India : Taxing Offshore Transfers – India Income Tax implications to drafting

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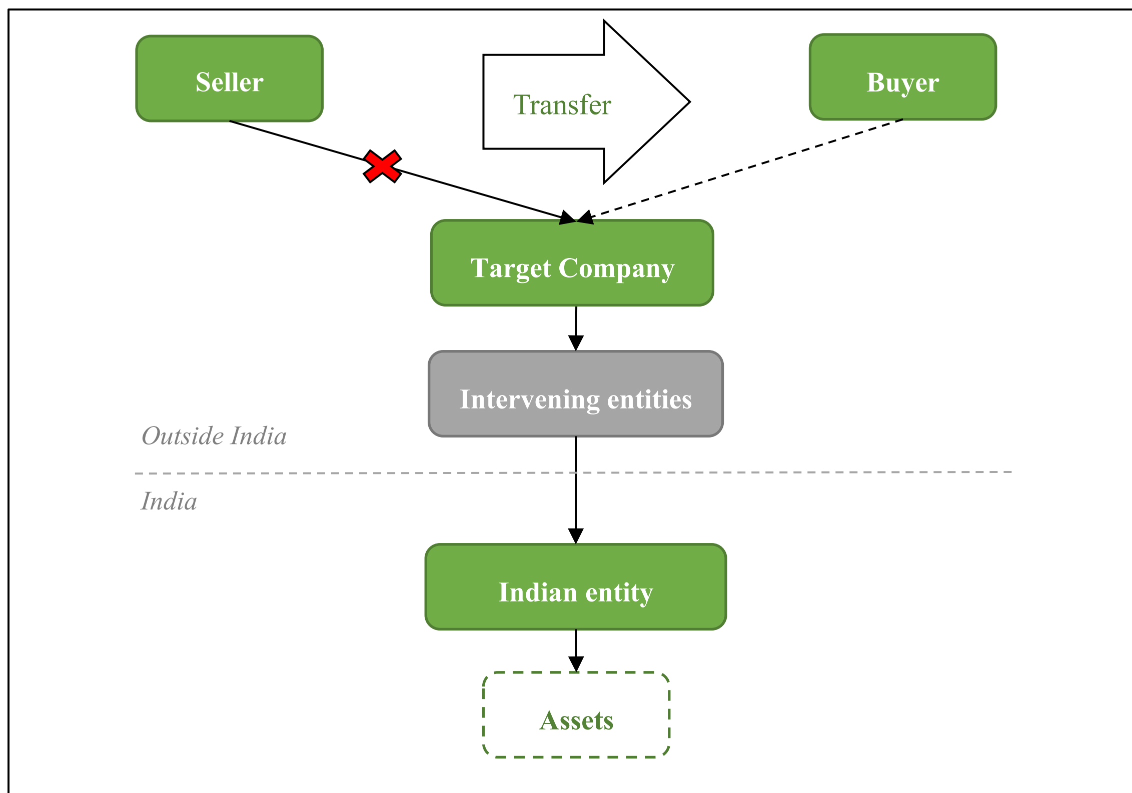
Indian income tax law taxes offshore share transfers - i.e., where the seller ("Seller") and the company whose shares are being sold ("Target Company") are both outside India - if the shares derive their value substantially from India. This provision of Indian law is not common in other tax systems, and is often overlooked when considering offshore transactions. However, it is important for the legal team to keep these provisions in mind when drafting and finalizing the definitive agreements, as they impose obligations on almost all the parties involved, non-compliance with which can attract heavy penalties.



1. Overview of provisions

Under the Indian Income Tax Act, 1961 ("**ITA**"), all income of an Indian tax resident is taxable in India. However, for a non-resident, only income that is sourced from India is taxable.[1] Income from transfer of a

[1] Section 5, ITA

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capital asset situated in India, is deemed to have its source in India,[2] and is taxed as capital gain income of the transferor.

Earlier, Indian law was silent on whether shares of a Target Company, being offshore, could be regarded as "situated" in India in any circumstances. However, in 2012, the law was amended to clarify that a share in a Target Company will be deemed to be "situated" in India if it derives its value substantially from assets located in India.[3] Further, in 2015, it was clarified that such share of the Target Company would be deemed to "derive its value substantially from assets located in India", if the value of the assets in India:[4]
(a) exceeds INR 100 million; and
(b) constitutes 50% or more of the value of all the assets of the Target Company.

Therefore, capital gain arising to a Seller from the transfer of shares of a Target Company can be taxed in India, if the above thresholds are breached. Detailed valuation rules are prescribed to determine if the thresholds are breached, and also to calculate the capital gain.[5]

To ease the rigour of the provisions, the ITA exempts from their purview Sellers who do not own a controlling interest in the Target Company. Specifically, the exemption applies in the following cases:[6]

- If the Target Company directly holds assets in India - to Sellers who in the year prior to the transfer did not hold management, control, nor shareholding of more than five percent of the Target Company; and
- If the Target Company indirectly holds assets in India (through other entities) - to Sellers who in the year prior to the transfer did not hold any rights in the Target Company that would enable them to exercise management, control or voting rights of more than five percent in the entity that directly holds the assets in India.

2. Obligations - tax payment and reporting

The Seller has the primary tax liability on the capital gain arising from the transfer, although the prescribed mechanism for tax collection is withholding by the buyer. If the buyer does not withhold tax, the ITA requires the Seller to pay the tax[7] and Indian tax authorities can proceed against the Seller to recover the tax. Irrespective of the manner of payment, the Seller is required to file a tax return in India and also file a report via Form No. 3CT, certified by a chartered accountant registered in India, that the capital gain has been computed correctly.[8]

As mentioned above, the buyer is required to withhold the relevant tax from the purchase price payable to the Seller,[9] and deposit the tax with Indian tax authorities within the prescribed timeline – which is generally within seven days from the end of the month in which the purchase price is remitted.[10]

From a timing perspective, it is important for advisors of all parties involved in a transaction to consider the applicability of the indirect transfer provisions at the initial stages of negotiations, especially if any of the underlying business of the Target Company is located in India. A conclusive determination can be made only on the basis of a valuation report prepared as per the prescribed valuation rules mentioned above, which can be a time-consuming process. Therefore, where parties are of the view that the value of the assets of the Target Company in India are likely to breach the thresholds listed above for applicability of the indirect transfer tax, it is preferable to initiate the valuation report process at the earliest stage so that parties can ensure certainty on this issue prior to the closing of the transaction.

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[2] Section 9(1)(i), ITA
[3] Explanation 5, Section 9(1)(i), ITA
[4] Explanation 6, Section 9(1)(i), ITA.
[5] Rules 11UB, 11UC and 114DB of the Income Tax Rules, 1962 ("**ITR**")
[6] Explanation 7, Section 9(1)(i), ITA
[7] Section 191(1), ITA
[8] Rule 11UC, ITR read with Form No. 3CT
[9] Section 195, ITA
[10] Rule 30(2), ITR. The exception is for purchase price remitted in March, in which case the tax withheld is required to be deposited by April 30.

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Such a valuation report, along with supporting documentation such as financial projections provided by the underlying entities, should be maintained on file by both the Seller and the buyer in case Indian tax authorities initiate inquiries later. These documents can be used to substantiate the computation of the capital gain tax where the valuation report determines that the indirect transfer tax applies, and also to prove why there is no tax incidence if the report determines that the indirect transfer tax does not apply.

Another practical aspect for parties and their advisors to keep in mind is for the buyer to have obtained a Tax Deduction and Collection Account Number ("**TAN**") - a registration in India required to be able to deposit the withheld tax - within the statutory timeline prescribed for depositing the tax withheld. Buyers who do not possess a TAN should ensure that they apply for a TAN at least three weeks before the due date for deposit of the withheld tax. Sellers should confirm whether the buyer possesses a TAN, or will be obtaining one within the timeline for depositing the withheld tax. A delay in obtaining a TAN would mean a delay in deposit of the withheld tax, which will require the buyer to pay interest at the time it actually deposits the withheld tax.[11]

3. Tax treaty exemptions

A Seller may seek exemption from these ITA provisions if they are subject to a beneficial position under a tax treaty between India and the Seller's country of residence.[12]

-When a seller is a Japanese tax resident-

Under the Japan-India tax treaty ("**Japan-India Treaty**"),[13] a provision similar to India's indirect transfer tax has been included with effect from 1 April 2020, but it only applies if the shares of the Target Company derive more than 50% value from immovable property situated in India.[14] The scope of the ITA provision is wider, as it applies in respect of all "assets located in India" and not just immovable property.

In cases where the underlying assets in India are mostly movable property, the aforesaid provision in the Japan-India Treaty would not apply. In that situation, Article 13 of the Japan-India Treaty on taxation of capital gain does not allow India taxing rights when a Japanese seller is selling shares of a non-Indian company.

-When a seller is a Singapore tax resident-

Unlike the Japan-India Treaty, the Singapore-India tax treaty ("**Singapore-India Treaty**")[15] does not have a provision specifically addressing indirect transfers.

In respect of shares acquired by a Singapore tax resident before 1 April 2017, the Singapore-India Treaty allows taxing rights only to Singapore.[16] However, a transfer of shares acquired by the Singapore tax resident on or after 1 April 2017 "*in a company which is resident of a Contracting State*" is not protected from taxation by India.[17] A Contracting State can mean either India or Singapore.[18] Therefore, India may tax capital gain arising to a Singapore-resident selling shares of a Singapore resident company which were

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11 Section 201(1A), ITA
12 Section 90(2), ITA
13 Convention between the Government of Japan and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("**Japan-India Treaty**")
14 Article 13, Japan-India Treaty, read with Article 9(4), MLI - the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting signed by Japan and India which modifies and supplements the Japan-India Treaty.
15 Agreement between the Government of the Republic of India and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income
16 Article 13(4A), Singapore-India Treaty
17 Article 13(4B), Singapore-India Treaty
18 Article 1(c), Singapore-India Treaty

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acquired on or after 1 April 2017. Further, the residuary clause of Article 13 of the Singapore-India Treaty limits taxing rights only to Singapore for any sale of shares not specified in the preceding paragraphs.[19]

Accordingly, under the Singapore-India Treaty, a Singapore resident seller should not be taxed in India if they are selling shares of:

(a) a Singapore-resident or an India-resident company, which were acquired before 1 April 2017, or
(b) a third jurisdiction, i.e. one that is not a Singapore-resident or an India-resident company, where the shares were acquired on or after 1 April 2017.

While claiming an exemption under a tax treaty, one must be aware that the provisions on indirect transfer are relatively new in the Indian legal system, and the question of availing tax treaty exemptions against these provisions of the ITA is one that is yet to attain finality before Indian courts. Some of the pending proceedings which require determination of this question pertain specifically to the interpretation of the Singapore-India treaty. In addition, with the recent global push towards anti-avoidance legislation, availing of tax treaty benefits in India is subject to tests against the Indian general anti-avoidance rule in Chapter X-A of the ITA, as well as the anti-avoidance tests in tax treaties.

To hedge their risks from liabilities under the indirect transfer provisions, it is advisable for buyers in such offshore transactions to request the Seller to provide a tax opinion obtained from a reliable tax adviser conclusively determining the buyer's withholding liability under the aforementioned provisions. This can be included as a condition precedent to the closing of the transaction under the share purchase agreement. In addition, it is advisable for buyers to negotiate an indemnity provision with a scope wide enough to cover the potential loss to the buyer.

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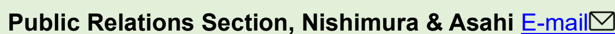

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[19] Article 13(5), Singapore-India Treaty

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