

Capital gains taxation for non-residents under DTC

Attempt to tax transfer of shares held in India by one multinational to another results in conflict in the interpretation of the Source Rule and the Residence Rule.

The Source principle will allocate income over a taxing jurisdiction on the basis of the source of the income or asset in that country, regardless of the residence of the taxpayer.

Nations have recognized that both the country of residence and the country of source have a valid claim to tax income. A nation that is neither the country of source nor residence or citizenship is generally not recognized as having right to tax.

Law requires a nexus between the country which seeks to tax and the source from which the taxable event occurs.

Such nexus may arise either from a business connection or by the situs of the property or from any asset or source of income or by the situs of the capital asset which is transferred.

Doctrine of apportionment

When the Source Rule is invoked and income can be taxed in more than one jurisdiction, a need for apportioning income arises.

When a multinational engages in a composite activity, one component taking place within the jurisdiction of the taxing territory and another outside, how do we tax the profits under the Source Rule?

It is here that courts have invoked the doctrine of apportionment. Indian law so far has no principle for applying the doctrine.

When a transnational corporation carries on multiple activities as part of a composite business which straddles more than one taxing jurisdiction, the income which results from those activities has to be apportioned so as to determine what part of the income can be attributable to the business which is carried on in the taxing jurisdiction. Apportionment presupposes a multiplicity of activities from which income accrues or arises.

DTC provisions

It is in this context that the DTC Bill provides new vistas with regard to taxation of non-residents based on Source Rule. Section 5 of the DTC Bill defines in specific terms when income will be deemed to accrue in India. Sec 5(1) of the DTC Bill is worded on similar lines of the Income Tax Act, 1961 under Section 9(1)(i).

However, the DTC Bill has a new provision excluding from consideration certain types of income in the hands of non-residents with regard to transfer of shares outside India.

Section 5(4) (g) of the DTC Bill lays down that income deemed to accrue in India under subsection (1) shall not include, in the case of a non-resident, income from transfer, outside India, of any share or interest in a foreign company unless at any time in 12 months preceding

the transfer, the fair market value of the assets in India, owned, directly or indirectly, by the company, represent at least 50 per cent of the fair market value of all assets owned by the company.

The assumption behind the new sub-clause (g) of 5(4) is that ordinarily, income from transfer of any share or interest in a foreign company is covered by Section 5(1) (the deeming clause). Upon such assumption, the Bill seems to be generous and gives the exemption of all such income in all cases except where the fair market value of the assets India, as mentioned in sub clause (g), representing at least 50 per cent of the fair market value of all assets owned by in the 12 months preceding the transfer. The incorporation of sub clause (g) in Section 5(4) appears a bit hasty.

The government has assumed that the views expressed by the Bombay High Court in this regard in the case of Vodafone International Holdings B.V Vs. Union of India 321 ITR 126 will ultimately be upheld by the Supreme Court in appeal. Assuming that the ultimate ruling goes in favor of Vodafone, what will happen to this new provision under 5(4)(g)?

New formula

In the Vodafone case, the court also examined the doctrine of apportionment. The difficulty in applying the principle of apportionment is sought to be resolved in Section 5(6) of the DTC Bill by incorporating a formula — $A \times B$ divided by C , where A represents income from the transfer computed in accordance with the provisions of the code as if the transfer was effected in India; B is the fair market value of the assets in India owned, directly or indirectly by the company; and C is the fair market value of all assets owned by the company. The formula looks very elegant and thus attempts to solve the problem relating to apportionment of income in respect of a multinational confronted with demands for tax from the source country as well as the residence country.

The utility of this formula will ultimately hinge on the final ruling of the Supreme Court in the Vodafone case.