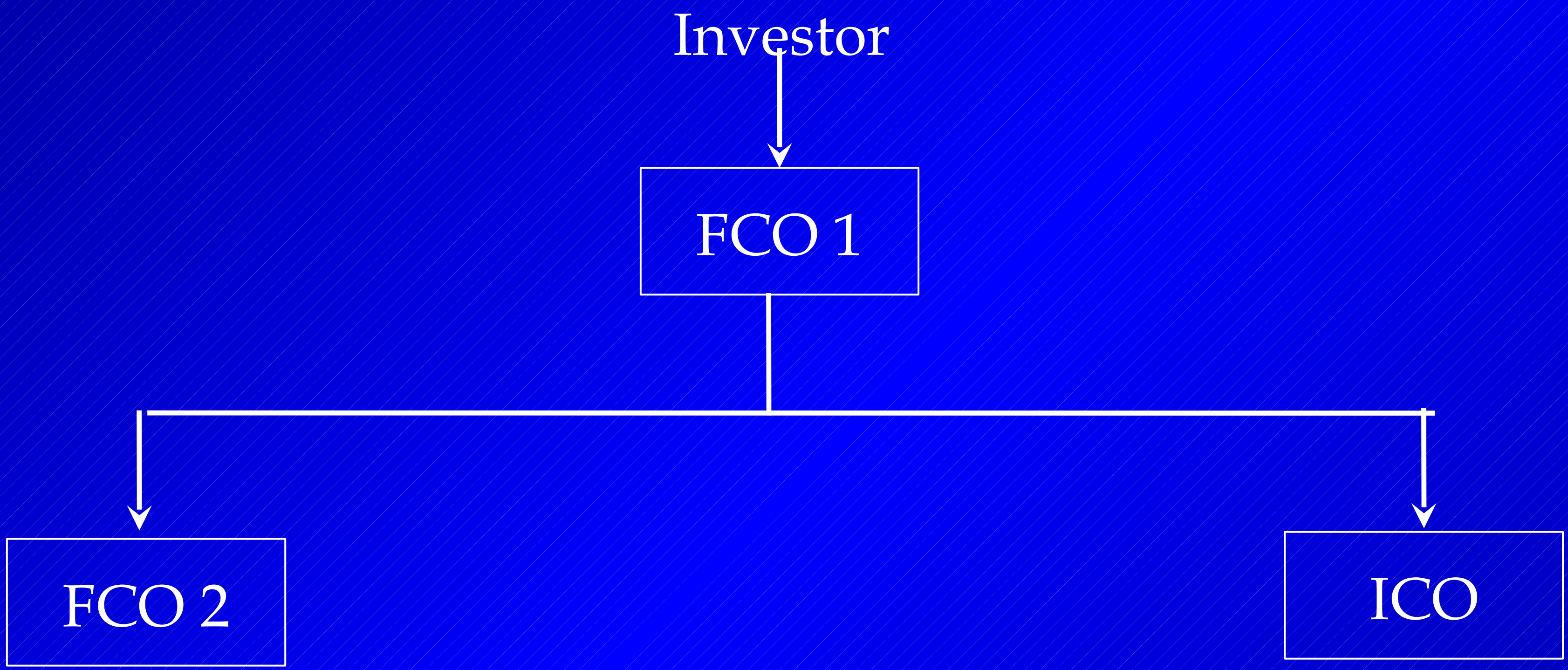
Liabilities		Assets	
Capital	1,500	Factory	2,500
Loan	1,000		

Consolidated

Liabilities		Assets	
Capital in India	….	In India	2,500
Capital outside India	1,000		
Loan in India	1,000	Outside India	900
Loan outside India	1,400		

Substantial value is in India.

Liabilities



Assets	**5,000**
Liabilities	**(--)**
Net Worth	**5,000**

Assets	**10,000**
Liabilities	**(8000)**
Net Worth	**2,000**

Next slide …

Liabilities

- Value of FCO1:

i) Value of ICO = 2,000+8,000	10,000	66.7%
ii) Value of FCO2	5,000	33.3%
Total Global Value	15,000	100.0%

Liabilities

- Gross assets in India > 50% - Hence substantial value in India.
- Net worth – not relevant.
- Only in case of listed shares where there are no management rights, liabilities are not to be considered.

Valuation Rule – R.11UC

- Income attributed to assets located in India:

$$\text{Capital Gain} \times \frac{\text{FMV of assets in India}}{\text{FMV of global assets}}$$

FMV to be seen on specified date.

Value – is to determine if; & how much income is taxable in India.

Taxable income is determined **based on actual consideration and cost.**

Valuation Rule – R.11UB

- If the FMV has been determined on the basis of an interim balance sheet on the specified date, the FMV has to be modified after finalisation of the balance sheet.
- Valuation can be undertaken by Indian accountant. Foreign entity can be valued by accountant in that country.

  Conditions are specified for accountants.
- FX fluctuation not available as shares are not of Indian company. Inflation adjustment available.

Tax rate

- Section 112(1)(c)(iii) – 10% on Long Term Gain - without inflation adjustment and FX fluctuation reliefs.
- Short Term Gain - 40% (foreign company) / 30% (non-foreign company) - without inflation adjustment and FX fluctuation reliefs.

Compliance

- Transferor is required to file a report in Form 3CT from an accountant with the tax return. (R. 11UC(2)).
- Indian company whose shares are transferred indirectly, has to file Form 49D within 90 days from the end of the year in which transfer takes place.

  In case transfer has the effect of transfer of management rights, Form has to be filed within 90 days from the transaction.

DTA – Indirect Transfer

- S.9(1)(i) Explanation 5 – deems situs of foreign company shares to be **in India.**

Foreign company shares are **not treated as Indian company shares/ Indian assets.**

- DTA – Capital gains on any other assets are taxable only in COR.

If this article applies, Capital Gains is not taxable in India.

- GAAR applicable.

Other provisions & Indirect Transfer Provision

- Indirect Transfer provisions apply to Transfer of shares or interest in foreign entity – including merger / demerger / liquidation.
- Not applicable for dividend – [Circular 4 dated 26.3.2015].
- Not applicable to acquisition at discount. [S.56(2)(vii) & (viia)].

Other provisions & Indirect Transfer Provision

- Not applicable to investment in shares [S.56(2)(viib)]
- Options or derivatives are not shares or interest in an entity. Hence should not be covered by Indirect transfer provisions.

- Transfer Pricing applicable.
- GAAR applicable.

Merger & Demerger – Indirect Transfer

- Exemption available for amalgamating & demerged company [S. 47(viab)& S. 47(vicc)].

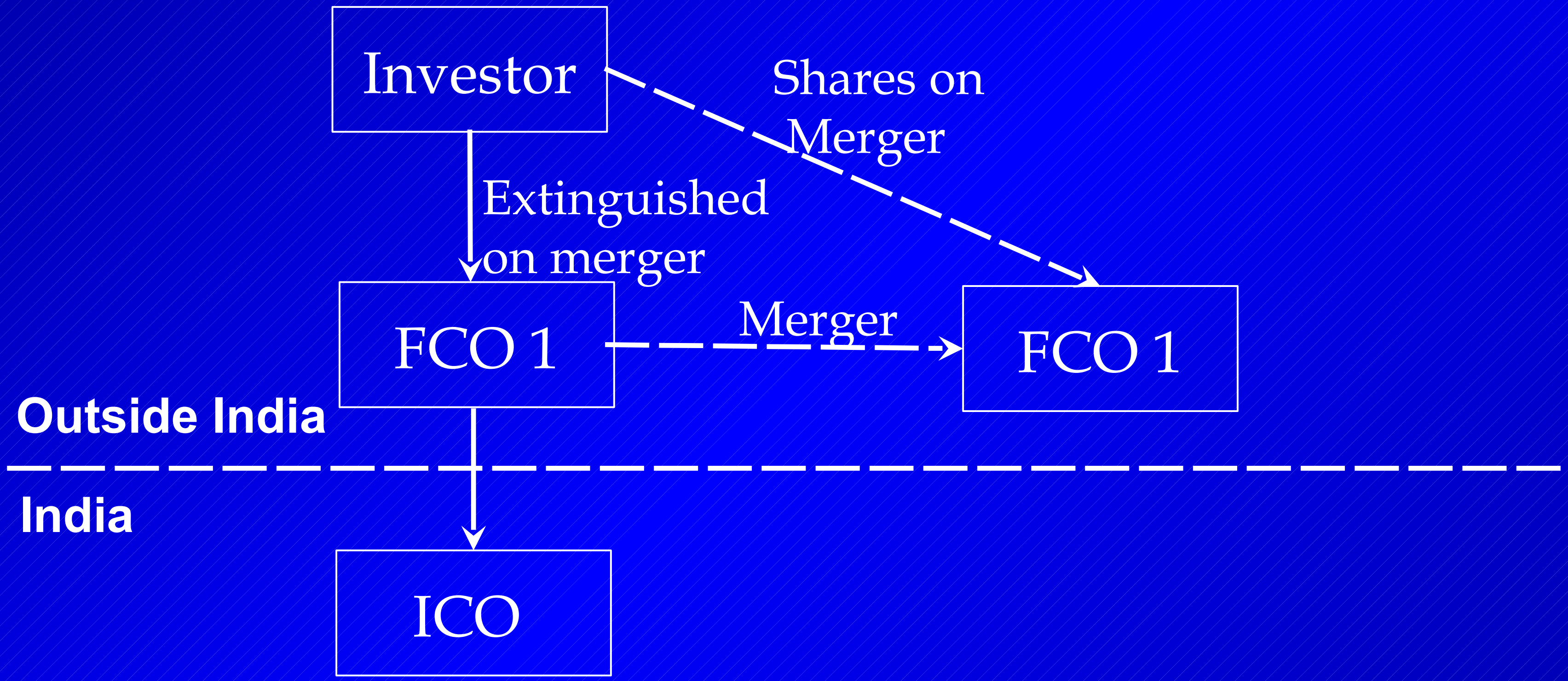
[In line with direct amalgamation / demerger of Indian co. [S. 47(vi)& S. 47(vib)]

- No exemption for shareholder of amalgamated & demerged company.

[Exemption available for domestic amalgamation / demerger - S. 47(vii)& S. 47(vid)]

- Exemption available for transfer to holding co. or subsidiary co. [S. 47(iv) & S. 47(v)]

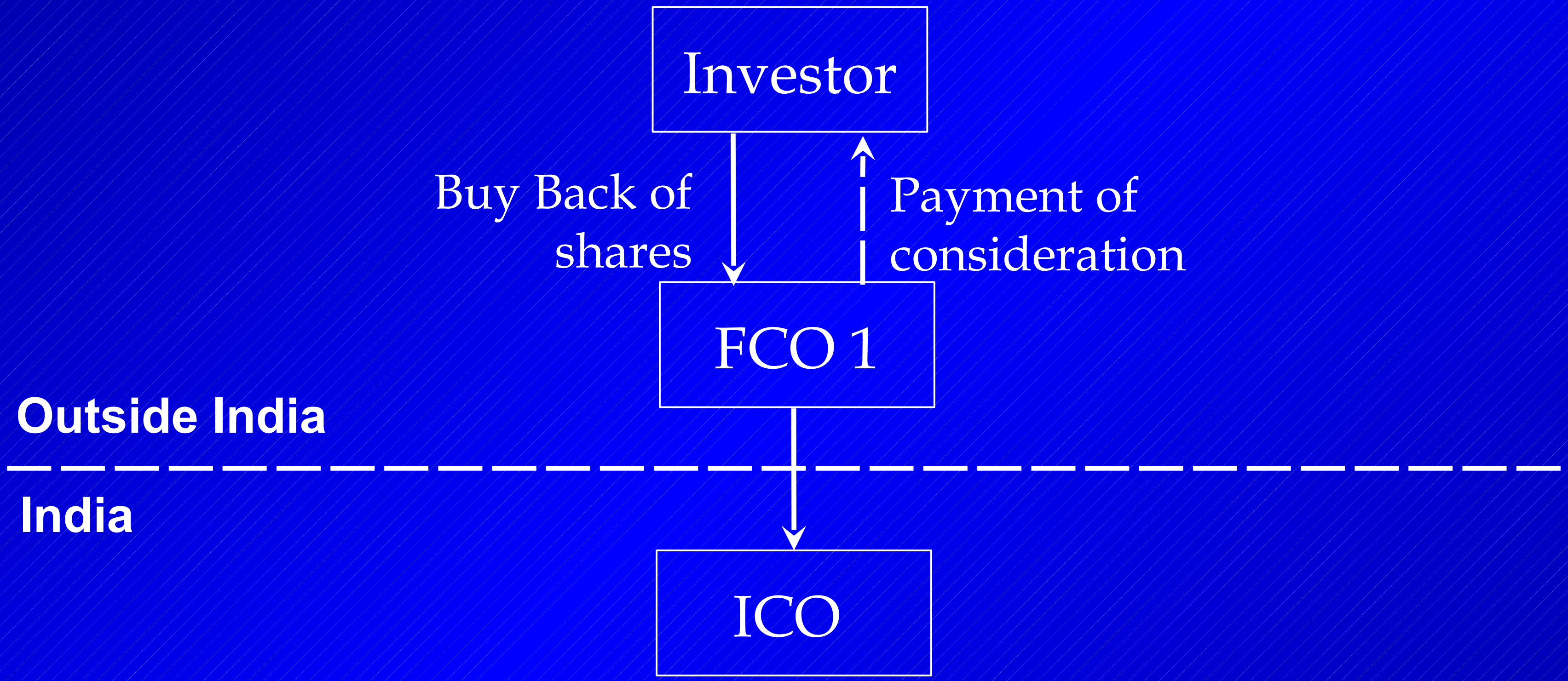
Merger



Exemption available for FCO 1 [S. 47(viab)]

No exemption for Investor.

Buy back of shares



Buy back of shares

- Buy back is Capital gain u/s. 46A, r/w S.2(22)(*iv*).
- U/s. 115QA, domestic company has to pay distribution tax if buy back is of unlisted shares.

- As foreign company buys back the shares, is income Capital gain? Or

  is it dividend income? It is Capital Gain.
- Is Capital gain / dividend taxable in India? Indirect transfer provisions will apply.

Questions and comments are welcome.

Thank you,

Naresh Ajwani

naresh@rashminsanghvi.com