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Tax alert: Taxpayer eligible for India-Cyprus tax treaty benefit, capital gains exemption

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The Delhi Bench of the Income-tax Appellate Tribunal, based on facts of the case and on documents on record, has rendered its decision that the taxpayer was eligible for exemption under Article 13 of the India-Cyprus tax treaty for the sale of shares.

In a nutshell

The approvals by regulators such as SEBI, RBI, etc. are granted after intense scrutiny and therefore cannot be overlooked.

As per the minutes of the board meetings, only one director from USA was present only in one meeting wherein the issue regarding transfers of shares of I Co was discussed. For other board meetings held during the year under consideration, only directors based in Cyprus were present in the meeting. Therefore, the taxpayer company was managed in Cyprus and not in the USA.

Once it is established that the taxpayer was carrying its business activities in Cyprus and taxpayer was having TRC issued by the Revenue Authority at Cyprus, and was not merely a pass-through entity, the Revenue's allegation that it is merely a pass-through entity, had no basis.

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Background:

- The taxpayer[1] is a company incorporated in Cyprus as an investment holding company. It carries out investment activities and holds investment in securities in Indian company.
- The taxpayer is a wholly owned subsidiary of another company (H Co) incorporated under the provisions of Cyprus company law. The taxpayer is a tax resident of Cyprus and held a Tax Residency Certificate (TRC) issued by Cyprus Revenue Authorities, for the year under consideration i.e. Financial Year (FY) 2020-21 corresponding to Assessment Year (AY) 2021-22.
- The taxpayer had acquired equity shares of a recognised stock exchange in India (I Co) from its holding company (H Co) in June 2014. During the year under consideration i.e. FY 2020-21 corresponding to AY 2021-22, the taxpayer sold shares of I Co in different tranches to unrelated independent third-party buyers.
- The taxpayer filed return of income and disclosed Long-term capital gain (LTCG) on sale of equity shares of I Co and claimed the LTCG as not taxable in India under Article 13 of India-Cyprus tax treaty (related to capital gains). The taxpayer also earned dividend income from I Co and offered the same to tax at the rate of 10% under Article 10 of the India-Cyprus tax treaty.
- During the course of audit proceedings, the Assessing Officer (AO) after examining the ownership structure of the taxpayer, list of directors of the company, beneficiary of the transactions of sale of shares etc. concluded that:
  - The ultimate beneficiary of the transaction of sale of shares of I Co was a company based in USA (US Co).
  - The entire profits i.e. LTCG on sale of shares was routed through the taxpayer based in Cyprus to its controlling company in USA.
  - The directors of the US Co were the directors of the taxpayer based in Cyprus. The decision-making process for the taxpayer was primarily carried out by US Co directors.
  - The authorized signatory for operating bank accounts was not based in Cyprus. One person based in USA was authorized by the Board to operate the bank account. However, the said person was not director of the taxpayer company and was based in USA and was VP Finance & Accounting of the USA Co.
  - The taxpayer company was run, controlled and managed by US Co. The taxpayer was merely a shell company established in Cyprus with an intention of circumventing Indian tax laws using India-Cyprus tax treaty as a tool.

  Hence, the AO denied the benefit under the India-Cyprus tax treaty to the taxpayer on the transaction of sale of shares of I Co and added LTCG in the total income of the taxpayer. Further, the AO also denied treaty benefit on the dividend income earned by the taxpayer on the shares held in I Co.
- Aggrieved, the taxpayer filed objections before the Dispute Resolution Panel (DRP). The DRP vide its directions confirmed the findings of the AO.
- Aggrieved, the taxpayer filed an appeal before the Delhi bench of the Income-tax Appellate Tribunal (ITAT).

Relevant provisions in brief:

Relevant extracts of ARTICLE 13 and Protocol of the India-Cyprus tax treaty (relating to Capital Gains)

Article 13

[1] Gagil FDI Ltd vs ACIT (International taxation), Delhi [2025] ITA No. 2661/Del/2024 (Delhi-Tirb.)

"...4. Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 in a company which is a resident of a Contracting State may be taxed in that State.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5, shall be taxable only in the Contracting State of which the alienator is a resident."

Protocol

"2. Ad. Article 13

*Notwithstanding anything in paragraphs 4 and 5 of Article 13 of the Agreement, gains from the alienation of shares that have been acquired at any time **prior to the first day of April 2017 shall be taxable only in the Contracting State of which the alienator is a resident**. However, nothing in this paragraph will apply to gains from the alienation of shares that have been acquired on or after the **first day of April 2017**."*

Decision of the ITAT:

The ITAT acknowledged that the question before them was whether the taxpayer was entitled to benefit under the India-Cyprus tax treaty? In this regard, the ITAT noted/ held as follows:

Investment in shares of I Co after getting clearance from various Indian agencies

- The taxpayer during the course of submissions had demonstrated that for making investment in the shares of I Co a thorough scrutiny was carried out by various Indian regulatory agencies under different statutory provisions. The primary purpose for carrying such scrutiny by Indian agencies was to ascertain genuineness of the investment making entity.
- The H Co, also based in Cyprus, had purchased shares of I Co. At the time of purchase of shares by H Co, Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI), FIPB[2] Unit of Department of Economic Affairs, Ministry of Finance, Govt. of India had made detailed investigation and thereafter approved investments made by H Co.

  Similarly, when H Co transferred shares of I Co to the taxpayer, similar exercise was carried out by all the aforesaid Indian agencies. This fact was evident from the approvals placed on record by the taxpayer. For the purpose of regulating ownership and governance in stock exchange, SEBI has laid down eligibility criteria for holding shares in a stock exchange in India.
- Further, under another regulations[3], SEBI had restricted the shareholding in a Stock Exchange. These regulations showed that the investing institutions/persons had to pass rigour scrutiny before approval was granted to them for making investment in shareholding of Stock Exchange. Any shell company making an endeavor to make such investment shall be caught.
- The approvals granted by regulators like SEBI, RBI, etc. are granted after intense scrutiny and therefore cannot be overlooked.

Taxpayer was based in Cyprus and not in the USA

- The taxpayer had also shown that the decisions of investment/disinvestment for taxpayer were carried out in Cyprus. The taxpayer had placed on record the gist of board meetings, key decisions made therein and the name of directors who participated in meetings during FY 2020-21.

  A perusal of the same revealed that only one director from USA was present only in one meeting held during the year, wherein the issue regarding transfers of shares of I Co was discussed. For other board

[2] Foreign Investment Promotion Board (FIPB)

[3] Securities Contracts (Regulation) (Manner of Increasing and Maintaining Public Shareholding in Recognized Stock Exchange) Regulations, 2006

meetings held during FY 2020-21, only directors based in Cyprus were present in the meeting. Therefore, the taxpayer company was managed in Cyprus and not in the USA.

Reliance on similar ruling

- Once it was established that the taxpayer was carrying its business activities in Cyprus and taxpayer was having TRC issued by Revenue Authority at Cyprus, and was not merely a pass-through entity, the allegation of Revenue that it was merely a pass-through entity had no feet to stand. Reliance was placed on an earlier ruling[4] of the ITAT in this regard, wherein the ITAT allowed the benefit of tax treaty to the taxpayer.

In view of the above, facts of the case and documents on record, the ITAT held that the taxpayer was entitled to India-Cyprus tax treaty.

Comments:

Eligibility to claim tax treaty benefits, especially in case of capital gains tax exemption has been a subject of litigation.

The ITAT in the case under consideration, by relying on similar earlier ruling and based on facts and documents, has the following:

- The approvals granted by regulators like SEBI, RBI, etc. are granted after intense scrutiny and therefore cannot be overlooked.
- As per the minutes of the board meetings, only one director from USA was present only in one meeting wherein the issue regarding transfers of shares of I Co was discussed. For other board meetings held during the year under consideration, only directors based in Cyprus were present in the meeting. Therefore, the taxpayer company was managed in Cyprus and not in the USA.
- Once it is established that the taxpayer was carrying its business activities in Cyprus and taxpayer was having TRC issued by Revenue Authority at Cyprus, and was not merely a pass-through entity, the allegation of the Revenue that it is merely a pass-through entity, had no basis.

Please note the Delhi HC in another ruling[5] wherein it was held that based on facts of the case and TRC, capital gains exemption under India-Mauritius tax treaty cannot be denied. The Revenue authorities have filed an appeal before the Supreme Court (SC) and it is currently pending before the SC.

Taxpayers with similar facts may evaluate the impact of this ruling to the specific facts of their cases.

[4] Saif II-Se Investments Mauritius Ltd. vs. ACIT [2024] 154 taxmann.com 617 (Delhi-Trib.)

[5] Tiger Global International III Holdings vs. AAR (Income-tax) [2024] 468 ITR 405 (Delhi HC)