Issues & Challenges in taxing Capital Gains from Indirect Transfer of Assets & the Indian Approach

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Part A: Policy Issues & Challenges

Capital Gains Tax Avoidance

- Domestic Resource Mobilization is essential for developing countries to garner resources for human and economic development & address challenges like poverty, inequity and infrastructure
- Capital Gains is an important part of Income tax base
- Many developing countries, including India opt for source based taxation of capital gains of equity shares in their tax treaties (UN Model Tax Convention)
- A direct transfer in such assets would usually be taxable
- However, artificial arrangements, without any commercial substance or purpose can be made to avoid this tax by indirect transfer of such assets

Capital Gains Tax Avoidance

- **Example**: SCo is a company in Country S with all business assets and a running business in Country S. All its equity shares are held by a of XCo (a company resident in country X, that has no other economic function or value), which in turn is a 100% subsidiary of RCo (a company in country R). Instead of transferring equity shares of SCo, RCo transfers the shares of XCo, so that the RCo can avoid taxes on capital gains from this transfer in Country S.
- **Outcomes:**
- If Country X is a very low tax jurisdiction, and it has a treaty with Country R based on OECD Model Convention, there would be double non taxation
- Country S loses taxes as a result of such artificial arrangement, resulting in erosion of its tax base

Challenges

- Particularly affects developing countries that prefer source based taxation of capital gains (UN Model Convention)
- Can the Artificial Arrangement be addressed by Anti-abuse provisions in domestic laws (GAAR) and/or treaties (PPT/LOB)
- Issue of territorial nexus (e.g. where transaction of equity shares of a company resident in another country takes place between two non-residents)
- Giving precedence to “substance” over “form” (Look through approach)
- Adequacy of domestic laws
- Adequacy of tax treaties to prevent such tax erosion

Principles agreed in BEPS Action Plan

- "**Governments are harmed**. *Many governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, Base Erosion and Profit Shifting (BEPS) undermines the integrity of the tax system, …..In developing countries, the lack of tax revenue leads to critical under-funding of public investment that could help promote economic growth. Overall resource allocation, affected by tax-motivated behaviour, is not optimal.*
- **Individual taxpayers are harmed.** *When tax rules permit businesses to reduce their tax burden by shifting their income away from jurisdictions where income producing activities are conducted, other taxpayers in that jurisdiction bear a greater share of the burden.*
- **Businesses are harmed.** *MNEs may face significant reputational risk if their effective tax rate is viewed as being too low. … Similarly, corporations that operate only in domestic markets, including family-owned businesses or new innovative companies, have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax. Fair competition is harmed by the distortions induced by BEPS."*

BEPS Action Plan & Reports

- "*BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place*."
- Though Addressing Indirect Transfer was not included as one of the Actions in BEPS Action Plan, G-20 recognized its importance and it was decided that work on it should be carried out by I.Os.
- India's view has been that such work should be carried out in consultation with the developing countries, as this will allow sharing of perspectives and actual challenges being faced, and ensure that outcomes of this work are implementable.
- India supports a process of broad consultation with all stakeholders, including interested countries, business, academicians and NGOs.

Technical Issues

- Taxation of Capital Gains from Indirect transfer of assets require tax provisions that are effective, predictable and simple to comply.
- Technical issues in the drafting of such rules to ensure that bona fide transactions are not affected in an unintended manner include:
  - Deciding the threshold of ownership (e.g.. percentage of total assets indirectly transferred, nominal thresholds of asset value)
  - Defining the underlying assets (immovable property, equity shares, other assets?)
  - Defining the taxpayer liable to pay taxes in the jurisdiction to ensure enforceability (payer liability, representative assessee)
  - Valuation of assets
  - Exempting genuine Business Reorganizations
  - Reporting Rules for such indirect transfers

Treaty Issues

- Need to ensure safeguards in tax treaties to prevent treaty abuse in respect of capital gains on indirect transfer
  - Unaddressed agenda of BEPS for developing countries?
  - Since OECD Model prefers resident based taxation of capital gains, while UN Model provides for source based taxation of capital gains, it may be preferable to take in the UN Subcommittee of Experts
- Options
  - Insert the "beneficial ownership" condition in Article 13 on Capital Gains in the UN Model
    - Also in OECD Model Tax Convention in view of source based taxation of capital gains arising from transfer of certain assets, like immovable property, equity shares deriving their value primarily/substantially from immovable property
  - Additional Guidance in the UN Model Commentary for denying treaty benefits in case of artificial avoidance of capital gains tax by application on anti-abuse provisions (PPT/LOB)
  - Amendment of Article 13 in UN Model to ensure source based taxation of capital gains from indirect transfer

Part B: Taxation of Capital Gains from Indirect Transfer in India-An Overview

Rules of Taxation in India

- Taxation in India both on residence and source basis.
- Non residents taxable in India on income which accrues or arises, or is deemed to accrue or arise or is received or is deemed to be received in India.
- In addition – deemed income concept - Non residents taxable in India on income accruing or arising, 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 situated in India.

Indirect Transfer Tax Rules In India

- Asset / share / interest in a foreign entity is deemed to be situated in India, if the share / interest derives, directly or indirectly, its value from assets located in India
- Offshore indirect transfer provisions triggered if the value of such share / interest :
  - exceeds INR 100 million; and
  - represents at least 50% of the value of all from assets owned by the foreign entity
- The value of the asset = Fair market value as on the specified date (without reduction of liabilities)
- Taxation of such capital gains on proportional basis.

Indirect Transfer Tax Exemption

- Offshore indirect transfer provisions not triggered if the transferor (individually or along with its associated enterprises) does not hold:
  - right of control or management, or
  - voting rights or share capital or interest exceeding 5% in the foreign company or entity,
  - at any time in the 12 months preceding the transfer date.
- Exemption also available in case of amalgamations and demergers

Compliance Obligations

- Reporting obligation on the Indian concern regarding modification of its ownership / control on account of offshore transaction.
- Penalty on Indian concern in case of non-reporting.
- Indirect transfer provisions in domestic law subject to the benefits available under DTAA

THANK YOU