LOWER CAPITAL GAINS FOR FOREIGN COMPANIES FROM ANY SECURITIES TRANSACTION

August 2009

While giving its ruling in an application filed by Fujitsu Services Limited, the Authority of Advanced Rulings (**"AAR"**) held that foreign companies transferring shares of a listed company can claim benefit of a lower rate of tax on capital gains arising from the transaction.

Facts of the case:

Fujitsu Services Limited (**"Fujitsu"**), a company incorporated in United Kingdom had acquired shares of an Indian company Zensar Technologies Limited (**"Zensar"**) constituting 26.55% of the share capital of Zensar and such shares were held for over 12 months. These shares were listed on the National Stock Exchange and the Bombay Stock Exchange. On July 04, 2007, Fujitsu sold its entire shareholding to Jubilee Investments and Industries Limited (**"Jubilee"**), an Indian company and Pedriano Investments Limited (**"Pedriano"**), a Cyprus company. Jubilee and Pedriano deducted tax from the sale consideration @ 20% but Fujitsu contended that tax ought to be deducted at 10%, the rate applicable to long term capital gain (**"LTCG"**).

Issues before the AAR:

1. Will tax be deducted @ 10% on the sale of shares of Zensar as per the proviso to section 112(1) of the Income Tax Act, 1961 (**"Act"**) pertaining to tax on LTCG?

2. Will the beneficial rate of 10% be levied on LTCG arisen by applying section 48 read with first proviso to section 48 of the Act, pertaining to indexed cost of acquisition, and rule 115A of the Income Tax Rules?

Ruling of the AAR:

The AAR held that explanation to section 112(1) is applicable to the shares held by Fujitsu but what it actually had to rule over was whether Fujitsu could take the benefit of a lesser rate of tax as per the proviso to section 112(1) of the Act. The proviso states that where tax payable in relation to any income arising from the transfer of a long term capital asset such as a listed security exceeds 10% of the amount of capital gains *before giving effect to the second proviso* to section 48, then such excess tax will be ignored while computing the tax payable by the assessee. The second proviso to section 48 is not applicable to any LTCG if the capital gain arises to a foreign company from transfer of shares of an Indian company. The AAR held that the words “before giving effect to the second proviso to section 48” merely imply that any calculation done under proviso to section 48 of the Act will not be considered while computing capital gains.

The AAR stated that while computing captain gains of a listed security held for more than 12 months, the indexation formula spelt out in the second proviso to section 48 of the Act cannot influence the computation process. According to the AAR, second proviso to section 48 of the Act is only a method of computing capital gains and it does not imply that the non-resident or foreign companies, who cannot avail the indexation benefit, are not eligible to the reduced rates under proviso to section 112(1). Accordingly, the AAR finally ruled that Fujitsu can claim tax deduction at a lesser rate of 10% on the sale of shares of Zensar to Jubilee and Pedriano.

Our observation:

LTCG is applicable on the sale of listed securities only if securities transaction tax (**“STT”**) is not paid by the assessee and the securities are kept for a minimum period of 12 months. In light of this ruling, foreign companies will not be discriminated with regard to deducting tax on LTCG arising on sale or transfer of any listed securities. They will be entitled to the same deduction benefits that are available to an Indian company under proviso to section 112(1) of the Act.

The government released its Direct Tax Code (**“Code”**) on August 12, 2009 which aims to abolish STT and allow the benefit of indexation to foreign companies as well. However, it is not certain by when this Code will come into force and till then, this ruling of the AAR on the point of deduction of tax by a foreign company on the sale or transfer of securities will only help bring in clarity for future transactions.

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