Capital Gains Tax Googly for Non-resident Investors

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The taxation of Capital gains in India can be a complex exercise. This is further aggravated by the twin issues of protracted litigation and high stakes on account of the amounts involved. Therefore, over a period of time, there has been demand for an overhaul in the taxation regime for Capital gains from all the stakeholders.

A recent ruling of the Mumbai Tribunal interpreting the applicability of Section 112(1)(c)(iii) of the Income-tax Act, 1961 ('the Act') vis-à-vis Section 48 of the Act in the case of a non-resident taxpayer has attracted the attention of non-resident taxpayers.

Scheme of taxation of Capital gains for Non-residents

Capital receipts are not chargeable to income tax unless specifically included in the scope of 'income' by Section 45(1) of the Act. It is not open to the Revenue to bring to tax hypothetical income. While Section 45 of the Act is the charging section for Capital gains, while Section 48 provides the mode of computation of such Capital gains.

Section 112 provides that where the total income of a taxpayer includes any income arising from the transfer of a long-term capital asset that is chargeable under the head 'Capital gains', the tax payable by the taxpayer on the total income shall be the aggregate of:

a. the amount of income-tax payable on the total income as reduced by the amount of such Long-term capital gains ('LTCG'); and

b. the amount of income-tax on such LTCG calculated at the appropriate rates.

In the case of Capital gains arising to a non-resident from the transfer of a capital asset being unlisted securities, the tax on Capital gains is payable at the rate of 10% on the amount of Capital gains computed without considering indexation and the benefit of foreign currency conversion [Section 112(1)(c)(iii)]. If the computation mechanism provided in Section 48 results in taxable Capital gains, the tax payable on such Capital gains is to be determined by applying the formula provided in Section 112(1)(c)(iii). Therefore, the interpretation commonly adopted by the taxpayers was that tax is to be computed as per Section 112(1)(c)(iii) only if the computation under Section 48 results in a taxable LTCG on the transfer of unlisted securities. If the computation under Section 48 results in a loss, there is no need to refer to Section 112(1)(c)(iii) to determine the tax payable, since there is no taxable income in the first place.

In a recent ruling in the case of *Legatum Ventures*[1], the Mumbai Tribunal has held that the provision of computation of capital gains provided under Section 112(1)(c)(iii), being a special provision prevails over the general provision under Section 48 for computation of Capital gains. This interpretation of the applicability of Section 48 vis-à-vis Section 112(1)(c)(iii) has raised interesting issues in the computation of LTCG.

If the ratio of the decision is applied to the computation of capital gains by non-resident entities, such non-resident entities may have to end up paying higher LTCG tax.

About the Tribunal Ruling

Legatum Ventures (the taxpayer), a company incorporated in the UAE, is mainly engaged in investment activities. During FY 2017-18, the taxpayer sold shares of Intellecap Advisory Services Private Limited (an unlisted Indian company) and claimed a Long Term Capital Loss ('LTCL') of nearly INR 36.4 million (~USD 0.45 million). In computing the capital loss, the taxpayer had calculated the Cost of acquisition after taking into consideration the exchange rate fluctuation (as per the first proviso to Section 48). The taxpayer had filed its return of income declaring NIL income and carrying forward the LTCL.

Disagreeing with the taxpayer, the Revenue computed the Long-Term Capital Gains ('LTCG') under section 112(1)(c)(iii) of the Act amounting to INR 171 million
(~USD 2.14 million). It was contended that Section 112 of the Act is a special provision applicable in certain specific circumstances. The taxpayers do not have the option to choose between the applicability of Section 48 and Section 112 of the Act.

The Tribunal observed that:

- Section 112(1)(c)(iii) of the Act is a special provision for the computation of capital gains arising from the transfer of unlisted shares and securities for non-residents. On the other hand, section 48 of the Act is a general provision that deals with the mode of computation of capital gains in all cases of transfer of capital assets.
- It is a well-settled rule of interpretation that if a special provision is made with respect to a certain matter, such matter is excluded from the general provisions under the rule which is expressed by the maxim 'generalia specialibus non derogant.
- It is also a well-settled rule of construction that when, in an enactment, two provisions exist, which cannot be reconciled with each other, they should be so interpreted that, if possible, effect should be given to both provisions.

In light of the above discussion, the Tribunal concluded that if the income chargeable under the head Capital gains is to be computed only as per the mode prescribed under section 48 it will render the computation mechanism provided under section 112(1)(c)(iii) redundant. Thereby, it upheld the computation of capital gains assessed by the Revenue.

With due respect to the Tribunal and wisdom of its members, we have analysed the ruling and its impact on similar transactions.

Analysis of the Tribunal's decision

By invoking the principle of interpretation of *generalia specialibus non-derogant* (meaning the general does not detract from the specific), the Tribunal has held that not only the determination of rate of tax on LTCG on sale of unlisted equity shares will be as per Section 112(1)(c)(iii) but also the computation of capital gains itself is

Application of specific provisions of law over the general provisions

The issue of interplay of Section 112 and Section 48 of the Act in connection with extending the benefit of indexation to non-resident entities in computing capital gains computation has been put forth to the courts on various occasions in the past.

The Bombay High Court in the case of *CIT V. Anuj A Sheth*[2] has held that Section 112 requires a comparison to be made on the one hand between the tax payable in respect of income arising from the transfer of listed securities computed at 20 percent with the tax payable at the rate of 10 percent on the capital gains before giving effect of indexation.

In the case of *Cairn U.K. Holdings Ltd. In Re*[3], it was held that there is no dichotomy between the proviso to section 112(1) and the third proviso to Section 48. Section 48 is a section which governs the mode of computation of income whereas section 112 determines the tax payable on such income. The relief provided for by the proviso to section 112 is intended to cover cases where the effect of inflation is not provided for.

Applicability of Section 48 and Section 112 is mutually exclusive

While Section 48 allows the taxpayers to compute the capital gains on the transfer of shares of an unlisted Indian company in foreign currency that was used for original investment, Section 112 provides for a reduced rate of tax of 10%, subject to the capital gains being computed without availing the benefit of indexed cost and conversion of foreign exchange.

Thus, Section 112 of the Act only provides computation of capital gains to avail of a reduced rate of tax. Each section can be given its full effect, without any contradiction. Neither Section 48 nor Section 112 overrule the other as both sections operate in different fields. Section 48 provides for the computation of taxable income while Section 112 provides for the quantification of tax.

Impact of the decision

The Tribunal ruling could potentially lead to non-resident entities being subjected to capital gains tax in India despite incurring actual losses. Let us take an example to understand:

- Say, a foreign entity has invested USD 1 million in an Indian unlisted company in FY 2013-2014 when the rate of exchange was, say, USD 1 = INR 60.
- In FY 2022-23 the foreign entity undertakes group restructuring and transfers the shares of the unlisted Indian company at cost for USD 1 million. The prevailing exchange rate is say, USD 1 = INR 80.

Computation of capital gains under Section 48 and Section 112

Particulars	**Section 48**		**Section 112**	
	USD	**INR**	**USD**	**INR**
Sale consideration	1,000,000	-	1,000,000	
In Indian currency (applying Rule 115/115A)				800,000,000
Less: Cost of acquisition				
In foreign currency	1,000,000	-	1,000,000	
In Indian currency (applying Rule 115/115A)				600,000,000
Taxable Capital-Gains		**-**		**200,000,000**

In the above example, the foreign entity is adversely affected by the fall in the rate of the Indian currency vis-à-vis foreign currency. As per the first proviso to Section 48, the foreign entity has the benefit of computing the capital gains in the same currency which was used for investing in India and then converting the amount of gain into Indian currency. In the above example, the amount of capital gains will be NIL, if calculated as per Section 48. However, if the capital gains are calculated as per Section

112 i.e. without the benefit of foreign currency conversion, it will result in capital gains of INR 200 million.

The computation of taxable income should be ideally based on the real income theory. Prior to the insertion of the first proviso to section 48 by the Finance Act, 1989, for non-resident Indians, the courts have held that capital gains from the transfer of shares of an Indian company shall be computed by converting the cost of acquisition, exclusively related expenditure and the sale consideration into the same foreign currency as was initially utilised for purchase of shares and the capital gains so computed in such foreign currency shall be reconverted into Indian currency.

If the decision of the Tribunal is to be followed the Capital gains of non-resident entities will depend on the performance of the Indian Rupee against foreign currencies. A fall in the value of the Indian Rupee will result in increased capital gains for the non-residents and as a corollary, if the Indian Rupee stands stronger against the foreign currency, the capital gains made by non-residents can escape taxation.

This issue seems to require the intervention of the higher authorities and it is likely that the Tribunal order will be appealed in the High Court.

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[1] [TS-210-ITAT-2023(Mum)]

[2] [TS-5297-HC-2010(BOMBAY)-O]

[3] [TS-419-AAR-2011]