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TAX FLASH NEWS

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Gains arising from the grant of the call option for 150 years are not taxable as capital gains under the India-Singapore tax treaty

Background

Recently, the Mumbai Bench of the Income-tax Appellate (the Tribunal) in the case of Praful Chandaria[1] (the taxpayer) dealt with a case where a Singapore resident entered into the call option agreement with a Mauritian company, granting the option, valid for 150 years, to the Mauritian company to call upon him to sell the entire shareholding in an Indian company. The Tribunal held that there is no alienation of shares, as per the call option agreement, but a valuable and substantive right in the shares of an Indian company has been given to a non-resident company. Such valuable right/interest in shares would certainly be a capital asset, and therefore, its transfer shall be considered as a transfer of an asset under the Income-tax Act, 1961 (the Act) which is assessable under the head 'capital gain'. However¸ the capital gain is not taxable in India under Article 13(6) of the India-Singapore tax treaty (the tax treaty), since the taxing right has been given to the resident state i.e. Singapore.

Facts of the case

- The taxpayer is a non-resident Indian (NRI) residing in Singapore and is a tax resident of Singapore.
- The taxpayer had acquired certain equity shares in Purse Holding (India) Pvt. Ltd. (PHIL), which was established as a Special Purpose Vehicle (SPV) along with ING Barring Mauritius (BM), a company registered in Mauritius. Both PHIL and BM had invested in an Indian company named as ING Barring India Pvt. Ltd (BI) having two Indian directors.
- BI was mainly established as a non-banking finance company dealing in investment banking, brokerage business, etc. in India. The BM held 75 per cent of the shareholding, whereas PHIL held 25 per cent of the shareholding in BI. The taxpayer's share in PHIL was more than 99 per cent, and it had two other Indian directors who were having one equity share each in PHIL.
- On 19 November 2009, the taxpayer along with other two directors entered into the 'Call Option Agreement' between BM and the first shareholders to sell their shares held in PHIL to BM. The call/strike price was agreed at USD1. As per the said agreement, the entire consideration for the grant of 'call option' was to be paid by BM to the first shareholders in their bank accounts.
- The right of 'call option' was to be exercised within the period of 150 years and it was agreed that, upon the receipt of call notice and the payment of call value, the first shareholders should be obliged to transfer the shares to BM within one month of the payment of call value.
- There was another 'Call Option Agreement' (the second agreement) dated 14 December 2001, between PHIL and BM, whereby PHIL agreed for giving BM an option to purchase the entire shares held by PHIL in BI, and the consideration for this option was agreed at strike value/call price at INR1, and period of option was again for 150 years.

[1] Praful Chandaria v. ADDIT(IT) [ITA No.: 4313/Mum/2011 (AY: 2002-03)] and Purse Holdings India P Ltd. v. ADDIT(IT) [ITA No.: 4717/Mum/2013 (AY: 2002-03)] - Taxsutra.com

- In response to the show cause issued by the Assessing Officer (AO), the taxpayer submitted that he has not transferred any of his shares in PHIL to BM. Therefore, there is no question of earning any capital gain from transfer of shares, and in any case, no income has accrued or arisen to him under Section 9(1)(i) of the Act.
- However, the AO held that the taxpayer had effectively alienated his shares in PHIL by way of an irrevocable undertaking and the power of attorney (POA) for which consideration was already received. The taxpayer had received income through or from the transfer of the capital asset situated in India, and therefore, the consideration received by the taxpayer is taxable in India as per Section 5(2) read with Section 9(1) of the Act.

The Tribunal's ruling

Giving a call option for perpetuity amounts to transfer of asset

- In common parlance, a call option is reckoned as a contract in which the holder (buyer) has the right (but not an obligation) to buy a specified quantity of a security/share at a specified price (strike price) within a fixed period. For the writer (seller) of a call option, it represents an obligation to sell the underlying security at the strike price if the option is exercised. The call option writer is paid a premium for taking on the risk associated with the obligation.
- In the present case, there is an agreement/arrangement, where the strike price has been mentioned as USD1 and the period for exercising the call option has been fixed for 150 years. This fact itself means that the call option in the shares has been given for perpetuity. Also, an irrevocable POA has been executed in favour of ING Bank in respect of all the shares in PHIL, confirming that the taxpayer will not at any time purport to revoke the same. These facts, inter-alia show that the taxpayer has alienated a substantive and valuable right as an owner of the shares in perpetuity, albeit without dejure (legally) alienating the shares itself.
- Based on the 'call option agreement' and other material facts on record, a valuable and substantive right in the shares of PHIL, namely giving the right to sell shares at a determined price, has been alienated by the taxpayer and hence it cannot be held merely as a call option agreement simplicitor.
- In the present case, though, there may not be any actual alienation of shares in terms of the 'call option agreement', but a valuable and substantive right in the shares of an Indian company have been given to a non-resident company i.e. BM.
- Under normal circumstances, no right in the shares is given away by way of 'call option', albeit only right to buy the shares at a strike price within a stipulated time period is given, which may not be termed as 'capital asset' under Section 2(14), because, without exercising the option no actual asset is created.
- In the present case, the right in the shares has been given for an incredibly large period of 150 years. Also, the rights which are enjoyed by the taxpayer as a shareholder have been exercised by the POA holders to participate in the affairs of the company, and the taxpayer shall not at any time purport to revoke the same. Such a bundle of substantive rights is generally not given under normal 'call-option agreements'.
- In the peculiar facts of the present case, such an option right in the shares has to be reckoned as transfer/alienation of a valuable and substantive right, which would be a class of asset in itself, separate from shares, which though continue to stand in the name of the taxpayer. Such valuable rights/interest in shares would certainly be a 'capital asset'. Parting with any substantive interest in the asset or creating any substantive interest in any asset or extinguishment of a right/s in an asset, directly or indirectly would surely be reckoned as a 'transfer' of an asset/property even under Section 2(47) of the Act.
- Hence, the consideration received has to be taxed under the head 'capital gain' as there is a transfer of an asset/property.

Taxability of capital gains under the tax treaty

- Paragraphs 1, 2 and 3 of Article 13 of the tax treaty, would not be applicable in this case. The alienation of shares as mentioned in para 4 and 5 of Article 13 will not be applicable because no actual shares have been transferred or alienated.

- A substantive and valuable right has been given in the shares, which has to be reckoned as capital asset or property; hence, it is the gains from the alienation of an asset or property. Any gain from the alienation of such kind of 'property', will fall within the scope of Para 6 of Article 13, whereby the taxing right has been given to the Resident State, i.e. the State of the alienator, namely Singapore. The allocation of taxing right under Article 13(6) cannot be attributed to India, but to the Resident State.
- Firstly, the consideration received by the taxpayer is arising from the assignment of substantive and valuable rights in the shares of an Indian company, which is assessable under the head 'capital gain'. Secondly¸ such a capital gain cannot be held to be taxable in India in terms of para 6 of Article 13 of the tax treaty.

Our comments

In the present case, the Tribunal observed that a call option simplicitor in shares is not a 'capital asset' because without exercising the option no actual asset is created. However, the right in the shares has been given for an incredibly large period of 150 years. Also, the rights which are enjoyed by the taxpayer as a shareholder have been exercised by the POA holders to participate in the affairs of the company, and the taxpayer shall not at any time purport to revoke the same. Such a bundle of substantive rights is generally not given under normal 'call-option agreements'. Accordingly, such valuable rights/interest in shares would be a 'capital asset', and its transfer, directly or indirectly, would be considered as a 'transfer' of an asset under the Act, assessable under the head 'capital gain'. Further, such capital gains cannot be taxable in India under Article 13(6) of the tax treaty, since the taxing right has been given to the resident state i.e. Singapore.

The Bombay High Court[2] held that there would be no transfer of 'call option rights' giving rise to capital gains in the hands of the taxpayer on the transfer of the business to the taxpayer group. Subsequently, the Supreme Court of India has allowed the Special Leave Petition[3] against this decision.

[2] Vodafone India Services (P.) Ltd. v. CIT [2016] 69 taxmann.com 283 (Bom)
[3] CIT v. Vodafone India Services (P.) Ltd. [2016] 70 taxmann.com 383 (SC)

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