

NON-RESIDENT *VIS-À-VIS* SECTION 112 & 48 OF THE INCOME TAX ACT, 1961

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1. Introduction

The position of a non-resident under the Indian Income Tax Act, 1961 ('IT Act') has always been under the radar, be it the current Vodafone controversy or the landmark Supreme Court judgment in Azadi Bachao Case. One of such issues is whether a non-resident can claim benefit of section 112 on the transfer of listed securities i.e. whether he can claim to pay tax @10%. The issue has been dealt at by the Income Tax Appellate Tribunal ('ITAT') level as well as Authority for Advance Ruling ('AAR') level and there are conflicting judgments to that effect. Currently the issue is *sub judice* before the Hon'ble Bombay High Court in the *Director of Income Tax (International Taxation) v Chicago Pneumatic Tool Company, USA*, ITXA/2251/2009 ('Chicago Pneumatic'), and the matter was last heard on 28 January 2010. The Hon'ble Bombay High Court in its order dated 28 January 2010 framed 3 questions for consideration amongst which the relevant to the issue under consideration is:

"Whether on the facts and in the circumstances of the case and in law the ITAT was justified in holding that the capital gains of the respondent were taxable @ 10% in view of the proviso to section 112 of the Act?"

The above issue also becomes relevant since the issue hasn't yet reached beyond High Court and the decision of the Hon'ble Bombay High Court would certainly bring clarity to the legal position. This article deals with the position proclaimed by AAR and ITAT in its positive as well as negative rulings dealing with the issue at hand.

2. Correlation of section 48 and section 112 of the IT Act *vis-à-vis* Non-resident

2.1 Section 48 of the IT Act deals with the mechanism for computation of capital gains and allows certain deductions that can be claimed *viz.*, Expenditure incurred wholly and exclusively in connection with such transfer, Cost of acquisition, Indexed cost of acquisition, Cost of improvement and Indexed cost of improvement. However, the benefit of indexation is not available to a non-resident where following conditions are satisfied:^{1[1]}

- (i) A non-resident transfers a capital asset being :
 - shares in an Indian company, or
 - debentures of an Indian company.
- (ii) Such capital asset is acquired by the non-resident by utilising foreign currency.
- (iii) The assessee is not covered under section 115AC or 115AD at the time of transfer of the asset.

2.2 Section 112 of the IT Act, on the other hand, deals with the method of computing income-tax on capital gain by taking into consideration section 48 of the IT Act. With respect to non-residents it provides that tax on capital gains shall be charged @20%, however the section provides a proviso which is worth reproducing:

"...Provided that where the tax payable in respect of any income arising from

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the transfer of a long-term capital asset, being listed securities or unit or zero coupon bond, exceeds ten per cent of the amount of capital gains before giving effect to the provisions of the second proviso to section 48, then, such excess shall be ignored for the purpose of computing the tax payable by the assessee."

That is, the proviso makes it clear that where the capital asset is a listed security and the tax payable before giving effect to second proviso exceeds 10%, the tax will be levied @10%.

- 2.3 A correlative reading of both the sections at first seem to give an impression that in the case of transfer of listed securities by a non-resident, tax will be levied @10% since the benefit of indexation is not available with a non-resident as provided under section 48 (second proviso). However, the proviso itself would become redundant if the position stated in the earlier sentence be followed and an absolute benefit is given to non-resident. The matter has been dealt cautiously by AAR and ITAT and produced below are relevant extracts of judgments by AAR and ITAT, ruling in favour as well as against the issue in consideration.

3. Conflicting Judicial Precedents

3.1 In favour of claiming tax @10%

- (i) *Chicago Pneumatic Tool Company v The DDIT, (IT)-I(2)*, 22 December 2008, ITAT Mumbai Bench

ITAT held that:

"On joint reading of section 112 and 48, it becomes clear that where Long Term Capital Gain arises from transfer of shares or debentures of an Indian company to a non-resident the benefit of indexed cost of Acquisition and indexed cost of improvement he allowed. In so far the case under consideration is than that can be read in the Second Proviso to Section 48 of the Act. Now, turning to proviso to Section 112, it is clearly borne out that where the tax payable in respect of transfer of a Long Term Capital asset being listed securities or units exceeds 10% of the amounts of capital gain then such excess shall be ignored. The significance of the words 'before giving effect to the second proviso to Section 48' is manifested by the fact that the rate is to be determined by computing capital gain by adopting the cost of acquisition 'and cost of improvement or the indexed cost of acquisition and the cost of improvement as a case may be. Since, in the case of non-resident on transferring shares of an Indian company the second proviso to Section 48 is not applicable in as much as the benefit of indexation cannot be granted, the mandate of the proviso to Section 112 will simply be to the effect that the tax payable has to be computed and such tax in excess of 10% is to be ignored. The authority for advance ruling in McLeod Russel Kolkata Ltd. have held that the benefit of proviso to Section 112(1) of the Act could not be denied to non-resident/foreign companies even if they are entitled to another relief in terms of first proviso to Section 48 of the Act. The protection in terms of first proviso to Section 48 of the Act is made available to non-resident might be a justification to deny the benefit of cost of indexation, but the same cannot be said

for the application on lesser rate. The Mumbai Bench of Tribunal in Alcan Inc. v. DDIT (IT) had also held that the assessee is entitled to concessional rate of tax @10% both on account of the originally held shares and bonus shares. Following the ratio laid down on the above said issue, we are of the view that the benefit of proviso to Section 112(1) of the Act is to be allowed to the assessee and the capital gains tax is to be charged at the concessional rate of 10%."

(ii) Timken France SAS, 212 CTR 349, AAR, 1 October 2007

AAR held that:

"...The first and foremost question is whether in terms of the proviso to section 112(1) of the Act, the income from capital gains arising from the transfer of shares answering the description of "listed securities" held for more than 12 months, is liable to be taxed at 10 % only...

...In plain and peremptory words, the proviso limits the rate of tax on the gains from the transfer of listed securities to 10%, but, with an important rider that the quantum of capital gains should be arrived at without taking into account the formula laid down in the second proviso to section 48 based on the indexed cost of acquisition. In other words, while computing the capital gains on the listed securities held for more than 12 months, do not give effect to the calculation spelt out in the second proviso to section 48 wherever it is applicable, or to put it in a different language, let not the indexation formula enter into the computation process-that is the mandate of controversial phrase in the proviso to section 112(1). It does not say-deny the concessional rate of tax to the category of assesses who are not eligible to have the benefit of indexed cost of acquisition under the second proviso. In other words, the eligibility to avail the benefit of indexed cost of acquisition (under the second proviso to Section 48) is not a sine qua non for applying the reduced rate of 10% prescribed by the proviso to section 112(1). The second proviso to section 48 is only a mode of computation of capital gains. The crucial words relied upon by the Revenue cannot be construed as the words of exclusion of a category of assesses i.e. non-residents who cannot avail of indexation benefit prescribed by the proviso to section 112(1). The second proviso to section 48 is only a mode of computation of capital gains. The crucial words relied upon by the Revenue cannot be construed as the words of exclusion of a category of assesses i.e. non-residents who cannot avail of indexation benefit."

(iii) Burmah Castrol Plc. 307 ITR 324, AAR, 19 November 2008

AAR relied heavily on Timken France SAS, 212 CTR 349 and ordered in favour of the Assessee.

3.2 Against claiming tax @10%

(i) Cairn U.K. Holdings Ltd., AAR/950/2010, AAR, 1 August 2011 (**'Cairn Holdings'**)

AAR held that:

"We are of the view that a ruling under the Act (Timken France) is confined to the facts and the law projected in the application leading to the ruling and binding only on that party and the revenue. In a case where, with respect, certain aspects germane to the issue are not examined and the authority has taken a view, we think that we are not hampered from taking a fresh look on that issue when raised before us. The applicant is not eligible to avail the benefit of lower rate of tax of 10% on the capital gains on the sale of shares."

4. CONCLUSION

Taking into consideration the ratio of the above-mentioned rulings, a view in favor of allowing benefit @10% seems to be higher than going against it. However, of all the above-mentioned rulings, the ruling of AAR in Cairn Holdings is the latest and may act as the current view when the Bombay High Court sits to decide Chicago Pneumatic. Thus, in view of the unsettled position *vis-à-vis* the issue in consideration, the Bombay High Court ruling in Chicago Pneumatic will act as a precedent to set down the principles for the interpretation of section 112 and 48 of the Income Tax Act, 1961 for the chargeability of capital gains tax in case of a non-resident.