Indian Court rules Dutch company's Indian share sale not taxable – Repudiates Revenue's paradoxical approach to invoke Art. 13(4)

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A State High Court in India recently held that capital gains arising to a Dutch company on the sale of shares, to a Singapore-based buyer, of its Indian subsidiary holding investment in an IT park was not taxable in India under the India-Netherlands double tax avoidance agreement (DTAA).

The taxpayer, Vanenburg Facilities BV, made investments in the equity share capital of an Indian company, Baan IT Park India Pvt Ltd., in a period from 14 August 1997 to 23 March 2000. The Indian company was renamed Vanenburg IT Park India Private Limited (VITP Limited) on 13 December 1999 and became a wholly owned subsidiary of the taxpayer. The investments in the Indian company were made based on the approval granted by the Foreign Investment Promotion Board. VITP Limited commenced the business of developing, maintaining and operating an industrial park at Madhapur in Hyderabad after obtaining the requisite approvals from the Secretariat for Industrial Assistance of the Department of Industrial Policy and Promotion. The first phase of the project was completed in June 2000 and the second phase in August 2002.

During the financial year 2004-05, the taxpayer sold all its shares in VITP Limited to Ascendas Property (Fund) India Pte Limited ("Ascendas") for a consideration of INR 2.25 billion in terms of the share purchase agreement dated 17 December 2004. The tax officer, in terms of an order issued under Section 195(2) of the Indian Income Tax Act, directed Ascendas to withhold tax from the remittance of sale consideration and to deposit the same with the Indian tax authorities. The taxpayer had contended that the transaction giving rise to the above capital gains was not taxable in India as it was covered by Article 13 of the India-Netherlands DTAA, which would override the domestic law provisions, in terms of Section 90 of the Indian Income Tax Act. The taxpayer claimed that Articles 13(4) and 13(5) of the DTAA dealt specifically with capital gains arising from the transfer of shares and therefore, unless the transaction fell within the inclusive clauses therein, it could not be taxed in India. The taxpayer claimed that, in the light of the specific provisions made for capital gains arising out of transfer of shares in Articles 13(4) and 13(5), the same would override the general provisions in the other paragraphs of Article 13. The tax officer held that the gains were taxable in India in terms of Article 13(1).

Article 13(1) of the India-Netherlands DTAA deals with the taxability of gains arising on the sale of immovable property. Furthermore, Article 13(4) of the DTAA deals with the taxability of gains arising from the alienation of company shares, the value of which is principally derived from immovable property other than that used in the business of such a company. Article 13(5) of the DTAA is the residuary clause, which provides that gains from the alienation of any property other than that referred to other paragraphs shall be taxable only in the State of which the alienator is a resident.

On appeal, the Indian High Court held that tax authorities erred in applying Article 13(1) of the DTAA by equating the alienation of a company's shares to the alienation of its immovable property "by applying the ludicrous logic that shares partake the character of immovable property". The Court cited the legal distinction between "share sale" and "asset sale" as summed up by the Indian Supreme Court in the famous Vodafone case. The Court agreed with the findings of the Indian Income Tax Appellate Tribunal that the alienation of shares by the taxpayer does not fall under Article 13(1) of the DTAA and, by virtue of the residuary clause in Article 13(5), gains will be exempt from taxation in India.

The Court also accepted the taxpayer's objection to Revenue's claim, raised for the first time before the High Court, of seeking to tax the transaction under Article 13(4) of the treaty. The Court noted that the lower authorities explicitly held that Article 13(4) did not apply to the transaction and later they also did not take any remedial steps. As a result, the High Court remarked that: "It is therefore too late in the day for the revenue to introduce this new element in the third appeal before this Court". The Court also rejected Revenue's argument that the applicability of Article 13(4) to share sale is purely a question of law. The Court observed that: "Whether immovable property from which the company's shares principally derived their value was property in which the business of the company was carried on or not is a question of fact".

The IRS also sought to tax the penal interest paid by the purchaser to compensate for the delay in remitting the sale consideration. In this respect, the Court upheld the Tribunal order that such interest was not taxable under Section 9(1)(v) of the Indian Income Tax Act in the absence of evidence of a debt being incurred or money being borrowed for any business purposes. Further, the High Court affirmed the applicability of Article 11 of the DTAA. Article 11(1) of the DTAA provides that interest arising in one of the States and paid to a resident of the other State would be taxed in that other State. Article 11(6) defines "interest" to mean income from debt claims of any kind, but penalty charges for late payment shall not be regarded as interest for the purpose of the said Article. In addition, Section 9(1)(v) of the Indian Income Tax Act provides that income by way of interest payable by a person who is a non-resident would be deemed to be income accruing or arising in India, where such interest is payable in respect of any debt incurred, or money borrowed and used, for the purposes of a business or profession carried on by this person in India. The Court rejected Revenue's stand that Article 11 was not applicable as it excludes penal interest from its purview. Referring to the share purchase agreement, the Court observed that the purchaser voluntarily undertook to pay interest for such late payment of the sale consideration. Therefore, the Court held that interest cannot partake of the character of penalty charges.

Consequently, the High Court directed the tax authorities to expeditiously issue a refund to the taxpayer of the tax withheld and deposited by the purchaser.