Income arising on Indirect Transfer of Shares

BACKGROUND

In India, non-residents are taxed on income which accrues, arises or received or is deemed to accrue, arise or received in India. However, many developing countries including India have concerns with non-residents avoiding capital gains on assets located in source country, by transferring those assets indirectly, i.e. by transferring interests in entities that own such assets, rather than the assets themselves. This is possible where global businesses are held through multi-tiered structures with intermediate holding company outside India deriving substantial value from assets/business carried on in India.

In order to tax such offshore indirect transfer deriving value from Indian business/assets/entities, India has deemed such indirect transfer to accrue in India so as to tax them in certain circumstances.

The Coverage of the article is as under:

I. What is Indirect Transfer?
II. When Share/Interest is said to derive its substantial value from assets located in India?
III. Exceptional situations where Indirect Transfer provisions are not applicable to Non-residents
IV. Reporting requirements for Transferor
V. Reporting Requirements for Indian Concern
VI. Computation of value of Assets

I. WHAT IS INDIRECT TRANSFER?

When shares of foreign company or interest in any entity incorporated or registered outside India is transferred and if such shares or interest **derives its substantial value from assets located in India** directly or indirectly, then such transfer is commonly referred to as 'Indirect Transfer'.

In case of such indirect transfer, the income shall be deemed to accrue or arise in India and would be taxable for all including not ordinarily residents as well as non-residents.

II. WHEN SHARE/INTEREST IS SAID TO DERIVE ITS SUBSTANTIAL VALUE FROM ASSETS LOCATED IN INDIA?

The share or interest would be regarded as deriving substantial value from assets located in India if on **specified date,** **<u>fair market value</u>** of such assets –

a. **Exceeds INR 100 million**, AND
b. Represents **at least 50% of the fair market value** of total assets owned by the foreign company/entity.

For the above purpose, **specified date** shall be -

a. **End date of the last accounting period** preceding the date of transfer of share/interest of foreign company/entity; or
b. **Date of transfer,** if book value of total assets of foreign company/entity on date of transfer exceeds book value of total assets on end date of last accounting period as above by 15%.

Note – Accounting period means 12 months period ending 31st March. If a foreign company/entity follows any other 12 months period for complying with tax provisions or reporting to shareholders/ interest holders, then such period shall be considered as the accounting period.

Note – The above deeming provision of indirect transfer does not cover declaration of dividend by such foreign company/entity.

III. EXCEPTIONAL SITUATIONS WHERE INDIRECT TRANSFER PROVISIONS ARE NOT APPLICABLE TO NON RESIDENTS

- The indirect transfer provisions are **not applicable to Category I and II Foreign Portfolio Investors** under SEBI (FPI) Regulations, 2014 **prior to 23rd September 2019**. Now the **exemption** from indirect transfer is **available only to Category I FPI under SEBI (FPI) Regulations, 2019 effective 23rd September, 2019**.
- Indirect transfer provisions shall not apply, if the non-resident transferor, directly or indirectly, at any time in the 12 months preceding date of transfer individually or along with its Associated Enterprise –
    a. **does not hold management or control rights**
    b. **does not have voting power or interest or share in capital exceeding 5%** of total voting power or interest or share capital, as the case may be.

- Transfer of shares of a Foreign Company (which directly or indirectly derives its value substantially from shares of Indian Company) under **scheme of amalgamation or demerger** subject to fulfillment of certain conditions. However, there is no express exemption available to shareholders of such Foreign Company.
- For a non-resident transferor, only **that part of income shall be deemed to accrue or arise in India, which is reasonably attributable to assets located in India** i.e. gains arising from transfer of share or interest in a foreign company/entity shall be taxable to the extent as such share or interest derives its value from Indian assets.

  As per Rule 11C of Income Tax Rules, the above attribution shall be based on the following formula:-

$$\boxed{\text{Income from Indirect transfer of Assets}} \times \frac{\boxed{\text{Fair Market Value of Indian Assets on specified date}}}{\boxed{\text{Fair Market Value of Total Assets of Foreign Company/entity on specified date}}}$$

  Note – If above formula is not applied, then assessing officer shall determine such income attributable to Indian assets as he/she may deem fit.

- CBDT has also clarified[1] that provisions of indirect transfer shall not apply to multi-tiered investment structures on redemption or buyback of share or interest held <u>indirectly</u> through upstream entities registered/incorporate outside India in Investment Fund/Venture Capital Fund/Venture Capital Company (specified funds) if such income accrues or arises from or in consequence of transfer of shares or securities held in India by specified funds and is chargeable to tax in India. The benefit shall be applicable only in those cases where the proceeds of redemption/buy back to non-resident do not exceed the pro rata share of non-resident in the total consideration realized by the specified funds from the said transfer in India. However, non-resident investing directly in the specified funds shall continue to be taxed as per the extant provisions.

[1] Circular No 28 of 2017 dated 07th November 2017

IV. REPORTING REQUIREMENTS FOR TRANSFEROR

A. The transferor of such share or interest needs to obtain an eligible accountant's certificate in **Form No. 3CT** providing the basis of the apportionment in accordance with above formula prescribed as per Rule 11UC and certifying that income attributable to assets located in India is correctly computed.

B. Form 3CT shall be furnished along with return of income u/s 139(1).

C. *Information required in Form 3CT :-*

- Details of consideration received
- Cost of Acquisition
- Date of Transfer
- Income derived from transfer of share or interest
- Income attributable to Indian Assets
- Value of Indian Assets
- Value of Global Assets
- Methods used for above valuations
- Other Supporting Documents

V. REPORTING REQUIREMENTS FOR INDIAN CONCERN

The Indian concern in/through which the foreign company /entity derives its substantial value shall have following reporting requirements as per Section 285A of income Tax Act, 1961 and rules laid down under Rule 114DB –

✓ Indian Concern shall electronically furnish information in **Form 49D** within **90 days from the end of financial year** in which any indirect transfer has taken place.

However, when above transfer has resulted in transferring the right of management or control in relation to Indian concern, then Form 49D shall be furnished within **90 days from the date of transfer**.

✓ Various information has to be provided by Indian Concern, few details that are required are –

a) Details about complete Holding Structure of Indian concern along with other group entities in India
b) Contract/Agreement for transfer of asset
c) Financial statements of Foreign Company/Entity for 2 years prior to date of transfer

d) Information on business operations, personnel finance, properties, etc

e) Audit Reports, Valuation Reports, etc. of foreign entity

f) Details of payment of tax outside India.

g) Valuation Report in relation to Indian Asset and Total Assets

VI. COMPUTATION OF VALUE OF ASSETS

The valuation of assets is necessary to determine the income attributable to assets located in India. The value of assets shall be Fair Market value without reduction of liabilities and shall computed as per provisions of Rule 11UB of Income Tax Rules. The summary of such rules is given as follows:-

Nature of Asset	Manner of Computation
I) Rules for FMV Calculation of Indian Assets	
a) Shares of a Listed Indian Company	
- Where share confers right of management or control, directly or indirectly	FMV = [(market cap of the company on the basis of observable price on stock exchange)+(book value of liabilities on specified date)]/Total no. of outstanding shares. (If listed on more than one stock exchange, then take the price of stock exchange which recorded highest volume of trading in the share)
- Other than those conferring rights as above	FMV = Observable Price of such share on stock exchange (If listed on more than one stock exchange, then take the price of stock exchange which recorded highest volume of trading in the share during the said period)
b) Share of an unlisted Indian Company	Determination to be done by a merchant banker or an accountant as per internationally accepted valuation methodology.

	The above shall be increased by value of liability, if any, considered in such determination.
c) Interest in a partnership firm or association of persons	Determination of value of partnership firm to be done by a merchant banker or an accountant as per internationally accepted valuation methodology. The above shall be increased by value of liability, if any, considered in such determination. **Allocation** The above value of partnership firm shall be apportioned to the extent of capital in the ratio of capital contribution and balance to be distributed in accordance with agreement as per asset distribution ratio on dissolution or in absence thereof, in the profit sharing ratio.
d) Any other asset than those covered above	Price it would fetch if sold in the open market as determined by a merchant banker or an accountant as per internationally accepted valuation methodology. The above shall be increased by value of liability, if any, considered in such determination.
Note – For determining FMV of above Indian Assets, all the assets/business operations shall be taken into account, even if such assets/business operations are located outside India.	
I) Rules for FMV Calculation of Total Assets of Foreign Company/Entity	
a) Where the transfer of share/interest is between the persons who are **not Connected Persons** as defined u/s 102(4)	FMV = (market cap of the foreign company/entity on the basis of full value of consideration for transfer)+(book value of liabilities on specified date, as certified by a merchant banker or accountant)

b) Where the transfer of share/interest is between the persons who are **Connected Persons**	
- Shares are listed on a stock exchange	FMV = (market cap of the company/entity on the basis of observable price)+(book value of liabilities on specified date). (If listed on more than one stock exchange, then take the price of stock exchange which recorded highest volume of trading in the share)
- Shares are not listed on a stock exchange	Determination to be done by a merchant banker or an accountant as per internationally accepted valuation methodology. The above shall be increased by value of liability, if any, considered in such determination.

Note: Observable Price shall be higher of average of the weekly high and low of the closing prices for

a) 6 months preceding the specified date, or

b) 2 weeks preceding the specified date.

16 May 2021