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Tax alert: Gain on sale of minority shares of real estate companies is not taxable

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The Mumbai Bench of the Income-tax Appellate Tribunal (ITAT) has held that capital gains on sale of minority shares of Indian real estate companies, are covered by Article 14(6) [residuary provision] and not Article 14(4) [relating to alienation of shares deriving value from immovable property] of the India-Spain tax treaty, as the taxpayer did not have any right of enjoyment, control or disposal over the immovable properties held by such companies.

In a nutshell

Article 14(1) to 14(5) carves out specific categories of capital gains which may be taxed in the source State, whereas paragraph 14(6) is the residuary provision allocating exclusive taxing rights to the State of residence in respect of gains arising from alienation of any property not falling within the preceding clauses.

For Article 14(4) to apply, it is not sufficient that the company whose shares are transferred, is engaged in the real estate business or that immovable property constitutes an important component of its assets; what is required is that the gains arising from the alienation of shares should, in substance, partake of the character of gains derived from immovable property situated in the source State.

The taxpayer's holding was minuscule and did not confer upon it any right of enjoyment, control or disposal over the immovable properties held by such companies, particularly when such properties constituted business assets / stock-in-trade of the companies themselves.

Hence, such gains could not be brought within the ambit of Article 14(4), but would come for consideration under Article 14(6) of the India-Spain tax treaty, and would accordingly be taxable only in the State in which the taxpayer was a resident.

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Background:

- The taxpayer[1] is a regulated company based in Madrid, Spain, and is licensed to purchase and sell securities in India as a Foreign Institutional Investor (FII), registered with the Securities and Exchange Board of India (SEBI).
- During the Financial Year (FY) 2015-16 corresponding to Assessment Year (AY) 2016-17, the taxpayer had invested in shares and securities in the Indian stock market and had suffered a net short-term capital loss (STCL) on sale of shares of companies engaged in real estate development activities classified under BSE Realty Index, which was claimed as exempt under Article 14(6) of the India-Spain tax treaty. For subsequent FY 2016-17, corresponding to AY 2017-18, the taxpayer earned short-term capital gains (STCG) which was also claimed as exempt under Article 14(6) of the India-Spain tax treaty.
- During the audit proceedings, the Assessing officer (AO) held that the STCL as well as the STCG earned by the taxpayer during the relevant AYs are taxable in India under Article 14(4) of the India-Spain tax treaty, on the grounds that the shares of the companies that were sold, were engaged in real estate development activities classified under BSE Realty Index, and the value of such shares was derived from immovable properties owned by them.
- Aggrieved, the taxpayer filed an appeal before the Commissioner of Income-tax (Appeals) [CIT(A)]. The CIT(A) allowed the appeal and deleted the disallowance made by the AO.
- Aggrieved, the Revenue filed an appeal before the Mumbai Bench of the Income-tax Appellate Tribunal (ITAT).
- The taxpayer contended before the ITAT that the shareholding of the taxpayer ranged from 0.01% to 2.62% which cannot be given any right to enjoy the immovable properties held by the real-estate companies. The investee companies were engaged in real-estate development business and the assets were acquired by them and held as stock-in-trade used by these companies towards development activity. Hence, there was no question that the taxpayer could have got any right in the immovable properties held by these companies.

Relevant provisions of Article 14 of the India-Spain tax treaty [Capital gains]

...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 for the alienation of shares of the capital stock of a company forming part of a participation of at least 10 per cent in a company which is a resident of a Contracting State may be taxed in that Contracting 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.

Decision of the ITAT:

The ITAT acknowledged that issue under consideration was whether the gains arising to the taxpayer from sale of shares of Indian real estate companies are covered by Article 14(4), i.e., gains from alienation of shares of a company whose property **consists directly or indirectly principally of immovable property situated in India**, or whether such gains fall in the residuary clause under Article 14(6) of the India-Spain tax treaty.

The ITAT noted as follows:

- Article 14(1) to 14(5) of the India–Spain tax treaty carves out specific categories of capital gains which may

[1] DCIT vs. Merrill Lynch Capital Markets Espana SA SV. [2026] 184 taxmann.com 716 (Mumbai - Trib.)

be taxed in the source State, whereas Article 14(6) is the residuary provision allocating exclusive taxing rights to the State of residence in respect of gains arising from the alienation of any property not falling within the preceding clauses.

- For Article 14(4) to apply, it is not sufficient that the company whose shares are transferred, is engaged in the real estate business or that immovable property constitutes an important component of its assets; **what is required is that the gains arising from the alienation of shares should, in substance, partake of the character of gains derived from immovable property situated in the source State.**
- The taxpayer's holding was minuscule and did not confer upon it any right of enjoyment, control or disposal over the immovable properties held by such companies, particularly when such properties constituted business assets / stock-in-trade of the companies themselves. Such gains could not be brought within Article 14(4) of the India-Spain tax treaty but would fall under Article 14(6) of the India-Spain tax treaty and would accordingly be taxable only in the State of which the taxpayer was a resident.
- The AO, while holding that the taxpayer was liable to tax in India on capital gains arising from the sale of shares held in real estate companies under Article 14(4) of the India–Spain tax treaty, had merely followed the earlier years' assessment orders on identical issues. However, when these same issues came up before the ITAT[2], it upheld the decision of the CIT(A) allowing the taxpayer's claim of exemption on capital gains under Article 14(6) of the India-Spain tax treaty.
- Since there was no material difference in facts involved in the current AY, following the orders of the ITAT in the taxpayer's own case for earlier AYs on the same issue, and there being no material change either in facts or in law, the order of the CIT(A) was to be upheld, capital gains were not chargeable to tax in India under Article 14(4), but fall within the ambit of Article 14(6) of the India–Spain tax treaty.

Comments:

Allocation of taxation rights in case of capital gains depends on the category of assets held by a taxpayer. In case of alienation of shares of a company which owns substantial immovable assets, a question arises whether the same can be covered under article governing gains from alienation of shares of capital stock of a company, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State. In such a case, the gains may be taxed in the Contracting State in which the immovable property is situated.

The ITAT in this ruling has laid emphasis on the fact that in substance the alienation of shares should partake of the character of gains derived from immovable property situated in the source State. Further, based on facts of the case, the ITAT has *inter-alia*, held the following:

- For Article 14(4) to apply, it is not sufficient that the company whose shares are transferred is engaged in the real estate business or that immovable property constitutes an important component of its assets; what is required is that the gains arising from the alienation of shares should, in substance, partake of the character of gains derived from immovable property situated in the source State.
- The taxpayer's holding was minuscule and did not confer upon it any right of enjoyment, control or disposal over the immovable properties held by such companies, particularly when such properties constituted business assets / stock-in-trade of the companies themselves. Hence, such gains could not be brought within Article 14(4) but would come for consideration under Article 14(6) of the India-Spain tax treaty and would accordingly be taxable only in the State of which the taxpayer was a resident.

It may be pertinent to note that as per Article 14(5) of the India-Spain tax treaty, gains covers cases only where the alienation of shares of the capital stock of a company forms part of a participation of at least 10 per cent in

[2] ITA No. 2824/Mum/2012 & Ors.

a company which is a resident of a Contracting State. Thus, where the shareholding is 10 per cent or more then one may want to examine if the gains from alienation of shares is taxable under Article 14(5) of the India-Spain tax treaty.

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