B S R & Co. LLP

Indirect transfers and related issues

Ajay Rotti

Partner, International taxation

BSR & Co LLP

July 2014

Contents

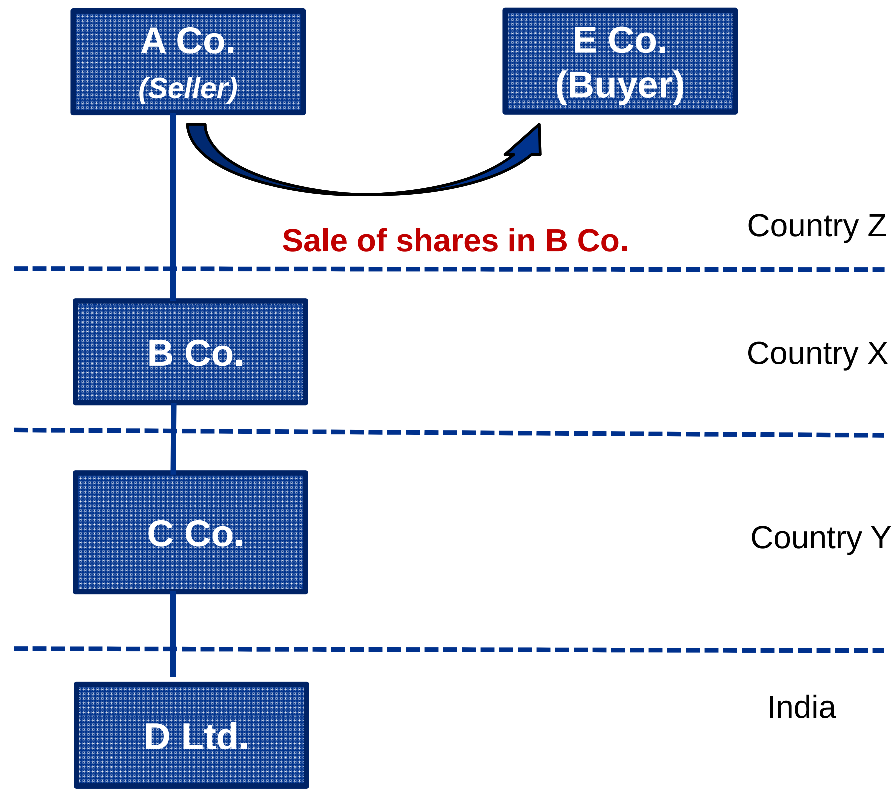
Sr No.	Contents
1	**Background – indirect transfer** ▪ Typical group structure ▪ Case study – Vodafone controversy ▪ Overview of retrospective amendments ▪ Retrospective amendment – Impact ▪ Areas of controversy ▪ Case study – indirect transfer
2	**GAAR & indirect transfer** ▪ Evolution ▪ Basic provisions ▪ Shome Committee ▪ Areas of controversy / impact ▪ Case study
3	**Indirect transfer** ▪ International practice ▪ Multiple taxation?

Background

Background

Typical holding structure* - with overseas transfer

- Several MNC groups set up holding companies or intermediate holding companies in their home jurisdictions to route investments into foreign jurisdictions. These holding companies are set up primarily for commercial reasons such as:
  - ✓ Ring fencing the liability of the ultimate parent which may arise in the operating companies.
  - ✓ Attracting partners/strategic investors who may be interested in a specific business without diluting or changing the parent company shareholding.
  - ✓ Segregation of investments from operations in the Parent Co.
  - ✓ Ability to effectively manage a diversified business through separate holding structures.



*There could be several other operating / holding subsidiaries in various countries in the structure

*The use of multi-level holding structures for international holdings examined at length by the Supreme Court in the Vodafone case and accepted as a commercial reality

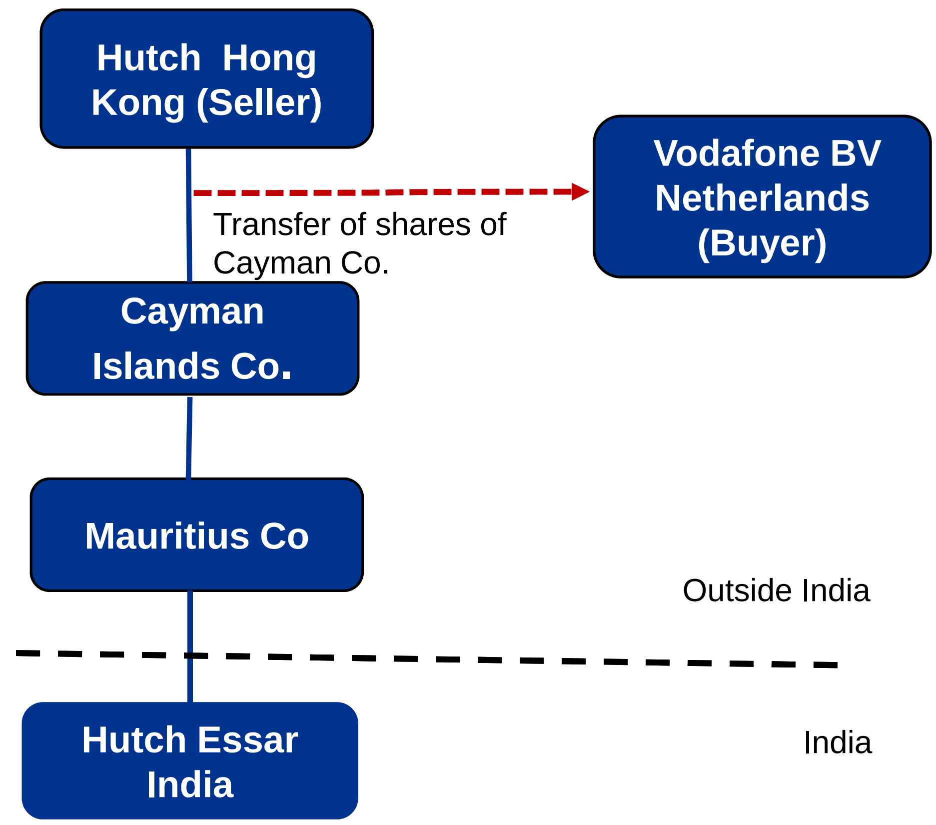
Case study – Vodafone controversy

The Vodafone Controversy…

Whether a transaction involving offshore sale of shares of a Cayman Islands company with downstream Indian assets is liable to tax in India?

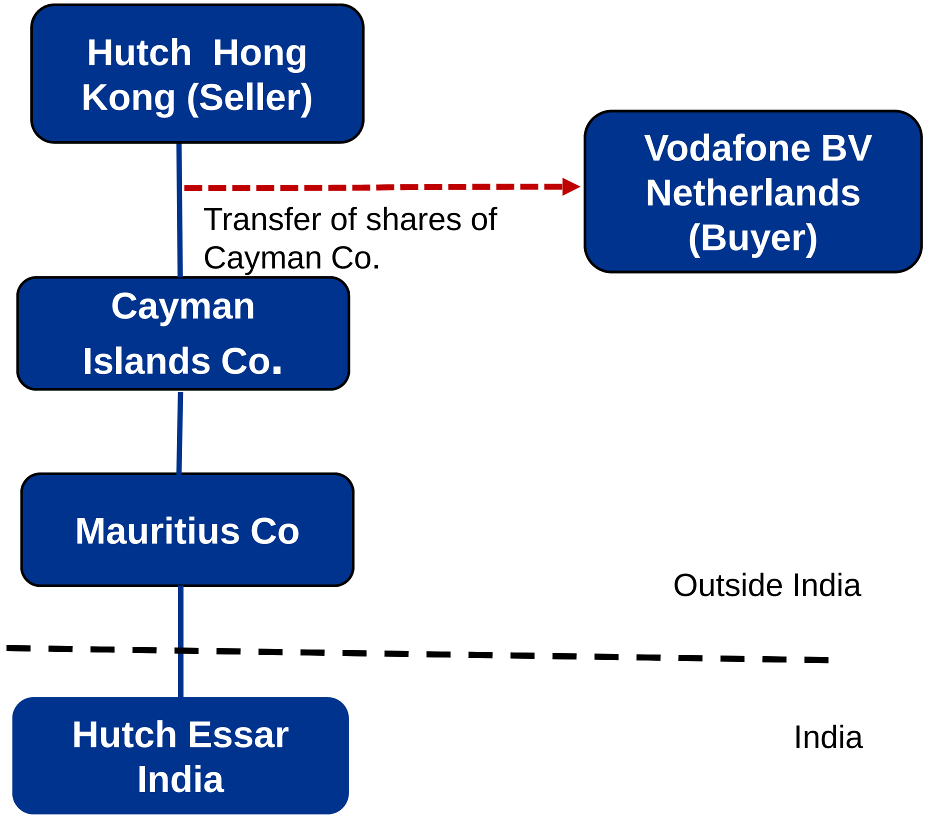
Whether a non-resident having no presence in India is liable to withhold tax on payments made to a non-resident?

Whether a non-resident acquiring shares of an overseas company (having downstream Indian assets) is liable to be assessed on the gains as a 'representative assessee' of the seller?



The Vodafone Controversy…

- Shares of Cayman Islands Co transferred to Vodafone BV
- Indian Revenue Authorities contended that :
  - Such shares indirectly deriving substantial value from assets located in India
  - income arising pursuant to sale of shares of the Cayman Islands Co taxable in India
  - Withholding tax proceedings initiated against Vodafone BV for failure to deduct tax on gains arising to Hutch on sale of shares



The Vodafone Controversy…

Revenue's Contention	*Taxpayer's position*	*Supreme Court's judgment*
• Transaction was designed for avoiding Indian taxes • Tax laws permit disregarding the form of the transaction and lifting the corporate veil • Transfer of foreign company's shares resulted into transfer of assets located in India • Controlling interest is a separate asset situated in India whose transfer gives rise to Indian tax • Tax withholding obligations extend to non residents	• Multi-pronged commercial rationale behind tiered structures such as ring-fencing liability, mitigation of risk, enabling separate verticals etc. • No provision for bringing 'indirect' transfers within the tax net • 'Rights and entitlements' flow from the transfer of shares and are not separate capital assets	• Transfer of shares in a foreign company does not lead to the transfer of assets situated in India • Tax planning is legitimate if within the legal framework • "Look at" test to be applied to determine true nature of transaction • Legal form cannot be disregarded unless the transaction is a sham or tax avoidant • Several factors to be considered in determining whether transaction is legitimate • Controlling interest is embedded in the shares and is not a separate asset

- **Taxpayer's position accepted by the Supreme Court in the Vodafone case**
- **Supreme Court ruled that offshore transaction of sale of shares not taxable in India**

Overview of retrospective amendments

Overview of retrospective amendments…

Impact

Legislative Response to the Vodafone decision under the Finance Act, 2012:

***Retrospective Amendments (w.e.f. 1 April 1962) made to the Income-tax Act, 1961 in order to clarify*:**

- the *situs* of shares/interest in certain foreign companies for s. 9(1)(i)
- the definition of "capital asset" under s. 2(14)
- the definition of "transfer" under s. 2(47)
- the meaning of the expression "through" in s. 9(1)(i)

Past notices etc. validated – Section 119 of the Finance Act, 2012

- Impact on judicial remedies

Overview of retrospective amendments …

Situs of shares/interest in certain foreign companies

Prior Legal Position:

Situs of shares is where the company is incorporated and where its shares can be transferred

Finance Act, 2012: (w.e.f. 1 April 1962)

Share/interest in a foreign company deemed to be situated in India, if the share/interest derives, directly or indirectly, its value substantially from the assets located in India

Definition of 'capital asset'

Prior Legal Position:

"Rights and entitlements" not identifiable or distinct capital assets from shares held

Finance Act, 2012: (w.e.f. 1 April 1962)

Capital asset deemed to include any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever

Overview of retrospective amendments …

Definition of 'transfer'

Prior Legal Position:

Shares and the rights which emanate from them, flow together and cannot be dissected

Finance Act, 2012: (w.e.f. 1 April 1962)

"Transfer" deemed to include disposing of or parting with an asset / interest or creating any interest in any manner, notwithstanding that such transfer of rights has been characterized as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India;

Meaning of 'through'

Prior Legal Position:

"Through" did not mean "in consequence of"

Finance Act, 2012: (w.e.f. 1 April 1962)

The expression "through" deemed to mean "by means of", "in consequence of" or "by reason of".

Overview of retrospective amendments …

Validation of past notices etc.- Section 119 of the Finance Act, 2012:

- All notices, levies, demands, assessments etc. in respect of indirect transfers deemed valid notwithstanding any contrary judicial order
- Notices etc. cannot be called into question on any ground
- Amounts deposited /collected need not be refunded

Budget 2014 | retrospective amendments …

Budget speech 2014 by Hon'ble Finance Minister: Retrospective amendments

- **The sovereign right of the Government to undertake retrospective legislation is unquestionable;**
- **Extreme caution and judiciousness shall be exercised in exercising the power;**
- **The Government will not ordinarily bring about any change retrospectively which creates a fresh liability;**
- **Consequent upon certain retrospective amendments to the Income Tax Act 1961 undertaken through the Finance Act 2012, a few cases have come up in various courts and other legal fora. These cases are at different stages of pendency and will naturally reach their logical conclusion; and**
- **All fresh cases arising out of the retrospective amendments of 2012 in respect of indirect transfers and coming to the notice of the Assessing Officers will be scrutinized by a High Level Committee to be constituted by the CBDT before any action is initiated in such cases.**

Retrospective amendments - Impact

Indirect Transfers

Vodafone Wins $2 bn Tax Case in Supreme Court

January 20, 2012

Supreme Court held that Indian Tax authorities have no basis to tax the sale of indirect interests held in the Indian Company

Finance Act 2012- India Imposes Tax on indirect transfer of Indian assets

May, 2012

- India makes retrospective changes to the law that would effectively reverse the decision of the Supreme Court in the Vodafone case
- Allows India to tax non-residents on gains arising from the disposal of share or interest if such share or interest derives its value "substantially" from Indian assets
- A validation clause has been introduced to legitimise recovery of tax on such indirect transfers (Clause 119 of the Finance Act)
- Withholding tax obligation to extend to all persons, resident or non-resident, irrespective of the presence of non-resident in India

Major Transactions impacted by such retrospective amendments

- Mitsui – Vedanta deal – Sale of 51% in Sesa Goa to Vedanta
- SABMiller's acquisition of 100% stake in Fosters India
- Sanofi Aventis' acquisition of majority stake in the Indian vaccine company Shanta Biotech
- Kraft – Cadbury takeover deal

Dampened Enthusiasm for International Investment in India

Retrospective amendments - Impact

Retrospective amendments

- Against international best practice
- Resort to retrospective amendments in other countries only in the rarest of the rare cases

Certainty in taxation

- a key driver of India's investment climate
- Retrospective amendments have a negative impact on investor confidence
- Pose significant challenges from a tax planning and compliance standpoint

Retrospective overruling of judicial precedents

- Potentially undermines rule of law in India

Concerns over retrospective amendments

- acknowledged by Prime Minister as well as Finance Minister
- Circular F. No. 500/111/2009-FTD-I dated 29 May 2012 clarifies that cases where assessment proceedings under s.143(3) have been completed prior to 1 April 2012 will not be reopened on account of the retrospective amendments

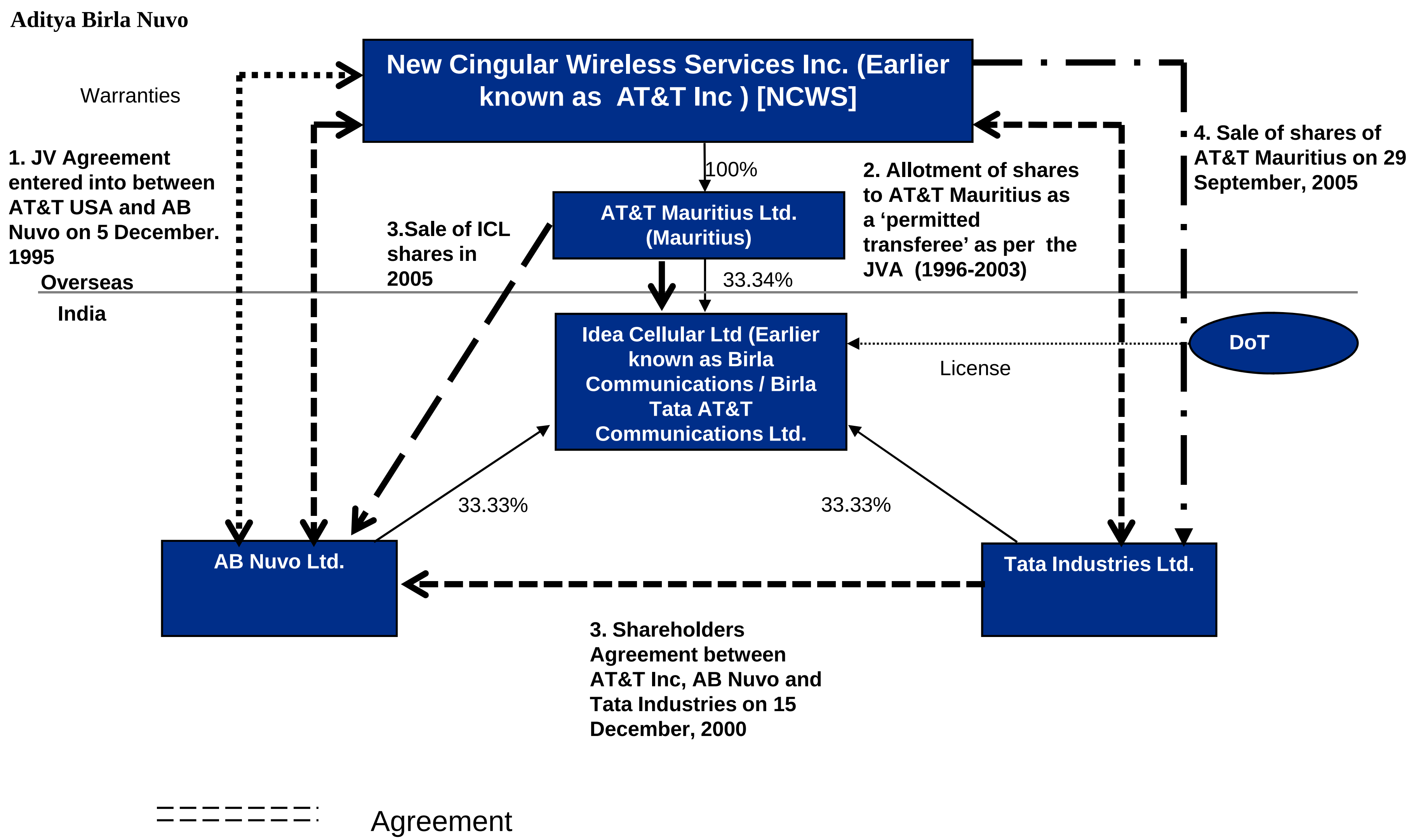
Areas of controversy - indirect transfer

Taxation of Indirect transfers – Areas of the controversy

Scope of 'substantially'	Transfer of 'controlling interest'	Applicability of treaty provisions
Withholding tax liability on past transactions	Availability of treaty benefits	Single stage levy
Group re - organization's	Transactions in listed securities	Methods for determining value derived from India

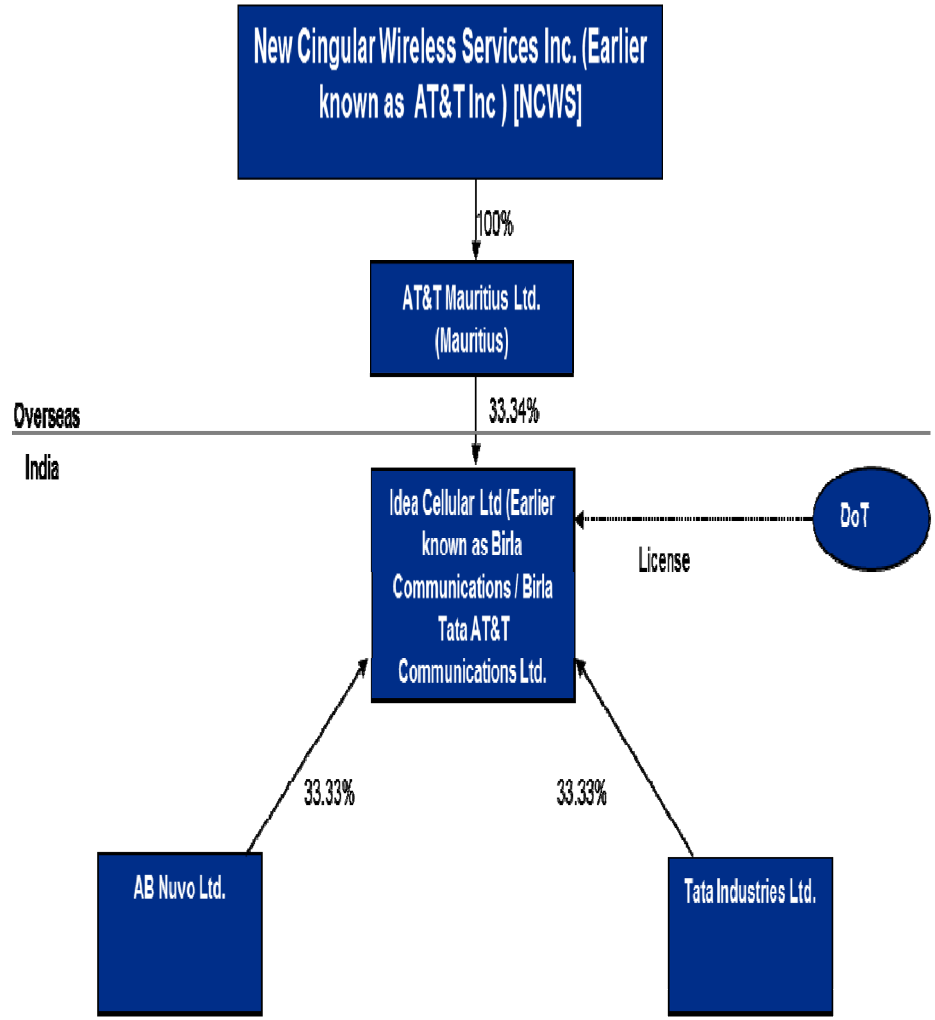
Case study

Case Study 1 | Aditya Birla Nuvo Ltd – Transaction overview



Facts of the case

- Under JV Agreement entered into between AT&T USA and AB Nuvo (December 1995)
  - AT&T USA under obligation to subscribe AND pay for shares constituting 49% stake in the JV Co i.e. ICL (name changed from BCL / BCL AT&T) (Page 7)
  - AT&T USA vested with power to direct management and policies of ICL (Page 7)
  - AT&T USA to exercise rights as member / shareholder of ICL (Page 7)
  - Shares of ICL could be sold by AT&T Mauritius only if AT&T USA consented to the sale (Page 13)
  - Shares in ICL to be held by AT&T USA in its own name or through a "permitted transferee" (as a 100% subsidiary of AT&T USA) – Allotment of shares to AT&T Mauritius as a permitted transferee (Page 7, 8)
  - AT&T Mauritius was funded by AT&T USA by way of equity and debt for purchasing shares in ICL



Facts of the case ..

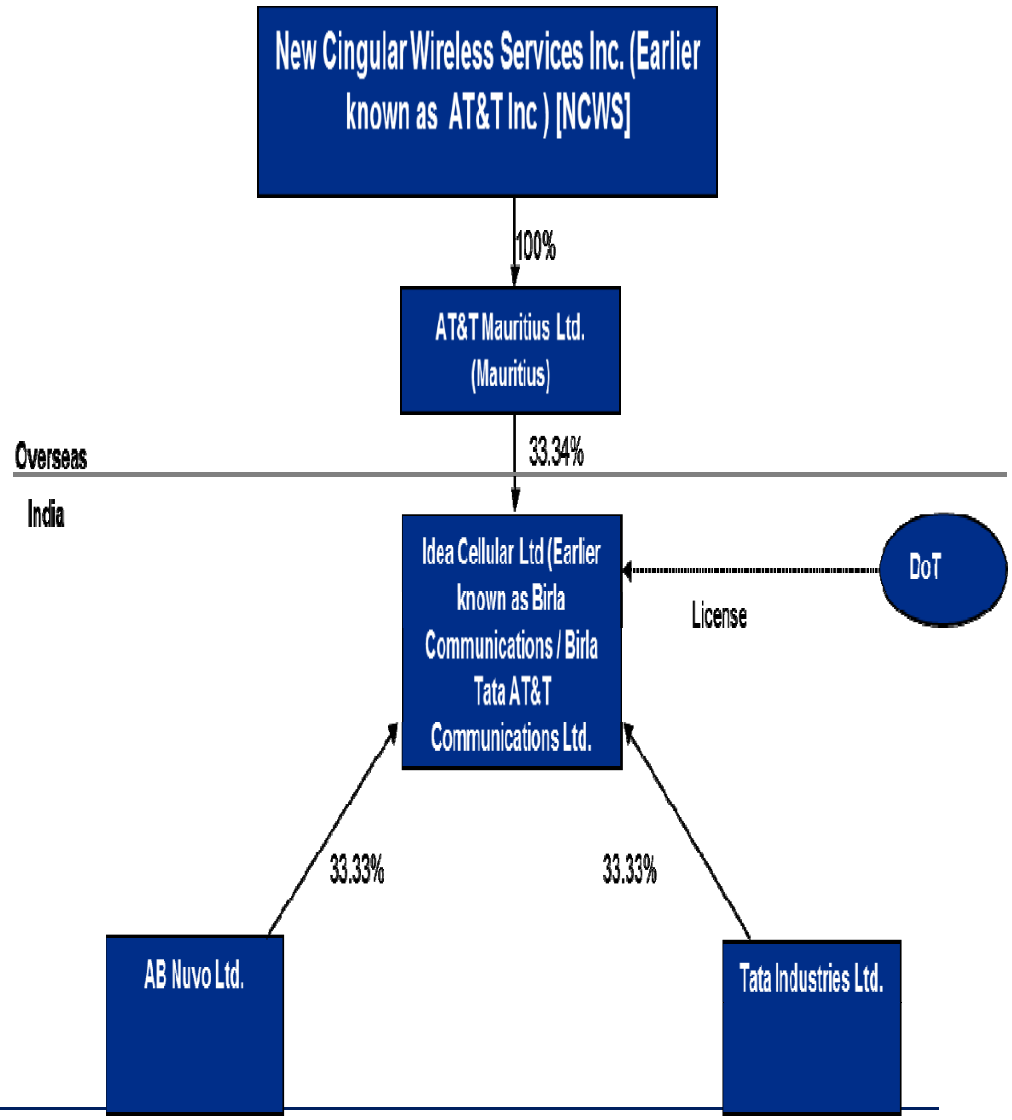
- Tata Industries Limited was added to the JV - new Shareholder Agreement ('SA') entered into (December 2000)

  - Under the SA, AT&T Mauritius shall designate AT&T USA as its representative to exercise all rights and obligations attached to shares except the obligation to pay for the shares (Page 43)

- Sale of ICL shares by AT&T Mauritius to AB Nuvo under a Sale and Purchase Agreement (September 2005)

  - NCWS, a party to the Sale and Purchase Agreement only for the purposes of warranties

  - NCWS sold shares of AT&T Mauritius to Tata Industries Limited under a Sale and Purchase Agreement (September 2005)



Tax Authorities action & Writ by the taxpayer

AB Nuvo

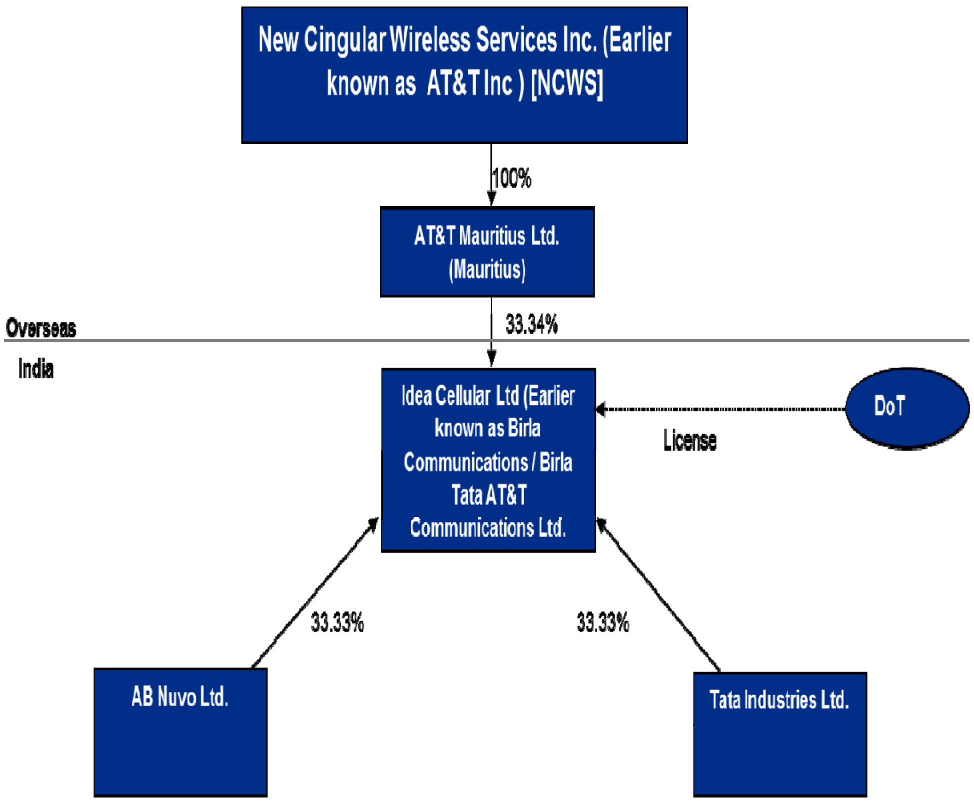
- Obtained 'Nil' withholding certificate from AO U/S 195(2) on basis of capital gains exemption under Mauritius tax treaty
- AB Nuvo alleged to be 'representative assessee' of NCWS U/S 163
- Transaction of sale of shares alleged to be chargeable to capital gains

Tata Industries Limited

- Order passed U/S 201(1) / 201(1A)
- Order passed U/S 163 as a 'representative assessee'
- Notices issued U/S 148 for reassessment
- Writ petition filed challenging the order U/S 163 and notices U/S 148

NCWS

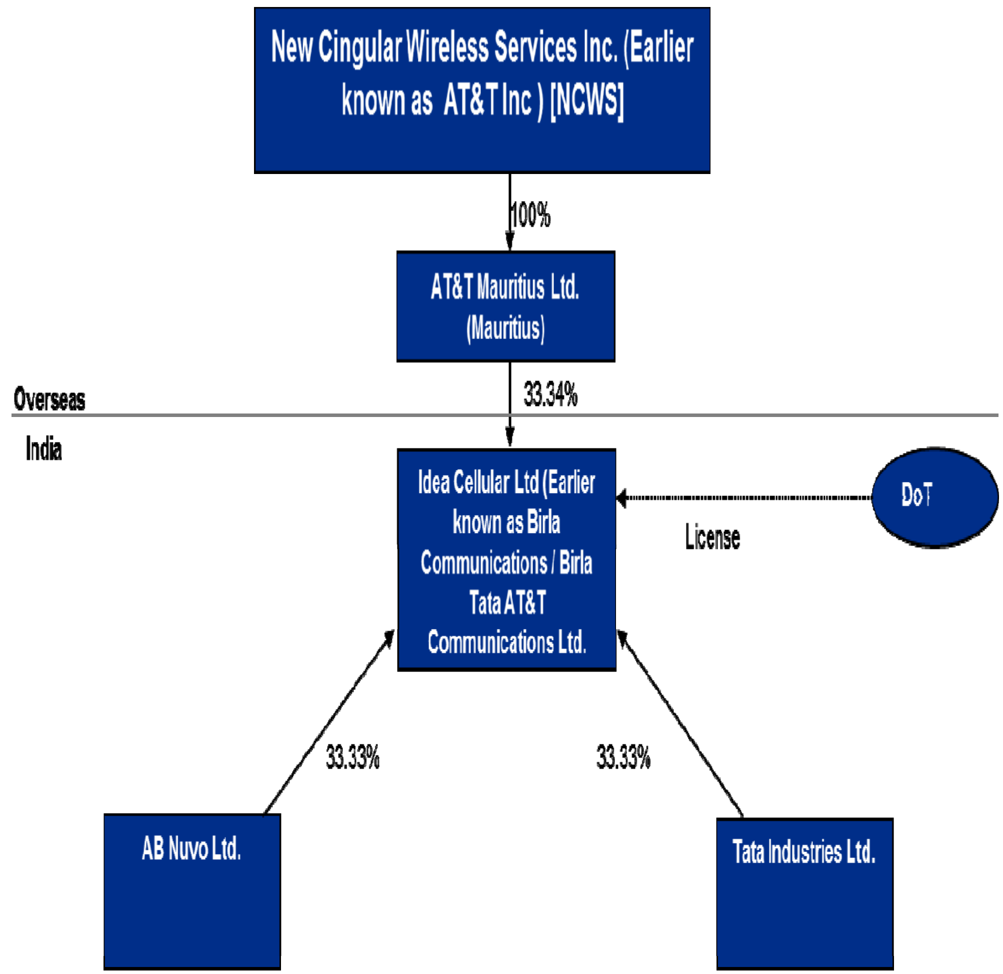
- Simultaneous issue of notice to NCWS U/S148 initiating reassessment



Observations of the High Court…

Capital gains tax on transfer of ICL shares

- The obligation to subscribe and pay for ICL shares under the JVA was on AT&T USA (Page 39)
- Under the JVA, all rights in the shares allotted in the name of permitted transferee vested in AT&T USA (Page 39, 40)
- There is no document to show that AT&T Mauritius has entered into any transaction to subscribe to the shares of ICL in its own name (Page 40)
- AT&T Mauritius was only a permitted transferee and allotment of ICL shares did not confer any beneficial ownership of ICL to it (Page 40)
- Hence, payments made by AT&T Mauritius cannot be said to be payments for subscribing for ICL shares in its name - the payments were made on behalf of AT&T USA (Page 41)



Observations of the High Court…

- Under the SA, AT&T Mauritius shall designate AT&T USA as its representative to exercise all rights and obligations attached to shares (Pg 43)

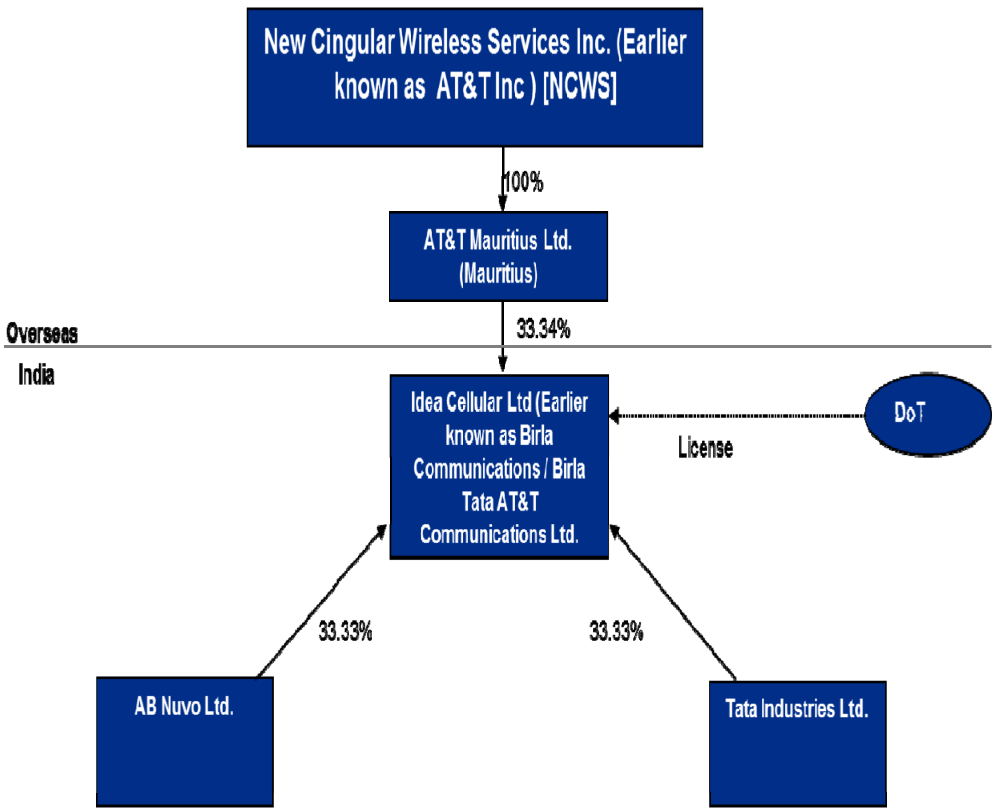
- If AT&T Mauritius was the beneficial owner of shares, NCWS need not be a party to the Sale and Purchase Agreement (Page 45)

- The argument that NCWS was a party to the SPA only because of warranties cannot be accepted

- RBI approval clearly suggests that it was in terms of the JVA, wherein the ownership of the shares allotted in the name of AT&T Mauritius was to vest in AT&T USA(Pg 46)

- Receipt of sale consideration by AT&T Mauritius from AB Nuvo and subsequent repayment of loan and payment of dividend to AT&T USA by AT&T Mauritius out of the sale consideration - merely a device (Page 52, 53)

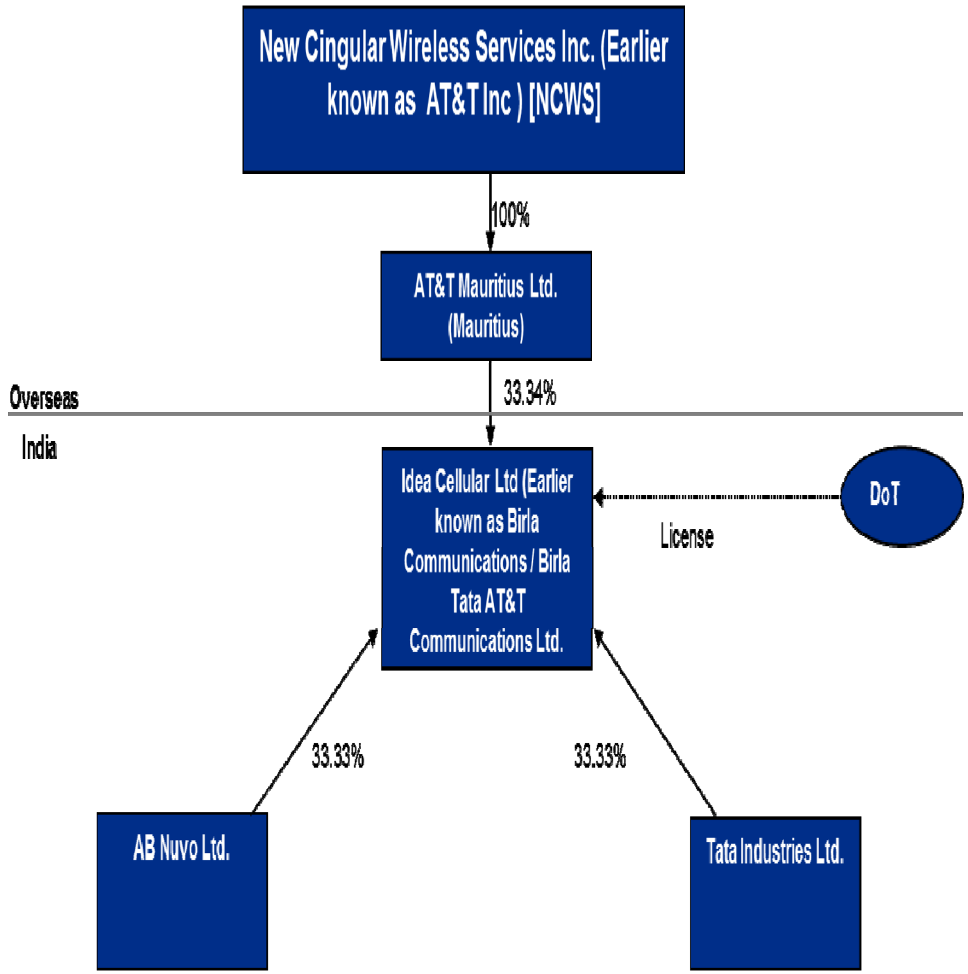
- Amount of sale consideration actually received by AT&T USA ”through“ AT&T Mauritius



Observations of the High Court…

- Name of AT&T Mauritius appearing in the register of members not relevant (Page 55)
  - AT&T Mauritius was a "permitted transferee" of AT&T, USA
  - All rights including rights to sell shares vested in AT &T, USA

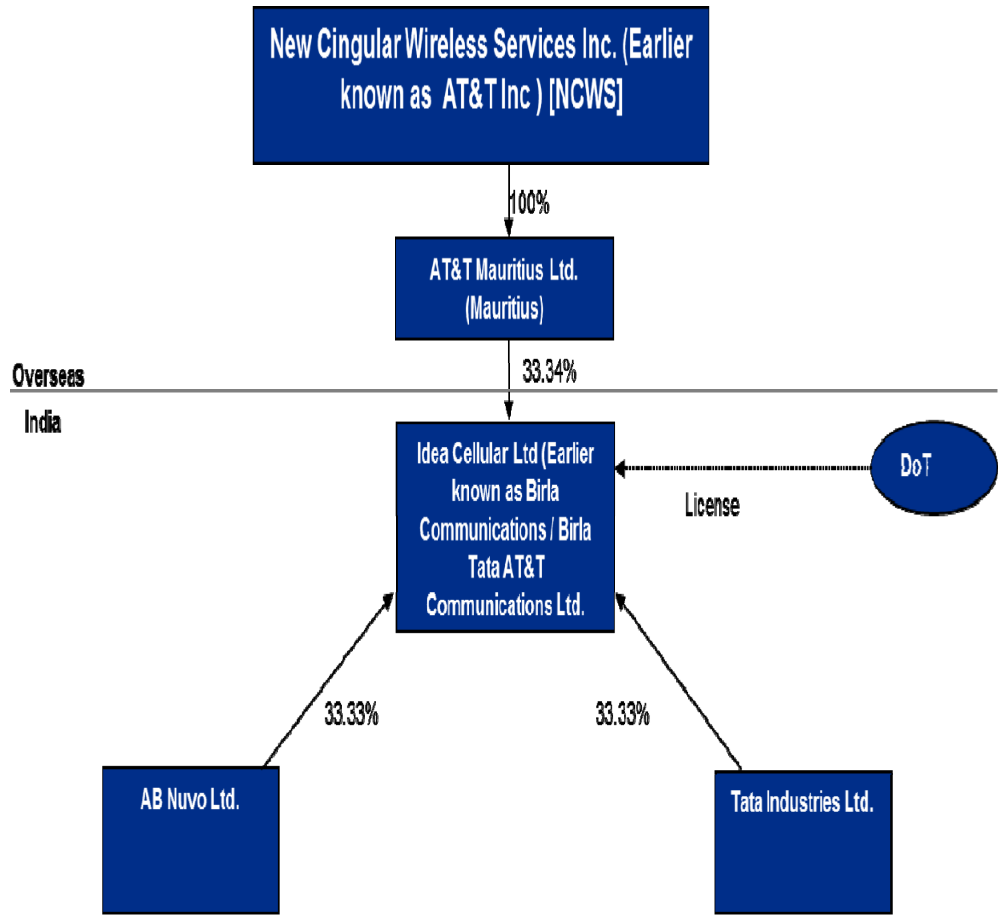
- AT&T USA (NCWS) is the legal owner of the shares of ICL and capital gains have accrued to it
  - Lifting of Corporate veil of AT&T Mauritius not relevant as AT&T USA was the legal owner of the shares (Page 57)



Observations of the High Court…

Treatment of AB Nuvo as representative assessee of NCWS

- Transfer of ICL shares constitutes transfer of a capital asset situated in India (Page 62)
- Income from such transfer of capital asset even if accrues or is received in India within the meaning of Section 5 of the Act, such income being specifically enumerated under Section 9 of the Act, would be income deemed to accrue or arise in India (Page 62)
- U/S 163, a resident may be regarded as an agent of the non-resident if the resident has acquired by means of a transfer, a capital asset in India from the non-resident



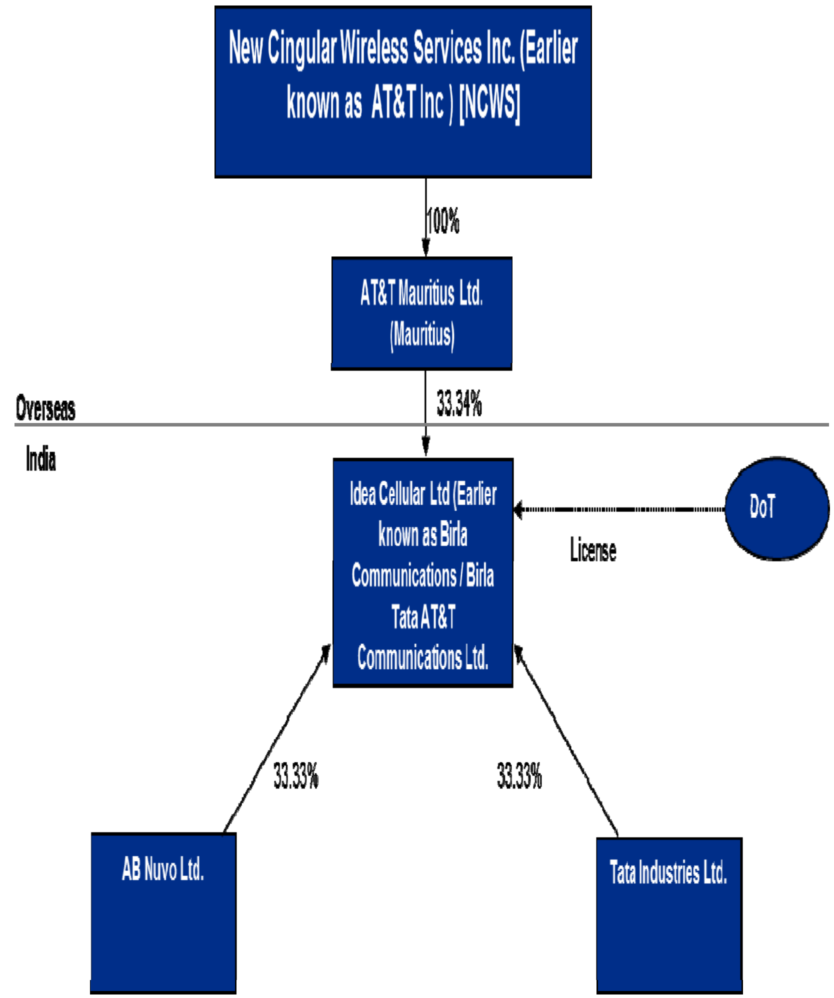
Observations of the High Court…

Treatment of AB Nuvo as representative assessee of NCWS

- In the present case, AB Nuvo has acquired shares of ICL from AT&T USA
- Therefore the capital gains accruing or arising to AT&T USA on transfer of ICL shares can be taxed in the hands of AB Nuvo as its agent U/S 163 (Page 63)

Impact of Certificate issued under Section 195(2)

- The fact that AB Nuvo was purchasing the shares under the right of first refusal option given by NCWS as per JVA was suppressed by AB Nuvo in obtaining the withholding certificate (Page 66)
- The proceedings U/S 163 and 195 operate in different fields (Page 69)
- There is merit in the Revenue's argument that liability of an assessee U/S 195 is in his capacity as a payer, whereas, the liability U/S 163 is as a representative assessee (Page 70)



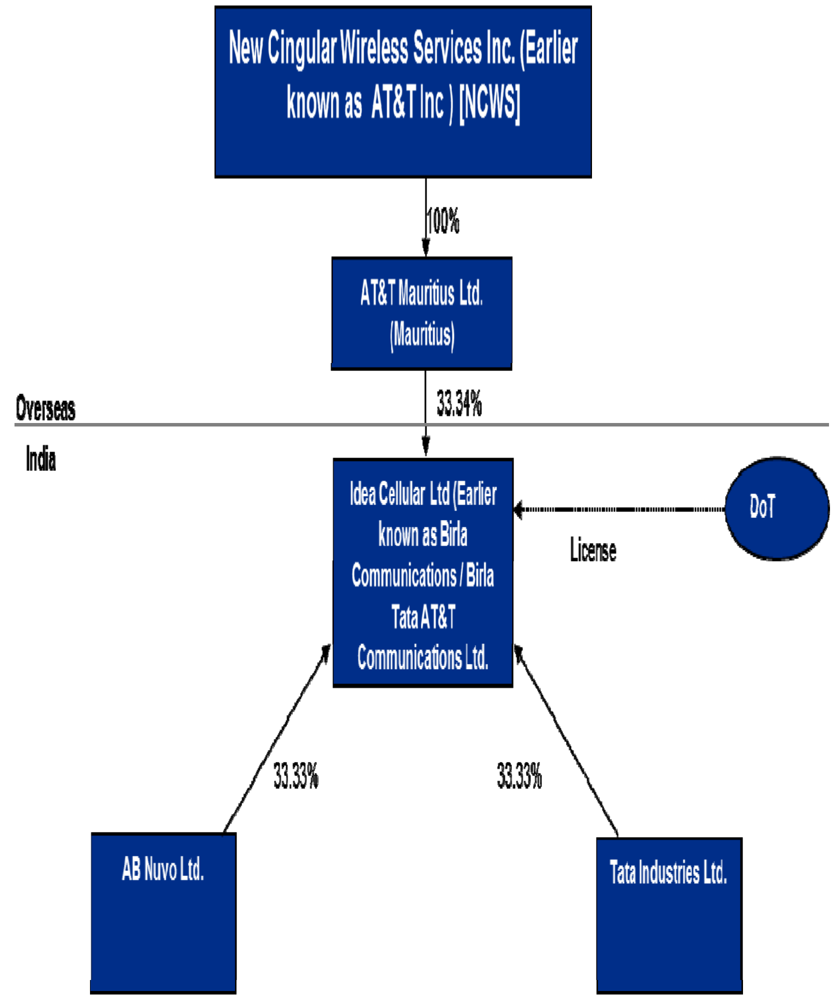
Observations of the High Court…

- **Representative assessee cannot escape liability on the ground that the assessee as a payer was not required to withhold tax in terms of the withholding certificate** (Page 70)

- The withholding certificate obtained by Ab Nuvo by furnishing incorrect facts and by making misleading statements would not preclude the Revenue from initiating proceedings U/S 163 (Page 73)

Assessment proceedings simultaneously against the resident and non-resident

- Though Section 166 contemplates one assessment either in the hands of the non-resident or in the hands of the representative assessee, the Section does not specify that once the assessment proceedings are initiated against the non-resident, representative assessee proceedings must be dropped (Page 75)

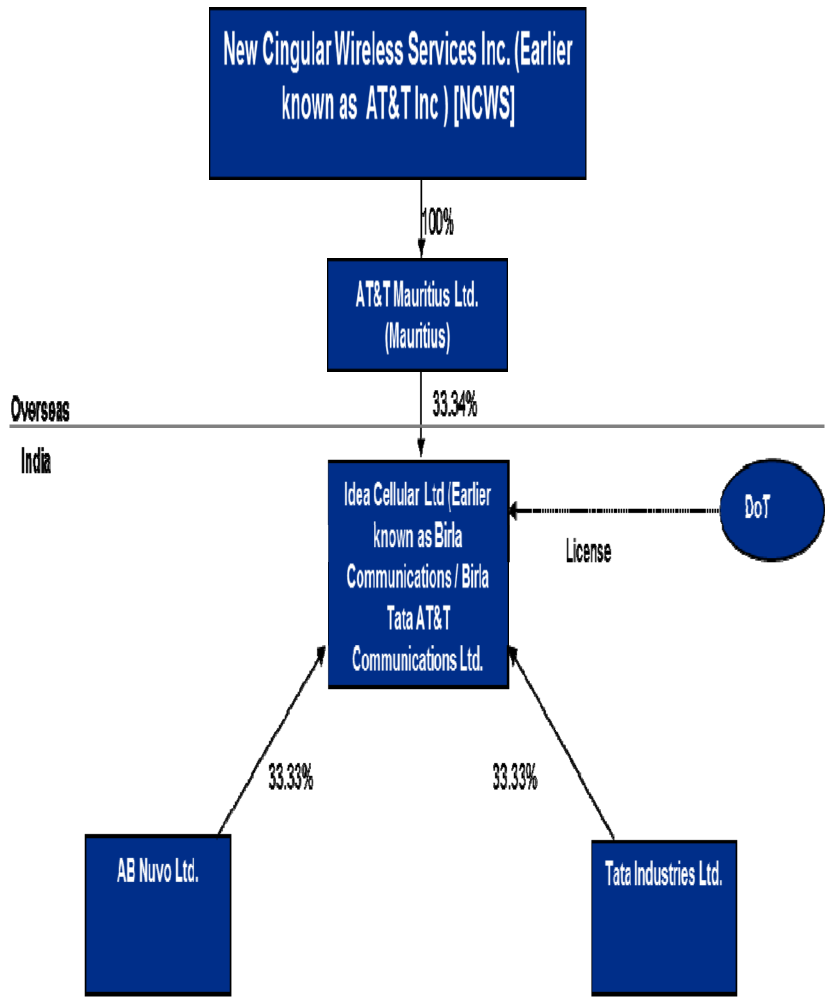


Observations of the High Court…

- There is nothing in Section 166 indicating that the choice to assess either the representative assessee or the non-resident has to be exercised at the threshold and not at the completion of assessment proceedings (Page 75)

- The objective of assessing income in the hands of a representative assessee is that it is quite often difficult to recover tax from the non-resident (Page 77)

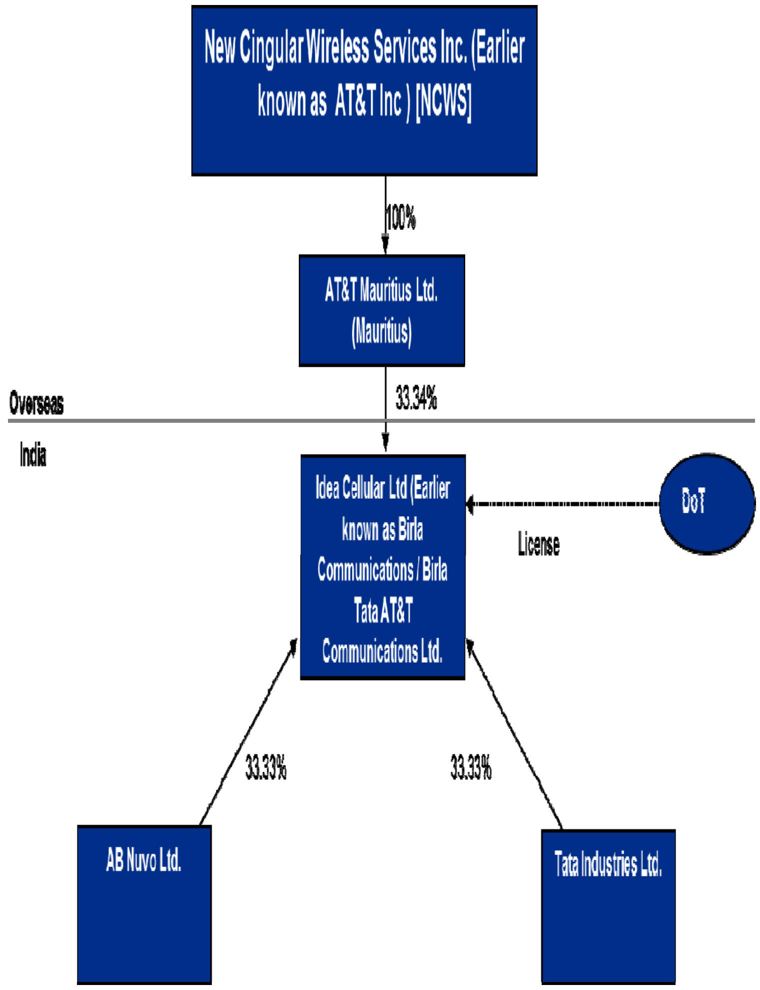
- **Where complex issues are involved and the AO is unable to make up his mind on account of suppression of material facts, it would be open to the AO to continue with the assessment against the representative assessee as well as the non-resident simultaneously till he decides to assess either of them (Page 77)**



Observations of the High Court ...

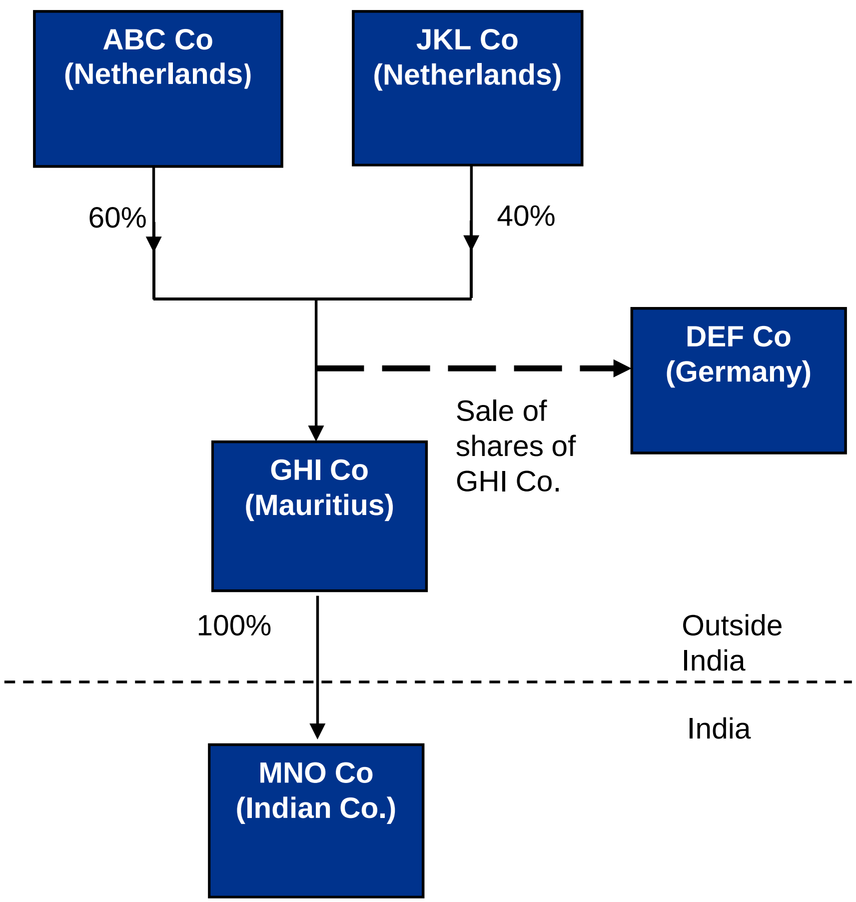
Writ petition by Tata Industries Limited

- TIL purchased shares of AT&T Mauritius after the completion of the purchase transaction by AB Nuvo
- Pursuant to proceedings similar to the AB Nuvo case, the tax office issued an order U/S 163 to TIL against which TIL filed a similar writ petition before the Bombay HC
  - **However instead of Mauritius treaty availability, the key issue was transfer of a capital asset being shares of AT&T Mauritius situated outside India and hence not being exigible to capital gains tax in India**
- **The HC observed that**
  - **Since TIL was part of same SA – as in the case of AB Nuvo, the transaction was in fact for sale of ICL shares from NCWS (Page 95)**
  - **The sale of shares of AT&T Mauritius was a colourable device (Page 96)**
  - **Therefore, prima facie case is made out by the Revenue for initiating proceedings U/S 148 as also U/S 148 read with Section 163 (Page 96)**



This case is pending before the Supreme Court

Case Study 2 | Transaction overview



Facts of the case

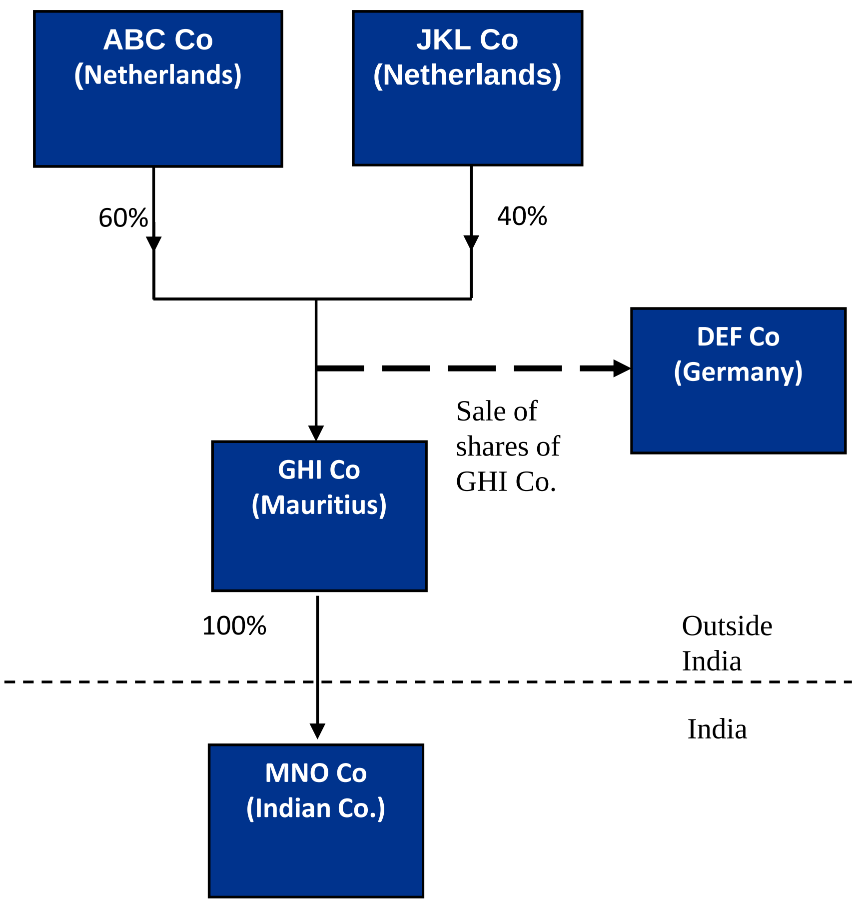
- ABC Co. and JKL Co. are companies incorporated in Netherlands.
- GHI Co. is a company incorporated in Mauritius.
- MNO Co is a company incorporated in India.
- DEF Co. is a company incorporated in Germany.

- ABC Co. formed a wholly owned Mauritius subsidiary namely, GHI Co. In the same year, ABC Co. entered into a share purchase agreement (SPA) for acquiring majority stake in an Indian company namely, MNO Co. GHI Co. was disclosed as a 'permitted assignee' in the agreement.

- After two years, JKL Co. acquired 40% shareholding of GHI Co. Thus, ABC Co. now had 60% shareholding in JKL Co. GHI Co. subsequently acquired shares of MNO Co. The original capital, including stamp duty, was paid by ABC Co., but later GHI Co. reimbursed ABC Co. in that respect.

- After two more years, both ABC Co. and JKL Co sold their shareholding in MNO Co. to a German Co. namely, DEF Co.

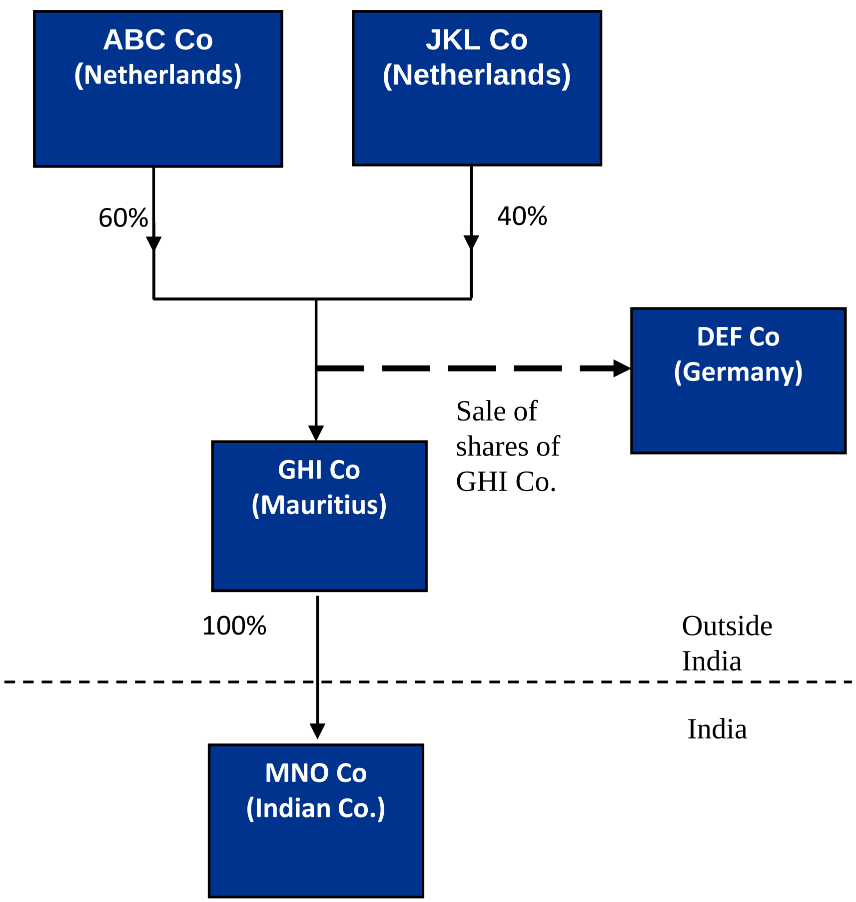
Issues



Issues

- Can the beneficial provisions of India-Netherlands tax treaty be invoked?
- Can the above transaction for sale of shares in GHI Co. be subject to capital gains tax in India under the contention that the investment vehicle used in the deal was a sham entity without commercial substance and what is sold in substance is the interest in MNO Co.?
- Is it a treaty policy of India even to cover indirect alienation of shares under the provisions of Article 13 of tax treaties?

Analysis



Analysis

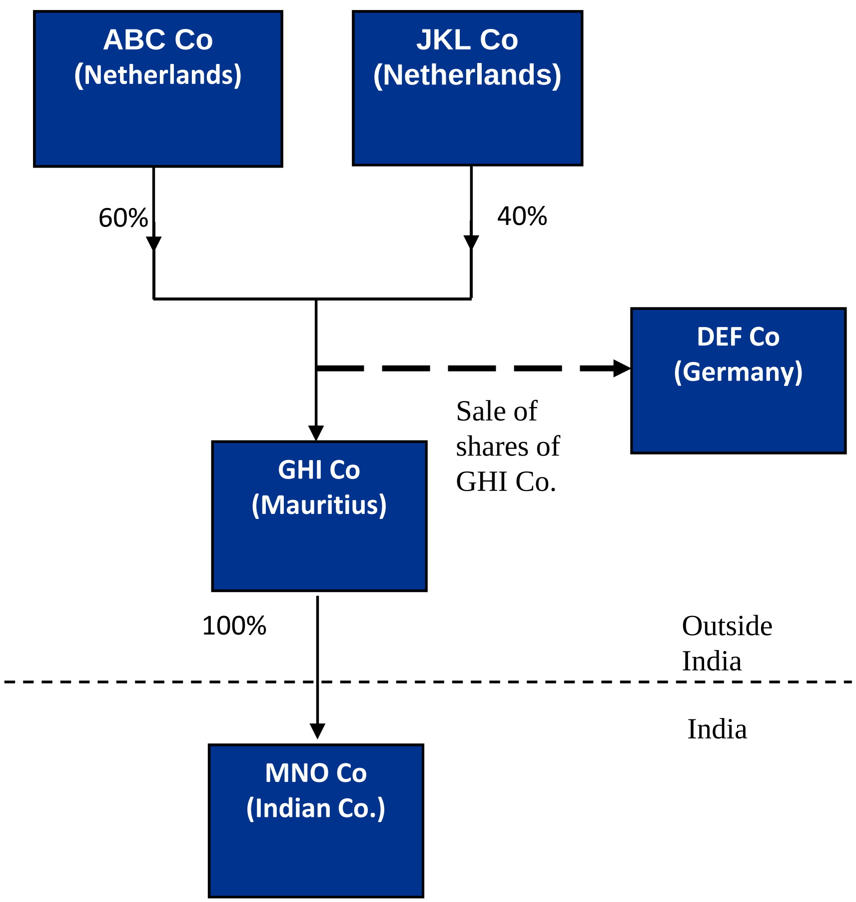
- Can the beneficial provisions of India-Netherlands tax treaty be invoked?

➢ No tax treaty between Netherlands & Mauritius.

➢ Though no capital gains tax in Mauritius on sale of shares of GHI Co, this transaction normally should be subject to capital gains tax in Netherlands in the hands of ABC Co and JKL Co by virtue of their residence of in Netherlands.

➢ Since ABC Co and JKL Co individually hold > 5% of the nominal paid-up capital of GHI Co, the said capital gains will be exempt in Netherlands by virtue of Participation Exemption available under the domestic tax law.

Analysis..



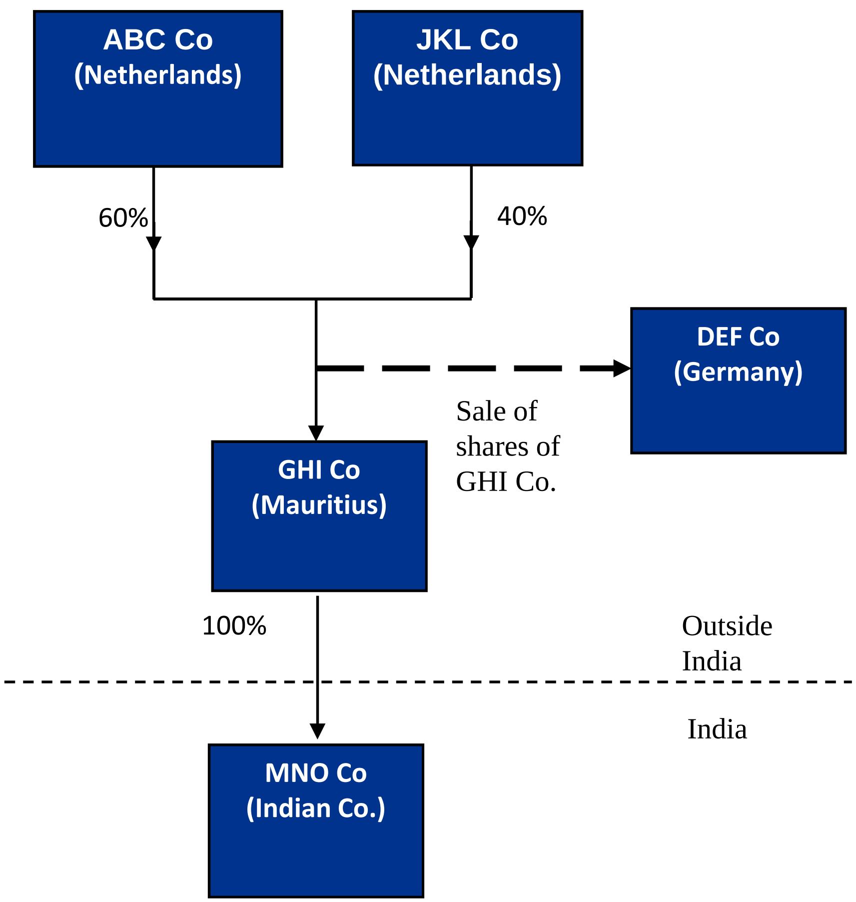
Analysis

- Is GHI Co a sham entity ?

We can infer that GHI Co is not a sham entity without commercial substance in light of the following principles laid down in Sanofi Pasteur Holding SA (2013)(AP HC):

- Transaction is for sale of shares of GHI Co and not transfer of Indian entity's (MNO Co.) shares or underlying assets.
- GHI Co is a distinct entity of commercial substance incorporated to serve as an investment vehicle of foreign direct investment in India by way of participation in MNO Co
- Subsequent to transaction in issue, GHI Co continues to be in existence as a registered Mauritian resident corporate entity and as legal and beneficial owner of MNO Co shares, being its registered shareholder.
- Creation of wholly owned subsidiaries or joint ventures either for domestic or overseas investment is a well established business / commercial organizational protocol.
- Tax treaty provisions are "non-derrogable".

Analysis..



Analysis

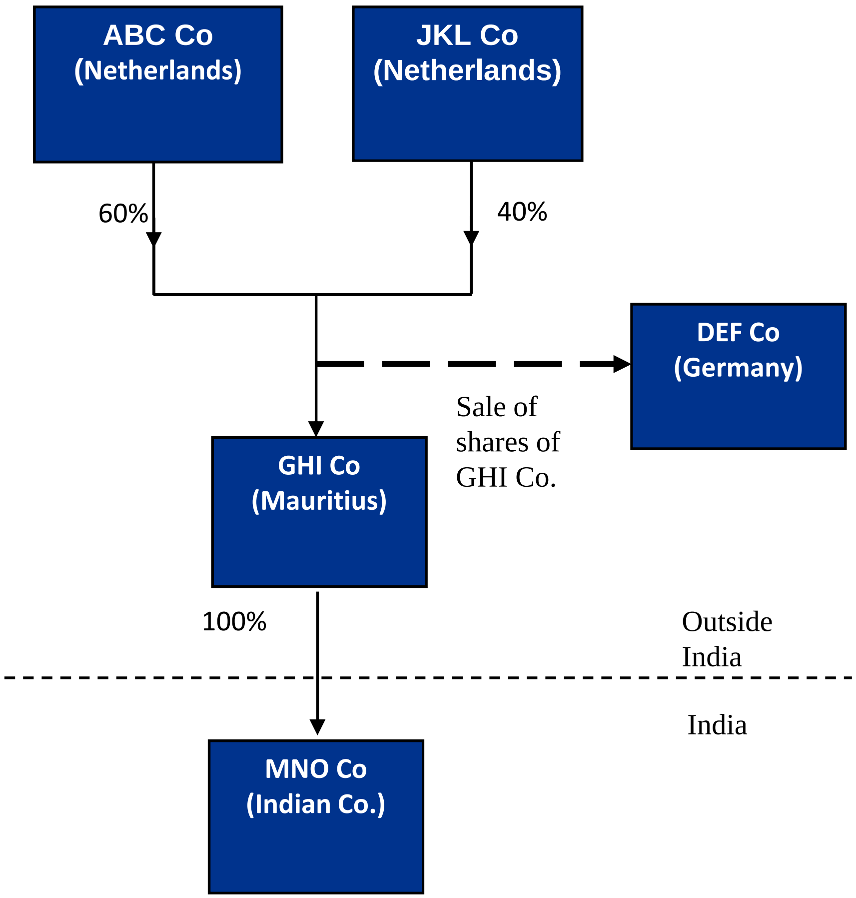
Is GHI Co a sham entity ? (contd.)

- "Treaty shopping" is an expression of "sovereign policy" choice. Developing countries need foreign investments and treaty shopping opportunities could be an additional factor to attract them.

- Controlling interest of GHI Co over the affairs, assets and management of MNO Co being incidental to its shareholding, it cannot be treated as a separate asset. Applying ratio of B.C. Srinivasa Shetty (SC), value of controlling rights over MNO Co attributable to the GHI Co's shareholding is incapable of determination & computation and consequently charging provision would not apply.

- The retrospective amendments do not impact the provisions of the treaty and also the retro- amendments to Section 2(14), Section 2(47), Section 9 and Section 195 of the Act are not fortified by a non-obstante clause to override the provisions of the treaty.

Analysis..

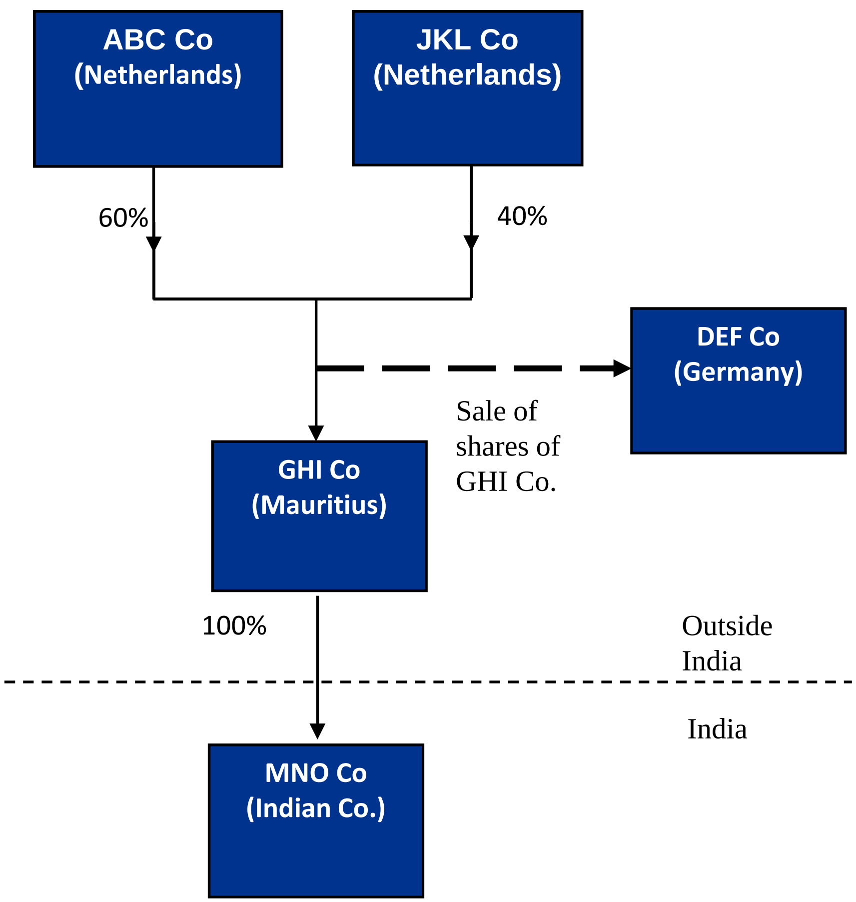


Analysis

- Is GHI Co a sham entity? (contd.)

➢ Also the Apex Court rulings in Azadi Bachao Andolan, Vodafone, Lamesa Holdings BV (Australia) and Prevost Car Inc. (Canada), provide adequate base to legitimize the conclusion that GHI Co is not a sham entity conceived for Indian tax-avoidance structure.

Analysis..



Analysis

- Can the transaction of under issue can be construed as deemed transfer of shares of the Indian entity viz. MNO Co

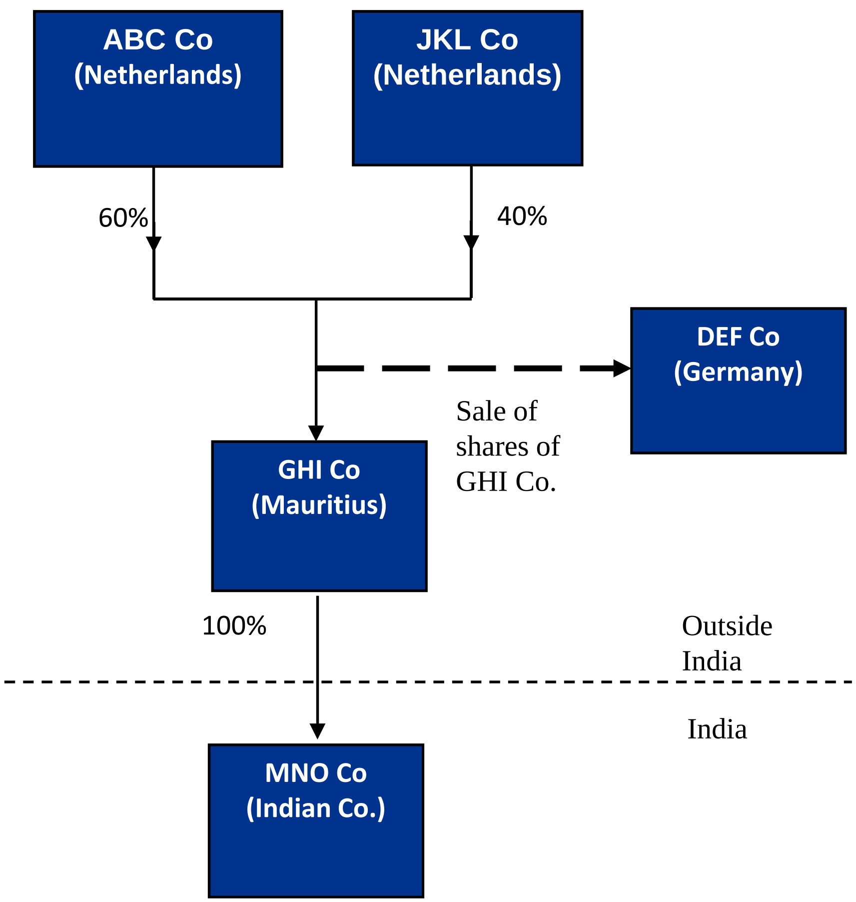
- Explanation 5 to Section 9(1)(i) inserted vide Finance Act, 2012 which states as under:

  For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India;

- In pursuance to the above amendment, the transaction under issue can be construed as deemed transfer of shares of the Indian entity viz. MNO Co.

- The constitutionally validity of the above amendment has been challenged and is currently pending before the courts.

Analysis..

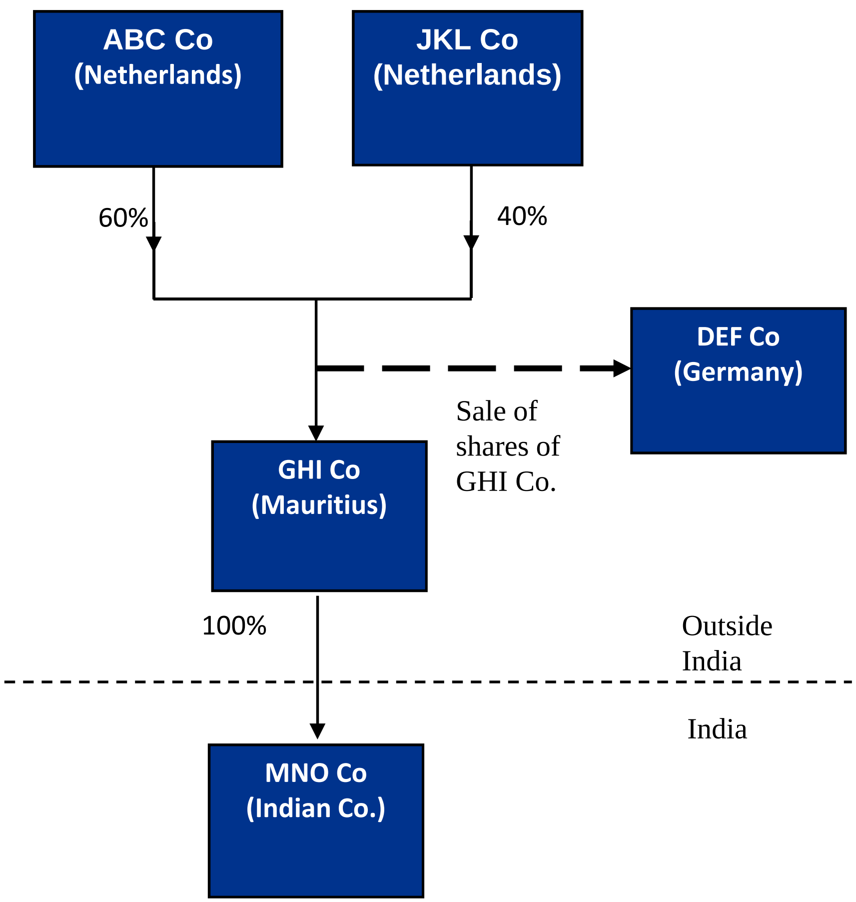


Analysis

- Can the transaction under issue can be construed as deemed transfer of shares of the Indian entity viz. MNO Co (contd.)

- ➢ But even if we presume that this transaction is a deemed transfer of shares of MNO Co, it is still protected by Article 13(4) and Article 13(5) of India-Netherlands tax treaty which are reproduced on next slide

Analysis..



Analysis

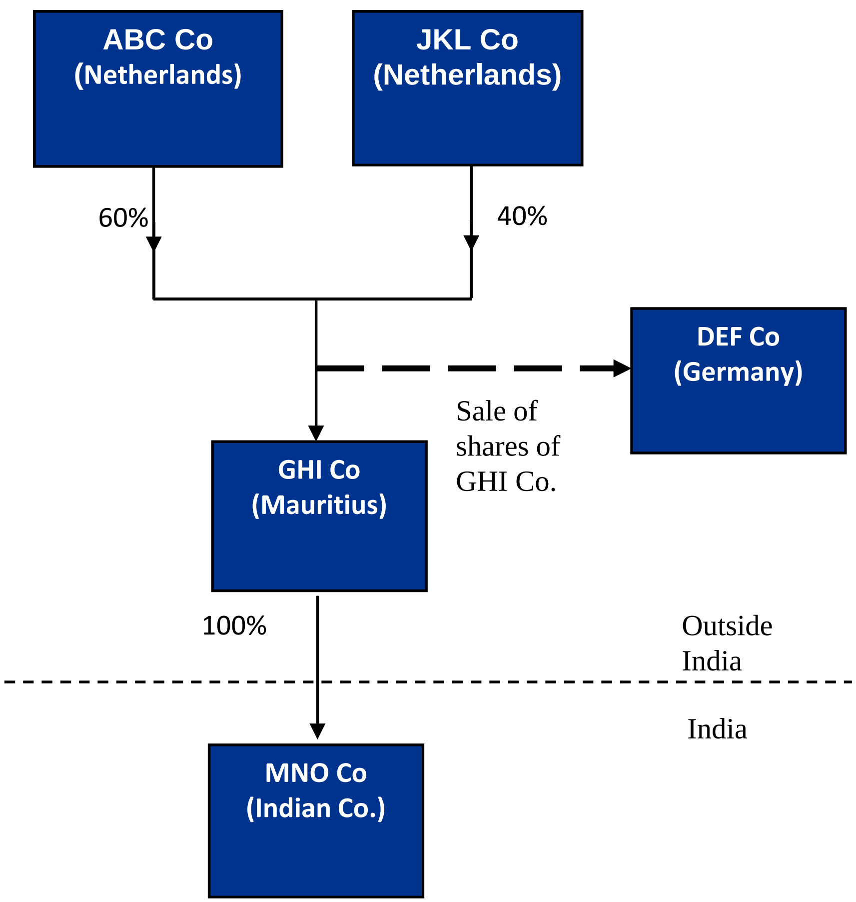
- Is it a treaty policy of India even to cover indirect alienation of shares under the provisions of Article 13 of tax treaties?

- Though Article 13(4) includes indirect transfer of assets, it covers only those cases where the 'value of shares is derived principally from immovable property situated in the other State other than property in which the business of the company is carried on' which is not the situation in the instant case.

- Article 13(5) does not deal with indirect transfer but even if it is so, India does not get the right of taxation as in the instant case, the transferee bring DEF Co is not a resident of India.

- In the current case, if we assume that DEF Co is a group company of the Netherlands group, then an argument can be put forth that the current transaction is in the course of corporate reorganization and hence, not taxable in India.

Analysis..



Analysis

- Is it a treaty policy of India even to cover indirect alienation of shares under the provisions of Article 13 of tax treaties? (contd.)

- Another view is that the Revenue Department of India may deny the treaty benefits of India-Netherlands tax treaty to the Netherlands entities on the grounds that the sale of shares is of Mauritian entity and not of Netherlands entity. However, on the same ground, the Revenue Department will also lose the right of taxation because the situs of shares in view of the argument is located in Mauritius.

- It needs to be noted that none of the Indian tax treaties at present have this clause. At best, the treaties cover indirect transfer of assets as discussed above.

- Nonetheless, the Revenue Department (Treaty Interpreters) has been strongly arguing that the treaty provisions include indirect alienation of shares. It would be interesting to see whether we have any contrary ruling favouring this view in future.

GAAR & indirect transfer

Evolution of GAAR

Pre DTC

- Specific anti avoidance rules (SAAR) – exist under current tax law
- General anti avoidance rule (GAAR) – principles emanating from case laws

DTC 2009 / 2010

- August 2009 – GAAR provisions introduced for first time
- August 2010 – No major changes over DTC 2009 except that guidelines were to be prescribed for implementation

Standing Committee Recommendations (9 March 2012)

- Standing Committee made several recommendations on DTC 2010

Finance Act, 2012

- Wider scope than DTC 2010
  - "one of the main purpose " v/s "main purpose" of obtaining tax benefit
  - Substantial commercial purpose test
  - Power to re-assign place of residence / asset situs, disregard corporate structure
  - Wider tax benefit scope
  - Vodafone ruling's 6 factor test nullified

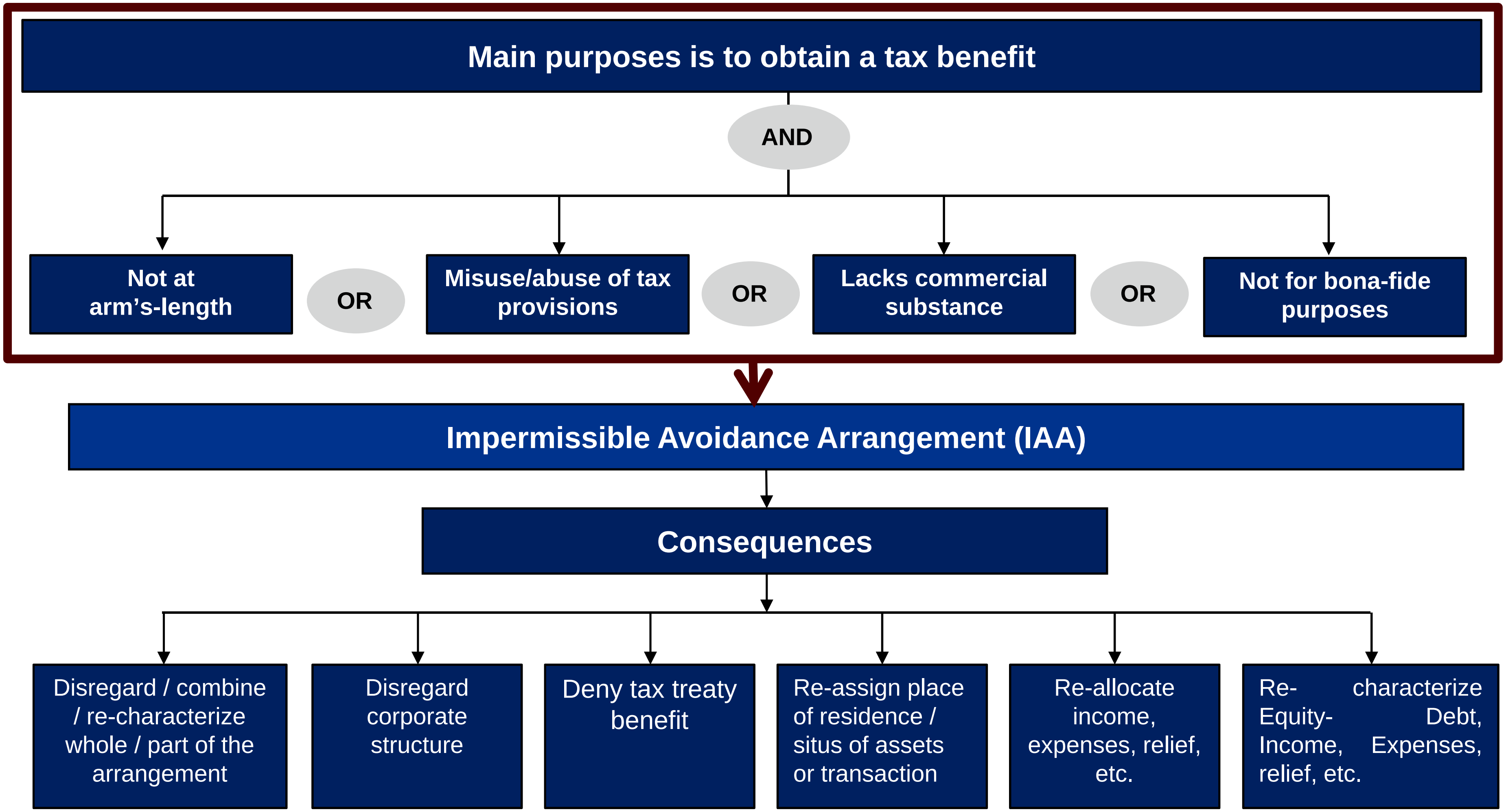
Conscious attempt to introduce wide GAAR

Evolution of GAAR

Standing Committee - Draft Guidelines	Standing committee issued draft guidelines in terms GAAR provisions introduced in the Act
Expert Committee - Second Draft Guidelines (1 September 2012)	Reworked the draft guidelines and issued its report inviting comments and suggestion
Expert Committee – Final Report (30 September 2012)	Expert committee submitted its final report to the Government
FM statement (14 January 2013)	Government accepted several recommendations of the Expert committee
Finance Act, 2013	**GAAR provisions** - 'One of the main purpose' is replaced by 'Main purpose' - Lack of commercial substance - if no significant effect on business risk or net cash flow - Definitions of 'associated person' and 'connected person' combined - GAAR provisions will be effective from 1 April 2016 (AY 2016-17)

New Zealand Court of Appeals applied GAAR to financing through Optional Convertible Notes as a tax avoidance measure

GAAR - Basic Provisions



Shome Committee

Shome Committee on GAAR - Tax Evasion, Avoidance & Mitigation

Tax Mitigation

- Tax mitigation is a situation where the taxpayer uses a fiscal incentive available to it in the tax legislation
- Taxpayer fulfills the conditions and economic consequences laid by the tax legislation e.g. Setting up of an undertaking in a Special Economic Zone

Tax avoidance

- Misuse or abuse of domestic Act or tax treaty
- Tax Avoidance is "the art of dodging tax without breaking the law"
  - ➢ McDowell & Co. Limited v. CTO 154 ITR 148 (SC)
- Tax Avoidance is mitigation of tax by use of tax preferences given under legislation or by unintended legislative means
- Unlike Tax Evasion, Tax Avoidance is not a criminal violation but is a transaction solely to avoid tax incidence
- Anti-Avoidance measures attempt to strike down unacceptable Tax Avoidance practices

Tax Evasion

- Tax evasion is the general term for efforts by individuals, corporations, trusts and other entities to evade taxes by illegal means
- Tax evasion is unlawful and is the result of illegality, suppression, misrepresentation and fraud
- Tax evasion is prohibited under the current provisions of the Income-tax Act
- India loses 14 trillion rupees ($314 billion) from tax evasion annually

Shome Committee:
Key observations / recommendations

- **Issue 1:**
  - **Amendments are arbitrary and unreasonable and violate Article 14 of the Constitution**
  - **Amendments negatively impact investor confidence**

- **Key observations / recommendations:**
  - Amendments on indirect transfers not ‘clarificatory’–should apply prospectively
  - Retrospective amendments should be used in exceptional cases after exhaustive and transparent consultation with stakeholders, exclusively to:
    1. correct mistakes in the statute
    2. remove technical defects; or
    3. protect the tax base from highly abusive tax planning schemes
  - Retrospective amendments should not be used to expand the tax base

- **Are other retrospective amendments truly ‘clarificatory’?**
- **Retrospective Notifications under s. 90(4)?**

Shome Committee:
Key observations / recommendations

Issue 2: Retrospective applicability…

- **Action under s. 201 / s. 163 on the basis of retrospective amendments is harsh, unreasonable and arbitrary**
- **Levy of interest and penalty - unfair and unjustified**

- **Key Observations / Recommendations (if amendments are to be retrospective):**
  - No person should be treated as an 'assessee in default' under s. 201 or a 'representative assessee' under s. 163 on the basis of retrospective amendments
  - Where a demand of tax is raised on account of a retrospective amendment, no interest under s. 234A, s.234B, s.234C and s.201(1A) should be charged
  - No Penalty proceedings should be initiated

Basis for recovery of tax from non-resident sellers?

- **Recourse to assistance in recovery provisions in treaties?**

Shome Committee:
Key Observations / Recommendations

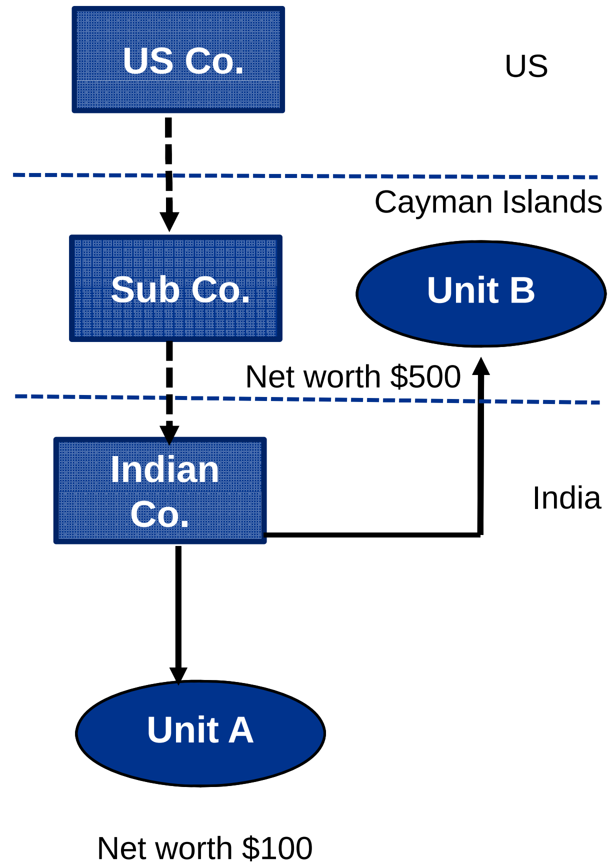
Issue 3:

Substantiality and Proportionality

- Lack of clarity on the meaning of 'substantially' may lead to ambiguity and litigation
- Low threshold for 'substantially' affects the adequacy of nexus with India required under Article 245
- India should not tax gains attributable to assets located outside India

Case Study

- All holdings are 100%, I Co has 2 units – Unit A (India) worth $100; and Unit B (Cayman) worth $500
- For "substantial test", what are the assets located in India and what should be the value of such assets?



Shome Committee:
Key Observations / Recommendations

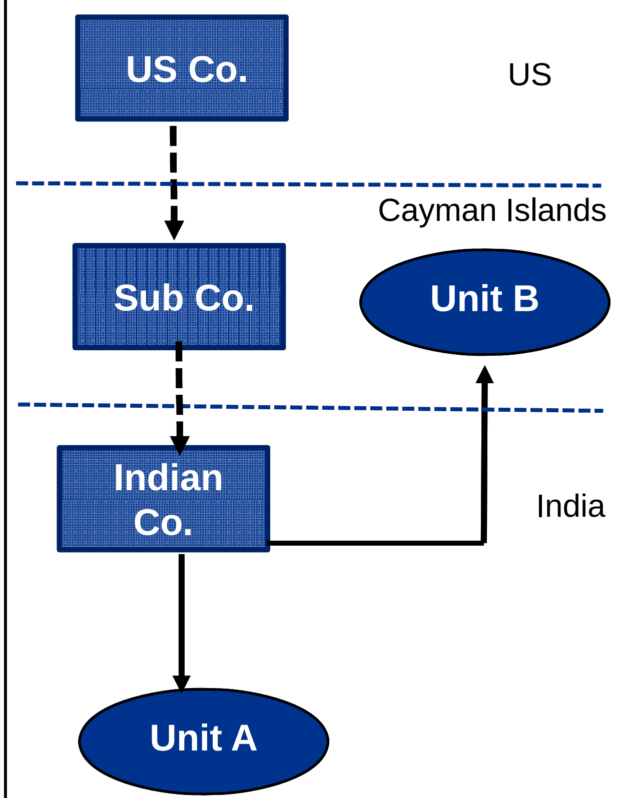
Shome Committee's approach:

- Approach 1 - Shares of Sub Co derive their value 100% from assets in India – should not go beyond shares of I Co, i.e., Sub Co's worth from Indian assets is $600 (taxable)
- Approach 2 - Shares of Sub Co derive indirectly only $100 from India, and $500 is from abroad (not taxable - substantial test fails)

Key observations / recommendations:

- 'Substantially' should be defined as a threshold of 50% of the total value
- Value of shares of Indian company to be considered; location of assets of the Indian company (whether in India or outside) irrelevant
- No basis for taxing all gains only because a majority of the foreign company's assets are located in India – Proportionate basis of taxation of gains to be adopted

Shome Committee - 1st approach preferred - corresponds with position of "direct" transfer under ITL



Shome Committee:
Key Observations / Recommendations

- **Issue 3: <u>Determination of value</u>**
  - **No clarity on how "value" of shares of a foreign company is to be determined**
  - **Considerations such as use of book value v. fair value, gross assets v. net assets, inclusion of intangible assets and the timing of the determination not clarified**
  - **Meaning of terms 'derives' and 'directly or indirectly' unclear**

- **Key Observations / Recommendations:**
  - Fair market value of assets to be adopted – DCF for Service Sector and NAV for others
  - Net assets (both tangible and intangble)after taking liabilities into account to be considered
  - Value as on last balance sheet date with appropriate adjustments to be adopted
  - "Directly or indirectly" represents a look-through approach. Intermediaries between the foreign company and assets in India to be ignored

More clarity in Valuation needed – Manufacturing / Trading sector?

Shome Committee:
Key Observations / Recommendations

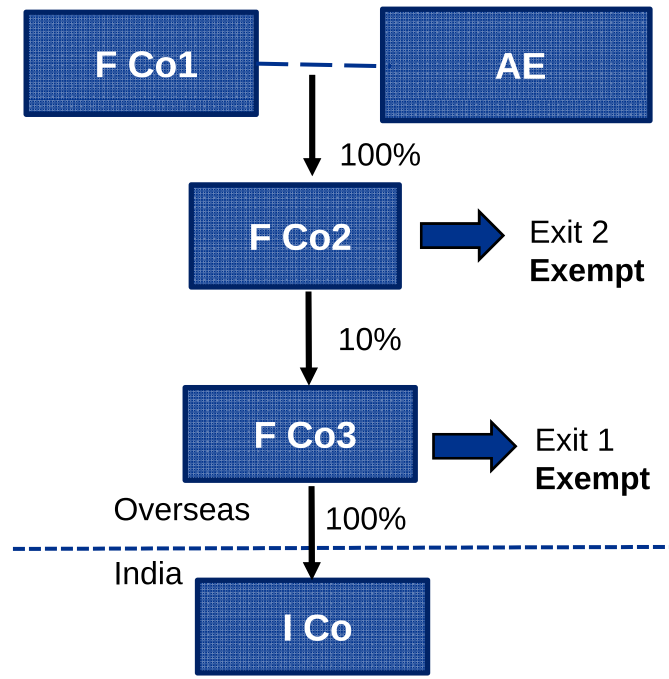
Issue 4 :

Impact on Small shareholders / listed entities

- Amendments wide enough to cover even sale of a single share in foreign companies, leading to undue hardship
- Difficulty in bringing to tax gains arising from frequent trading of shares of foreign companies in stock exchanges outside India

Key Observations / Recommendations

- Amendments wide enough to cover even sale of a single share in foreign companies, leading to undue hardship
- Transfer should not be taxed if transferor (if associated enterprises) owns less than 26% of voting power/share capital in immediately preceding 12 months
- In case of indirect holdings, holdings should not result in 26% or more interest in the immediate holding company with underlying Indian assets
- An exemption may be provided to foreign companies which are listed on a recognized stock exchange (under RBI norms) and its shares are frequently traded therein (as understood under the SEBI Takeover Code)



Shome Committee:
Key Observations / Recommendations

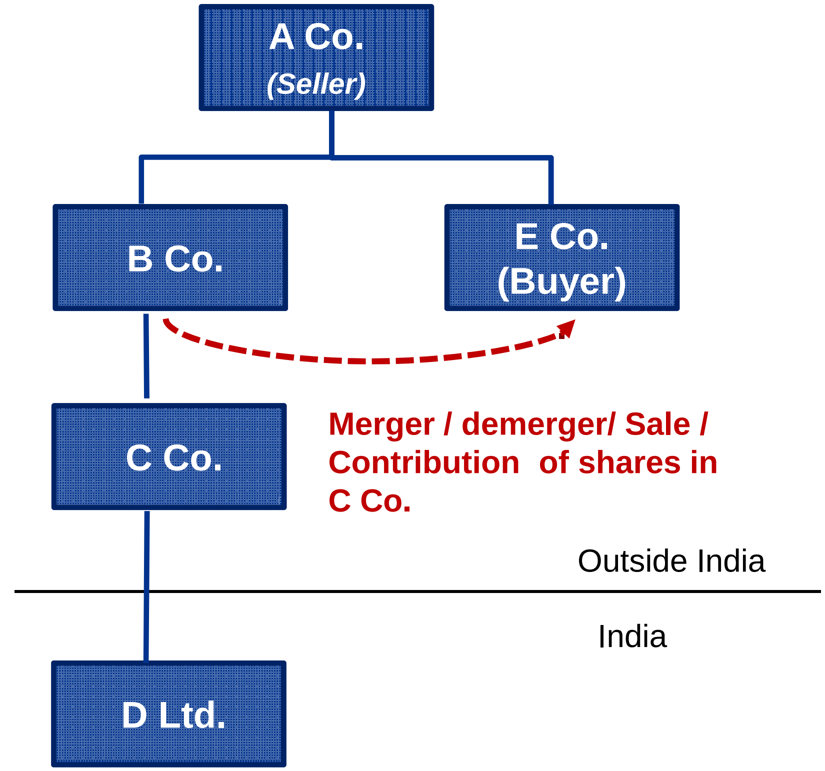
Issue 5:

Business reorganizations outside India

- Group reorganisations typically undertaken for commercial / strategic reasons
- As there is no monetisation of investments, there should be no tax incidence on ‘indirect’ transfers under group re-organisations
- Neutrality provisions for group reorganizations under s. 47 do not extend to ‘indirect transfers’

Key Observations / Recommendations:

- Transfers of shares or interest in a foreign company/entity under intra-group restructuring may be exempt provided that such transfers are not taxable in the jurisdiction where such company is resident
- Intra-group restructuring may be defined to mean an amalgamation or demerger as defined under the Income-tax Act, or any other form of group restructuring subject to continuity of 100% ownership



Meaning of ‘group’ may need clarification- Takeover code definition?

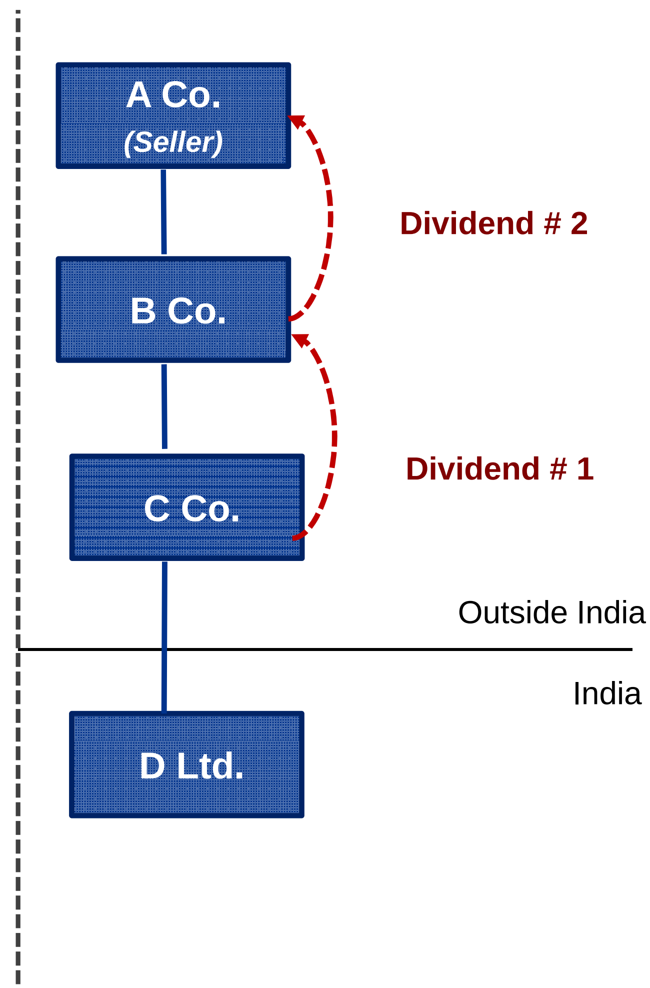
Shome Committee:
Key Observations / Recommendations

Issue 6: <u>Impact on dividend taxability</u>

- Income from assets in India taxable in India
- Shares in foreign companies deriving value substantially from Indian assets are deemed to be *situated* in India
- It is potentially open to the tax authorities to contend that dividends paid on such shares are earned from assets in India and are hence taxable in India (notwithstanding the specific provisions of s. 9(1)(iv))
- Possibility of multi-level taxation of dividends paid through tiered structures
- Above characterization – not the intent behind introduction of the 'indirect' transfer provisions

<u>Key Observations / Recommendations:</u>

- Applicability of retrospective amendments to dividend taxation an unintended consequence
- Dividend paid by a foreign company shall not be deemed to accrue or arise in India under s. 9(1)(i) read with Explanation 5



In line with treaty provisions - Article 10(5)

Shome Committee:
Key Observations / Recommendations

- **Issue 7: <u>Impact on Tax Treaties</u>**
  - **An unilateral expansion of its tax base by India may not be respected by treaty partners, possibly resulting in double taxation**
  - **The expanded definition of 'transfer' under the retrospective amendments may potentially be used to interpret the term 'alienation' used in tax treaties**

<u>Key Observations / Recommendations:</u>

In cases where there is tax treaty with the country of residence of the non-resident transferor, gains will not be taxable in India <u>unless</u>:

- The treaty provides for capital gains taxation under Indian domestic law;
- The treaty specifically provides right of taxation to India on transfer of shares or interest of a foreign company or entity

- **UK / US treaties – no relief available**
- **Impact of 'transfer' definition on treaties not addressed**

Shome Committee:
Key Observations / Recommendations

- **Issue 8: <u>Underlying transfers</u>**
  - **Transfers at foreign holding company levels may be taxable under the expanded definition of ‘transfer’ even where Explanation 5 to s. 9(1)(i) is not attracted**
  - **In such cases, there is no clarity on the computation of capital gains and the**

Key Observations / Recommendations:

- As a company is a separate legal entity, a 1% transfer of shares of a company cannot be said to be a transfer of 1% interest in all assets of the company. Only when there is a transfer of 100% shares of a company that the assets of the company may be considered as having been disposed of indirectly
- Mindful of the specific provisions of Explanation 5 to s. 9(1)(i), the general provisions of s. 2(47) relating to transfer should not be applied on a standalone basis

Expanded definition of ‘transfer’ to continue to apply to situations covered by Explanation 5

Shome Committee: Key Observations / Recommendations

- **Issue 9: Impact on FIIs**
  - **All non-resident investors in FIIs will directly or indirectly have underlying assets in India, and hence transfer of investments by the non-resident investors may lead to tax liability in India**
  - **Such taxation may arise at every upper level of investment, leading to multiple taxation of the same income**

Key Observations / Recommendations:

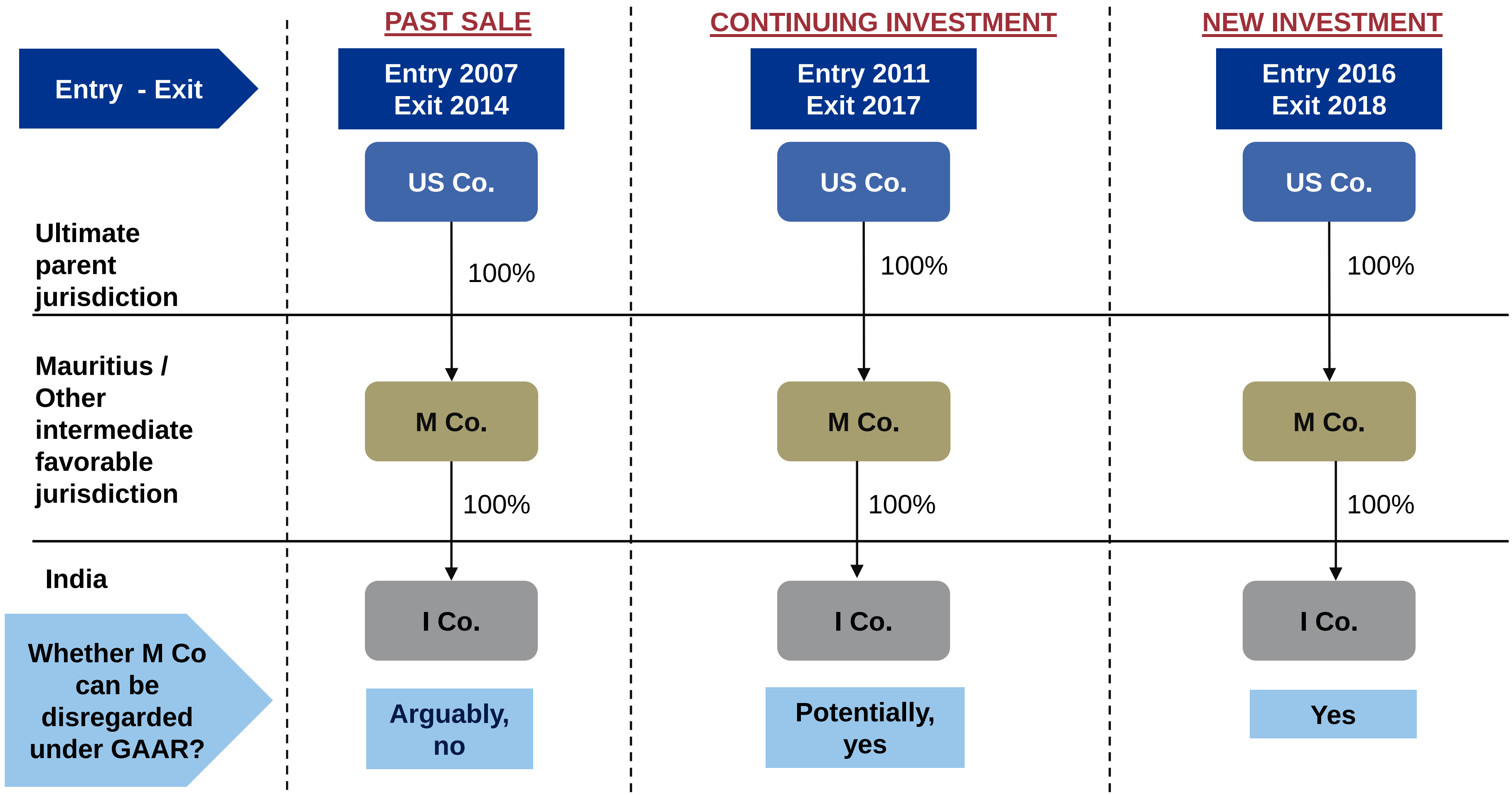
- Investments made by an FII under SEBI Regulations are subject to tax in India in the hands of the FII. Hence, it should be clarified that a non-resident investor will not be taxable in India under s. 9(1)(i) where:

→ Such investor has made any investment, directly or indirectly, in an FII; or

→ The investment made by an FII in India represents, directly or indirectly, the underlying assets of investment by a non-resident

GAAR – Areas of controversy

Will GAAR apply to continuing / new investments?



Expert committee – Grandfathering of investment made before introduction of GAAR

FM's statement – Grandfathering of investment made before 30 August 2010 (i.e. from DTC 2010)

The Finance Act 2013 does not provide the grandfathering provisions

Can GAAR override treaties ?

Possible views	Countries
GAAR overrides treaties	Canada, UK*, Germany
Treaty prevails over GAAR	New Zealand
Treaty prevails unless contrary is specifically mentioned in treaty	China
‘Later in time rule’ – More recent provision prevails	USA
No clear provision in law	Singapore, South Africa

*** Proposed***

- Section 90(2A) provides- GAAR provisions to override treaties
- Ministry’s response to Standing committee’s recommendation - GAAR to deny treaty benefit if IAA entered into
- Treaty itself not applicable in cases of tax avoidance –Vienna Convention on Law of Treaties
- OECD and UN Model – Treaty benefits to be denied in case of abuse

GAAR to override treaty shopping / abuse

Burden of proof

Country	Burden of Proof
Australia, China, New Zealand, USA	Purely on taxpayer
Canada	Primarily on taxpayer, tax authorities only to prove abusive nature
South Africa	Primarily on tax authorities, taxpayer to prove avoidance was not main objective
Germany, UK*	Purely on tax authorities

**Proposed*

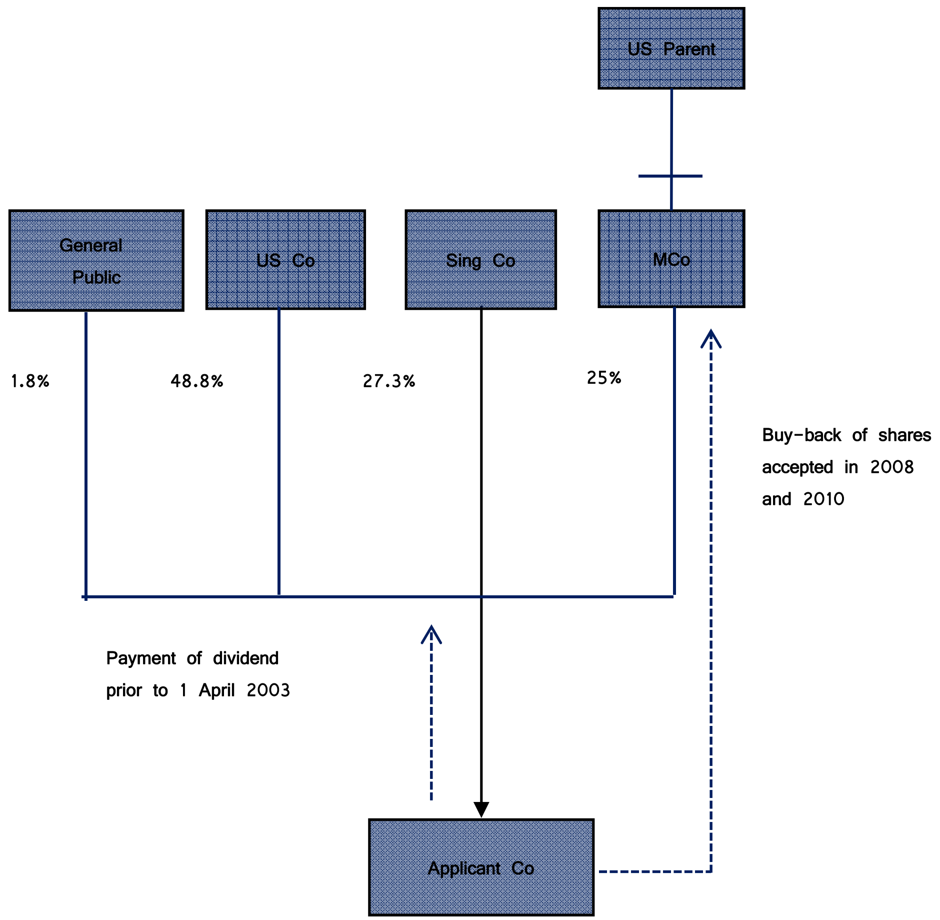
India's view on burden of proof

- Main purpose of arrangement deemed to be 'tax benefit' unless taxpayer proves otherwise
- Opportunity of being heard to be given to taxpayer by Approving Panel
- Expert committee recommended onus should rest on tax authorities

Need to maintain appropriate documentation to discharge burden of proof

Case study

Case study | A Mauritius – Facts of the case



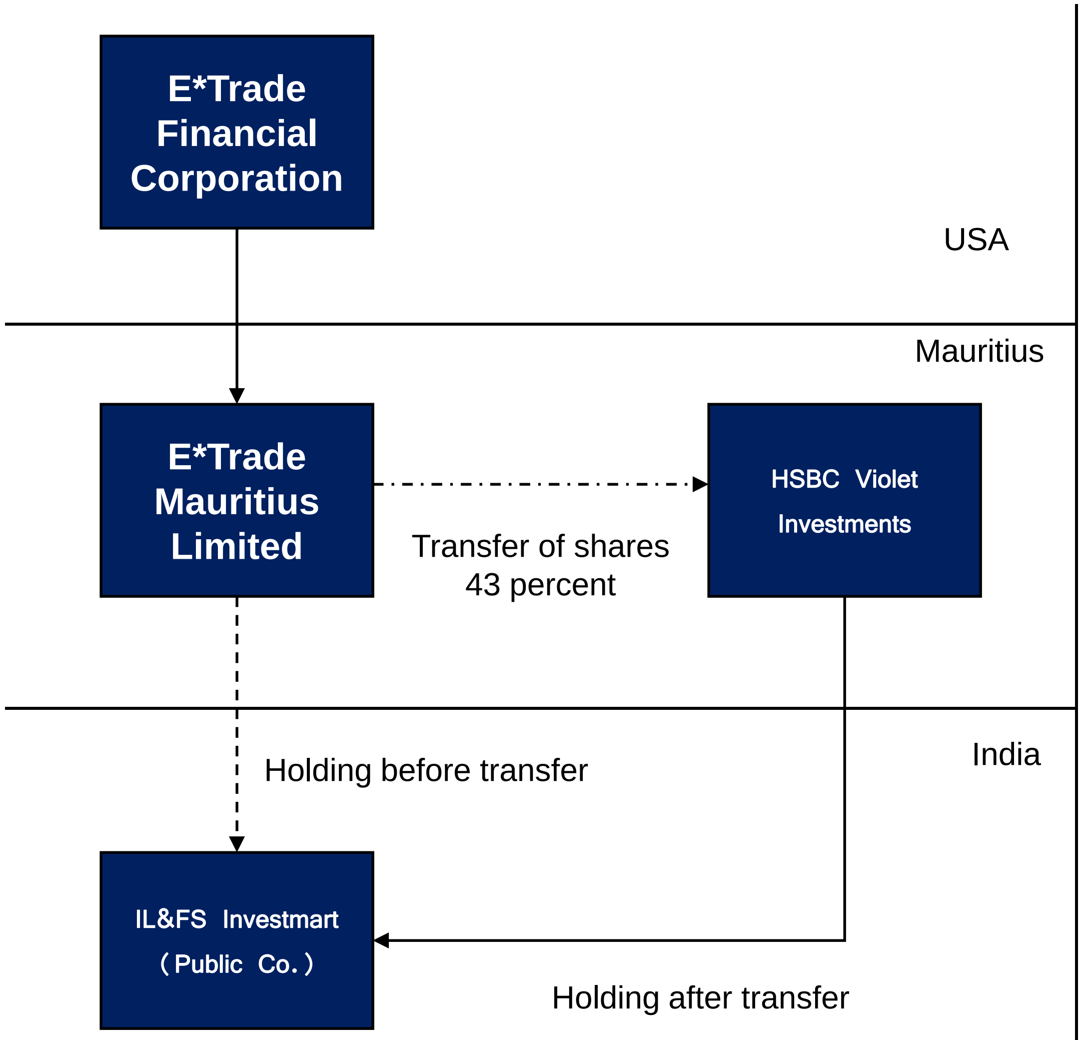
Facts

- The Applicant Co had declared dividends to its shareholders till 2003 and had thereafter accumulated reserves on year on year basis
- A scheme of buy-back was also announced by the Applicant Co in 2008 and in 2010, where only Mauritius Co had accepted the offer
- The tax department contended that -
  - After the introduction of DDT, the Applicant Co had not declared or paid dividend to any of its shareholders
  - Such a scheme of buy back was undertaken to avoid payment of DDT and to take the benefit of the India - Mauritius tax treaty

Case study | A Mauritius – AAR ruling

- The Applicant Co had not declared or paid any dividend to its shareholders after introduction of DDT in 2003
- There was no proper explanation on the part of the applicant as to why no dividends were declared subsequent to 2003 when the company was making regular profits
- The offer of buy-back was accepted only by M Co. The US Co did not accept the buy-back as it would have been taxable in India as capital gains under the US tax treaty. Further the Singapore Co also did not accept the offer as its taxability would have depended on certain conditions being fulfilled under the Singapore tax treaty
- The transaction of buy-back is a scheme devised for avoidance of tax. In fact, it is a colourable device for avoiding tax on distributed profits as contemplated in Section 115-O of the Act
- Since the transaction is a colourable device, it is not a transaction in the eyes of the law. The arrangement can only be treated as a distribution of profits by a company to its shareholders.

Case study | E*Trade Mauritius Limited - Transaction overview



Legal position (Pre E*Trade) on availability of capital gains exemption under Tax Treaty

- **<u>Circular 789</u> - TRC issued by Mauritian Revenue sufficient for granting Tax Treaty benefits**
- **<u>Azadi Bachao Andolan (SC)</u> - upholding validity of Circular as well as Treaty shopping in the absence of a LOB clause**

- E*Trade Mauritius Limited 324 ITR 1 (AAR)

E*Trade – Sequence of events

E*Trade actions | **Authorities actions**

1

Application for ‘Nil’ tax withholding →

- Application rejected by AO with directions to withhold tax at 41 percent

2

Filed writ petition against order with HC →

- File revision petition with DIT
- Release sale proceeds after withholding tax
- Tax withheld to be deposited with HC

3

Filed revision petition with DIT →

- DIT effectively upheld AO order; marginal relief on tax rate
- Substance of M Co challenged

4

Writ petition with HC →

- Taxes to be deposited with Tax Authorities
- No comment on taxability of transaction

Pursuant to the above E*Trade filed an application before the AAR

E*Trade – contentions before AAR

Tax Authorities' position

- E*Trade Mauritius is merely a façade used by US Co to avoid capital gains in India
- Beneficial ownership referred in Circular 789 applicable only in respect of taxation of dividend
- Real and beneficial owner of capital gains appears to be the Holding company i.e. US Co
- Inquiries should be made with US Co to confirm/ arrive at the above position
- If the inquiry confirms the above, benefits of India Mauritius Tax Treaty should be denied

E*Trade's position

- E*Trade Mauritius has a valid TRC. E*Trade Mauritius is a distinct legal entity. Transaction undertaken by E*Trade Mauritius within legal framework
- Based on CBDT Circular 789 and decision of SC in Azadi Bachao Andolan, tax treaty benefits should be available to E*Trade Mauritius

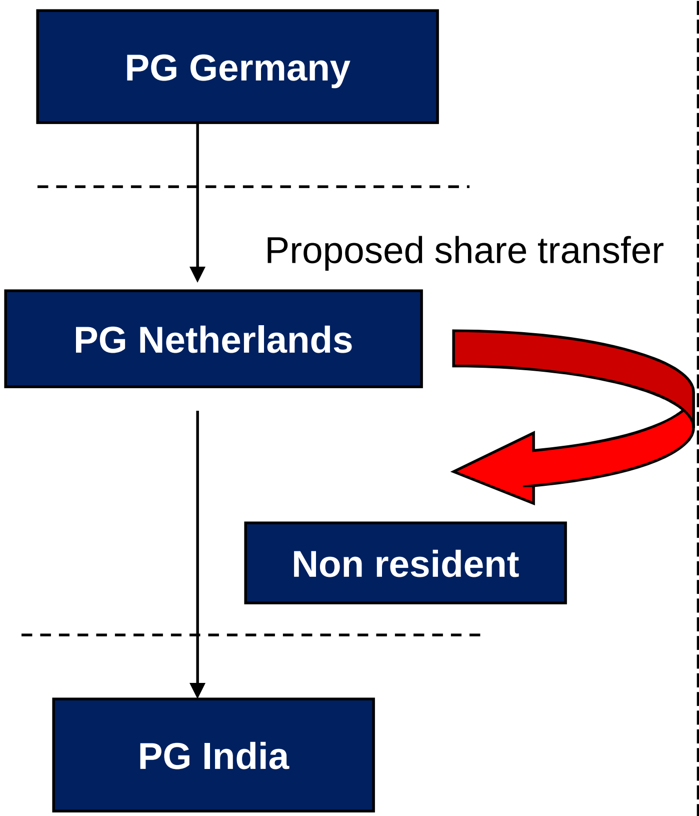
E*Trade – AAR Ruling

AAR views → **Capital gains tax exemption under India Mauritius Tax Treaty available to E*Trade, Mauritius**

- Validity of Circular 789 - TRC issued by the Mauritius Tax Authority is at least a presumptive evidence of beneficial ownership for both dividend as well as capital gains
- SC decision in case of Azadi Bachao Andolan validating the Circular applies
- Scope of inquiry on US parent company to be confined on the lines of the legal position laid down by the SC

Validity of treaty shopping - based on the SC decision and the facts and circumstances, the design of tax avoidance itself may not be objectionable and Treaty shopping may be permitted, if it is within the framework of law and is not prohibited by law

Case study | KSPG Netherlands Holding B.V. – Transaction overview



- KSPG Netherlands Holding B.V.– 322 ITR 696 (AAR)

Facts

- PG Netherlands and PG India are part of KSPG Germany
- At the time of incorporation of PG India, PG Germany was the sole shareholder
- Subsequently all the shares in PG India were transferred to PG Netherlands by PG Germany for a consideration
- PG Netherlands made substantial equity investment in PG India to facilitate its expansion plans
- PG Netherlands proposes to transfer shares of PG India to another non resident
- KSPG Netherlands Holding B.V.– 322 ITR

KSPG – contentions before AAR

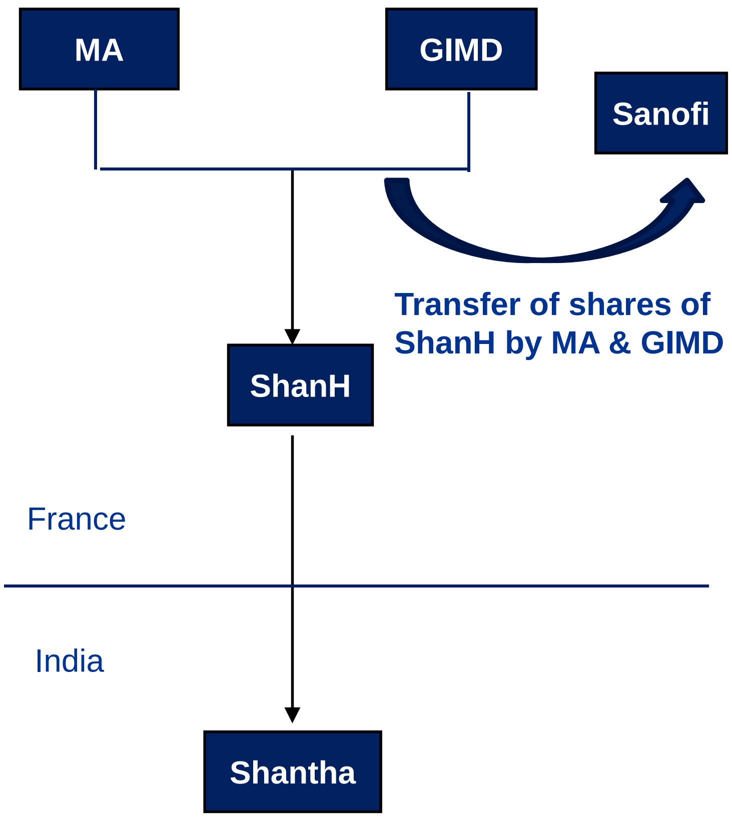
Tax Authorities' position	KSPG's position
▪ Beneficial owner of capital gains would be PG Germany, and therefore India Germany Tax Treaty will apply ▪ PG Netherlands is a conduit/ sham entity interposed for avoiding capital gains tax in India	• Transfer of shares by PG Netherlands to another non-resident expressly exempt under the India Netherlands Tax Treaty

KSPG – AAR Ruling

AAR views → Proposed share transfer between PG Netherlands and another non resident not taxable under the Tax Treaty

- Significant investments made in India - demonstrates substance for PG Netherlands
- No factual or legal basis for concluding that PG Germany is the real and beneficial owner of the shares in PG India
- PG Netherlands, although a subsidiary of PG Germany, is a distinct legal entity
- Transfer of shares of an Indian company (i.e. PG India) by a non resident (i.e. PG Netherlands) company to another non resident is not taxable under the India Netherlands Tax Treaty
- Not possible to assume that PG Netherlands would merely act as a conduit to siphon off gains to the ultimate holding company by means of a colorable device

Case study | Sanofi Pasteur Holding SA – Facts of the case



Facts

- MA and GIMD, French Companies holding 100 percent shares of ShanH another French company
- ShanH was holding shares in Shantha Biotechnics Ltd (Shantha), an Indian company
- In 2009 MA and GIMD transferred their shareholding in ShanH to Sanofi (a French company)
- AAR held that

✓ ShanH was created only to acquire the shareholding of the Indian company

✓ The transaction was a pre-ordained scheme to avoid tax in India

✓ The capital gains arising on transfer of shares of ShanH was taxable in India

Sanofi Pasteur Holding SA | High court's ruling

High court's ruling

- ShanH was an independent corporate entity and has a commercial substance and a purpose (FDI in Shantha)
- There is no warrant for lifting the corporate veil of ShanH and even on looking through the ShanH corporate persona
- ShanH's controlling interest of Shantha being identical to its shareholding cannot be considered as a separate asset and has no distinctive value
- ShanH serves as an investment vehicle which remains intact even post transfer of shares – reliance placed on Vodafone judgment to conclude ShanH is not a sham or colourable device
- The retrospective amendments made in the Finance Act, 2012 have no impact on interpretation of the tax treaty
- The AAR ruling and the AO's order treating Sanofi as an 'assessee in default' under Section 201 were unsustainable

Indirect transfers - International practice

International Practice

China

- Circular 698 empowers tax authorities to ignore existence of offshore holding companies “if the offshore investor indirectly transfers equity interests in a Chinese resident enterprise via abuse of organizational forms”
- Provisions typically invoked only where:
  - There is no substance or commercial purpose for the holding company
  - The holding company whose shares were transferred was not listed
  - Substantial holdings of the holding company were transferred.

Chinese Tax authorities received $25 mn capital gains tax payment resulting from an indirect stock transfer, in 2010….

International Practice

Brazil

- Supplementary Law No. 104 empowers tax authorities to disregard transactions where the intention is to avoid a tax realization event
- Typically employed only where a non-Brazilian company without economic substance / business purpose is interposed to avoid Brazilian capital gains tax

Peru

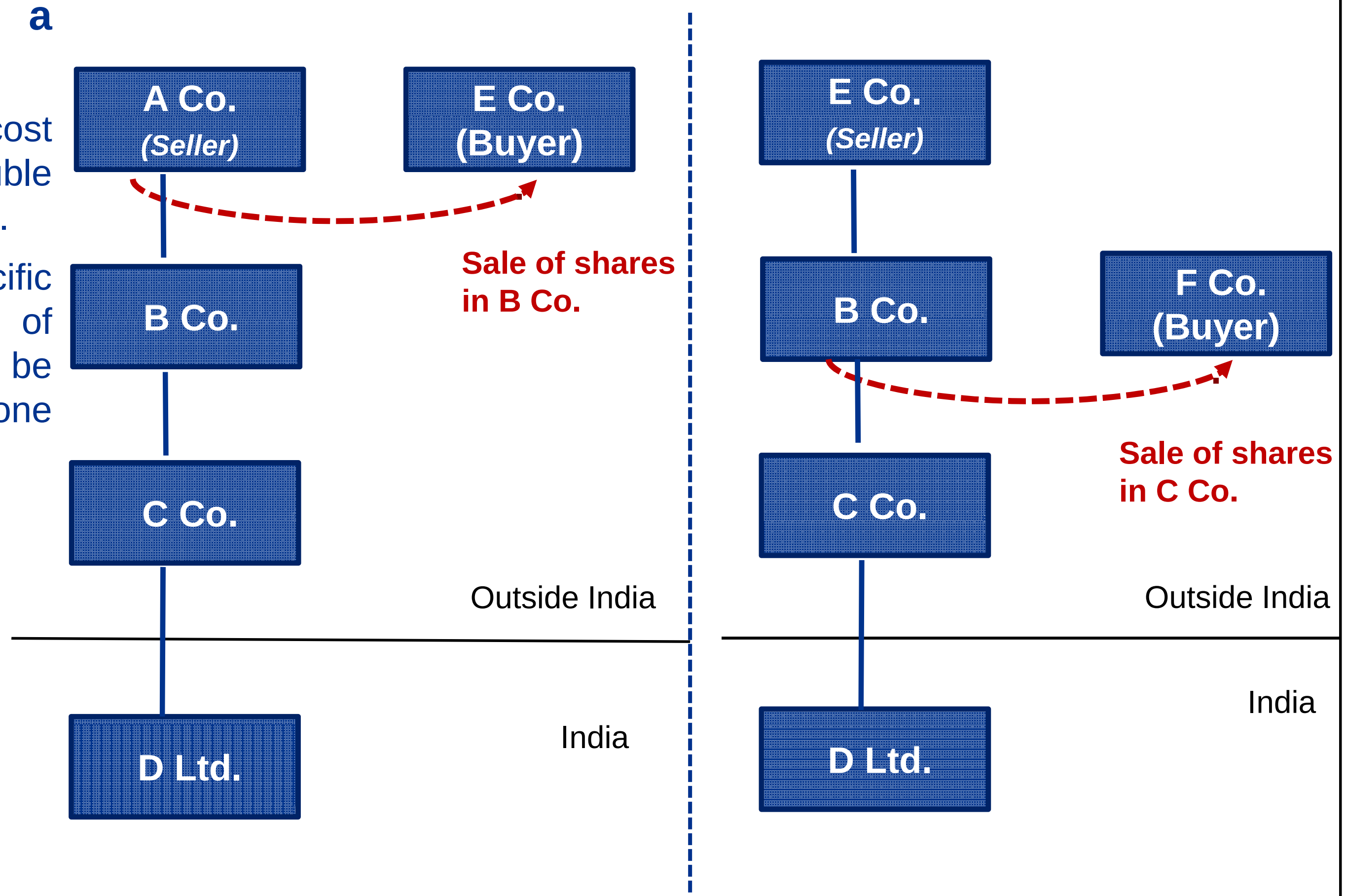
- Provides objective criteria for taxation of ‘indirect’ transfers
- Applies only when shareholding of more than 10% in the foreign entity holding Peruvian shares is transferred.
- Provides for pro-rata taxation of gains based on ratio of fair value of the Peruvian company to the value of the foreign company whose shares are being transferred.

Indirect transfer – Issue for thoughts

Multiple taxation – A possibility?

Multiple taxation – still a possibility

- No provision for adjustment to cost of acquisition to protect double taxation of subsequent transfers.
- In the absence of specific provisions, gains on transfer of shares ‘situated’ in India could be subjected to tax on more than one occasion



Thank you