ARTICLE

Indirect Transfer Taxation in India: From Vodafone to Cairn

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Indirect transfers refer to situations where when foreign entities own shares or assets in India, the shares of such foreign entities are transferred instead of a direct transfer of the underlying assets in India. There are innumerable permutations to such indirect transfers, many of which have been sought to be taxed by the Indian Government in the recent past. Beginning from the Vodafone case involving a tax demand of approximately USD 2.1 billion, which was followed by knee-jerk amendments to the Income Tax Act annually, to the recent Cairn case involving a tax demand of approximately USD 1.6 billion, the imposition of this tax has taken quite a few twists and turns. This article seeks to summarize and present a brief timeline of the issues related to indirect transfers, including the unintended issues that arose and those that continue to remain unresolved. These unresolved issues present potential concerns for future investments into India and for current foreign investors with investments in India. Further recognizing that unilateral measures by countries in taxing indirect transfers can result in incoherence and uncertainty, the United Nations, International Monetary Fund, Organization for Economic Co-operation and Development and World Bank Group have come out with a draft paper aimed at achieving international consensus on this issue.

1 Introduction

India includes within the scope of its tax net any income that accrues or arises in India. India also taxes income that is deemed to accrue or arise to a person in India irrespective of whether such person is a tax resident in India.[1] However, with respect to the power of the Parliament to enact legislations with extra-territorial applicability, the Supreme Court has laid down that there needs to be a sliver of nexus with India for the application or enforcement of law extraterritorially.[2] Therefore, with respect to indirect transfers, normally there should not be sufficient nexus to trigger applicability of Indian income tax laws since the asset that is being transferred and the parties to the transaction are situated outside India. The same was confirmed by the Supreme Court of India in the Vodafone case as well, which stated that absent a specific law, there was insufficient nexus to tax the indirect transfer.

Thus, the crux of the question relating to taxation of indirect transfers revolves around what income can be deemed to 'accrue or arise in India'. The tortuous journey commencing with Vodafone is yet to reach a clear destination. In fact, recently an Income Tax Appellate Tribunal ruled against Cairn UK Holdings Limited with respect to an indirect transfer transaction that occurred many years prior to the controversial retrospective amendment that was introduced by the Government in the wake of the Vodafone ruling. The genesis of the indirect transfer provisions, which continue to allow for retrospective application, is better understood in the context of the Vodafone ruling which is discussed below.

2 The Vodafone Decision

Vodafone International Holdings BV (hereinafter 'Vodafone'), a Netherlands tax resident, sought to acquire the entire share capital of CGP Investments (Holdings) Limited (hereinafter 'CGP'), a Cayman Islands tax resident ultimately held (through various non-Indian entities) by Hutchison Telecommunications International Limited

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1 The relevant portions of s. 5 of the Income Tax Act, 1961 read as follows:
'5. (1) Subject to the provisions of this Act, the total income of any previous year of a person who is a resident includes all income from whatever source derived which –
…
(b) accrues or arises or is deemed to accrue or arise to him in India during such year;
(2) Subject to the provisions of this Act, the total income of any previous year of a person who is a non-resident includes all income from whatever source derived which –
…
(b) accrues or arises or is deemed to accrue or arise to him in India during such year.'

2 *GVK Inds. Ltd v. The Income Tax Officer* [2011] 4 SCC 36.

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(hereinafter 'HTIL', another Cayman Islands tax resident). CGP, through various Mauritian and Indian companies, indirectly held a 67% stake in Hutchison Essar Limited (hereinafter 'HEL'), an Indian tax resident. The consideration for the transaction was around United States Dollar (hereinafter 'USD') 11.1 billion.

One of the major arguments of the Revenue, was that the acquisition of CGP shares by Vodafone should be taxable in India by virtue of section 9 of the Income Tax Act, 1961 (hereinafter 'ITA'), which reads as follows:

> *9. (1) The following incomes shall be deemed to accrue or arise in India:–*

(i) *all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India. {Emphasis added}*

The Revenue advocated for the application of a 'look through' approach towards the interpretation of section 9 of the ITA, contending that if there is a transfer of a capital asset situated in India 'in consequence of' an action taken overseas, then all income derived from such transfer should be taxable in India. Therefore, the Revenue sought to recover around USD 2.1 billion which, in its view, was required to be withheld from payments made to HTIL under domestic withholding obligations that applies to all sums remitted to a non-resident that is subject to tax.

The Supreme Court of India, in *Vodafone International Holdings B.V. v. Union of India*[3] (hereinafter '*Vodafone*'), partially reversing the decision of the Bombay High Court,[4] negated the aforesaid contention of the Revenue. The Supreme Court considered the last sub-clause of section 9(1)(i) as a charge on capital gains arising from transfer of a capital asset situated in India thereby requiring the satisfaction of three conditions, namely the existence of a capital asset, the situation of such capital asset in India and its transfer. It further held that the main purpose of section 9(1)(i) is to create a legal fiction where income that accrues to non-residents outside India due to the transfer of a capital asset situated in India would be deemed to accrue or arise in India. The Supreme Court observed that a legal fiction has limited scope and that the ambit of section 9(1)(i) cannot be extended to cover indirect transfers of capital assets, since such a reading would render the last condition under section 9(1)(i), namely the situation of the capital asset in India, nugatory.[5]

Further, specifically in the case of capital assets being shares of a company, the Supreme Court observed that while contractual rights may be capital assets and transferring such rights may amount to a transfer of a capital asset, shares being a bundle of rights cannot be broken up into individual components, like right to vote, management rights, controlling rights etc. and be regarded as constituting a transfer of separate capital assets situated in India.[6]

3 Finance act, 2012

As a reaction to the *Vodafone* decision, the Government of India, swiftly introduced legislative amendments to the ITA, with the following intent:

> *Certain judicial pronouncements have created doubts about the scope and purpose of sections 9 and 195. Further, there are certain issues in respect of income deemed to accrue or arise where there are conflicting decisions of various judicial authorities.*[7]

The Government made retrospective amendments to purportedly clarify the scope of the legislative provisions pertaining to income deemed to accrue or arise in India.

The Finance Act, 2012 (hereinafter the '2012 Act')[8] introduced Explanation 4 and Explanation 5 to section 9 (1)(i) the ITA, which read as follows:

> Explanation 4.– For the removal of doubts, it is hereby clarified that the expression 'through' shall mean and include and shall be deemed to have always meant and included 'by means of', 'in consequence of' or 'by reason of'.

> Explanation 5.– 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.

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3 *Vodafone International Holdings B.V. v. Union of India* [2012] 341 ITR 1. For a detailed analysis of this decision, reference may be made to Nishith Desai Associates, *Vodafone Victorious in Multi Billion Tax Battle*, http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/vodafone-victorious-in-multi-billion-tax-battle.html (accessed 30 July 2017).

4 *Vodafone International Holdings B.V. v. Union of India* [2010] (112) BomLR 3792.

5 *Vodafone International Holdings B.V. v. Union of India* [2012] 341 ITR 1, para. 78.

6 *Ibid.*, at para. 88.

7 Memorandum to the Finance Bill 2012, at 19.

8 For an analysis of the budget, the proposals in which were legislated upon through the 2012 Act, reference may be made to Nishith Desai Associates, *India Budget 2012: A Jolt to Foreign Investors,* http://www.nishithdesai.com/fileadmin/user_upload/Html/Budget2012/BUDGET%20HOTLINE_March1712.htm (accessed 30 July 2017).

The 2012 Act also introduced clarificatory explanations to definitions of 'capital asset'[9] and 'transfer' under section 2 of the ITA in the following terms:

> **Explanation.–** For the removal of doubts, it is hereby clarified that 'property' includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever; … .
>
> **Explanation 2.–** For the removal of doubts, it is hereby clarified that 'transfer' includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India;

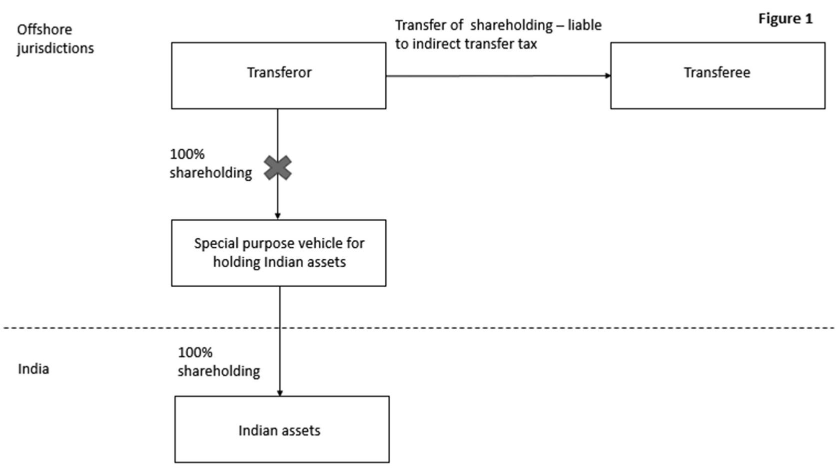
Most controversially, all of the aforesaid amendments introduced by the 2012 Act with retrospective effect were deemed to have been inserted with effect from 1 April 1962, thereby being made applicable to transactions that concluded prior to 2012 (which was the case under the Cairn case discussed later, where the impugned transactions were completed between 2006 and 2007).

A classic situation wherein the indirect transfer provisions introduced by the 2012 Act would apply is depicted below in Figure 1. The authors have, for the sake of simplicity, assumed a structure wherein the subsidiaries are wholly owned subsidiaries.

4 Shome Committee and Finance Act, 2015

Clearly the amendments introduced by the 2012 Act were intended to negate the basis for the *Vodafone* decision. The amendments were viewed adversely by various stakeholders. Considering that the 'clarificatory' amendments went against a Supreme Court decision on the point, there were widespread concerns about the certainty, predictability and stability of tax laws in India. In this backdrop, the Government appointed an Expert Committee under the chairmanship of Dr Parthasarathi Shome to analyse the issues pertaining to the retrospective amendments relating to indirect transfer. The Expert Committee submitted a draft report to the Government in 2012 (hereinafter the 'Shome Report').[10]

The Shome Report observed that the manner of introduction of amendments by the 2012 Act led to a conflation of two issues by those who reacted adversely to the amendments, the two issues being retrospectivity in tax law and taxation of indirect transfers. The Shome Report sought to untangle the two issues.[11] Pursuant to the recommendations contained in the Shome Report, the Finance Act, 2015 (hereinafter the '2015 Act')[12] introduced certain amendments to relax the harshness with which the 2012



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9 S. 2(14) of the ITA broadly defines capital asset to mean 'property of any kind held by an assessee, whether or not connected with his business or profession'.

10 Draft Report of the Expert Committee on Retrospective Amendments Relating to Indirect Transfer (2012), at 4.

11 *Ibid.*, at 4.

12 For an analysis of the budget, the proposals in which were legislated upon through the 2015 Act, reference may be made to Nishith Desai Associates, *India Budget Insights (2015–16),* http://www.nishithdesai.com/fileadmin/user_upload/Html/Budget2012/BUDGET%20HOTLINE_March1712.htm (accessed 30 July 2017).

Act amendments operated. Chiefly, two relaxations were introduced by the 2015 Act, as summarized here in below:

(1) **De Minimis Thresholds:** The 2015 Act, through Explanation 6 to section 9(1)(i) of the ITA (hereinafter 'Explanation 6'), introduced certain thresholds for the invocation of indirect transfer provisions through the application of Explanation 5 to section 9(1)(i) of the ITA (hereinafter 'Explanation 5'). Essentially, Explanation 6 states that a share or interest shall be deemed to derive value substantially from assets located in India only if the fair market value of such assets

(a) exceeds the amount of Indian Rupees ('INR') 10 Crores (approximately USD 1.5 million); and

(b) represents at least 50% of the value of all assets owned by the company or entity.[13]

(2) **Small Shareholder Exemption:** The 2015 Act, through Explanation 7 to section 9(1)(i) of the ITA (hereinafter 'Explanation 7'), provides that indirect transfer under Explanation 5 shall not apply if the non-resident, directly or indirectly, does not hold the right of management or control (including a right which would entitle the person to the right of management or control) or holds voting power, share capital or interest exceeding 5% of the total voting power, share capital or interest (as the case may be) of the company or entity which directly owns the assets situated in India.[14]

Further, Explanation 7 also clarifies that only such portion of the income of the non-resident transferor as is attributable to the assets located in India shall be deemed to accrue or arise in India.

The 2015 Act also introduced exemptions from the scope of the indirect transfer provisions in the case of transfers of Indian assets pursuant to overseas amalgamations and demergers involving foreign companies, subject to the satisfaction of certain conditions.[15]

Reporting requirements: Section 285A of the ITA was inserted by the 2015 Act, requiring an Indian concern through which or in which Indian assets were held to comply with certain reporting obligations. The obligation is on the Indian concern that holds Indian assets or in which the Indian assets are held, meaning if there is a structure where the foreign entity owns an Indian company which in-turn owns a subsidiary or which holds the Indian assets in itself, the Indian holding company through or in which the Indian assets are held would have to comply with this requirement.

5 CBDT clarifications on indirect transfer

In March 2015, the Central Board of Direct Taxes (hereinafter 'CBDT') issued Circular No. 4/2015 (hereinafter 'Circular 4') clarifying the applicability of

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[13] Explanation 6 reads as follows:
'Explanation 6. – For the purposes of this clause, it is hereby declared that –
(a) the share or interest, referred to in Explanation 5, shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if, on the specified date, the value of such assets –
(i) exceeds the amount of ten crore rupees; and
(ii) represents at least fifty per cent of the value of all the assets owned by the company or entity, as the case may be;.'

[14] Explanation 7 reads as follows:
'Explanation 7. – For the purposes of this clause, –
(a) no income shall be deemed to accrue or arise to a non-resident from transfer, outside India, of any share of, or interest in, a company or an entity, registered or incorporated outside India, referred to in the Explanation 5,
(i) if such company or entity directly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, neither holds the right of management or control in relation to such company or entity, nor holds voting power or share capital or interest exceeding five per cent of the total voting power or total share capital or total interest, as the case may be, of such company or entity; or
(ii) if such company or entity indirectly owns the assets situated in India and the transferor (whether individually or along with its associated enterprises), at any time in the twelve months preceding the date of transfer, neither holds the right of management or control in relation to such company or entity, nor holds any right in, or in relation to, such company or entity which would entitle him to the right of management or control in the company or entity that directly owns the assets situated in India, nor holds such percentage of voting power or share capital or interest in such company or entity which results in holding of (either individually or along with associated enterprises) a voting power or share capital or interest exceeding five per cent of the total voting power or total share capital or total interest, as the case may be, of the company or entity that directly owns the assets situated in India;
(b) in a case where all the assets owned, directly or indirectly, by a company or, as the case may be, an entity referred to in the Explanation 5, are not located in India, the income of the non-resident transferor, from transfer outside India of a share of, or interest in, such company or entity, deemed to accrue or arise in India under this clause, shall be only such part of the income as is reasonably attributable to assets located in India and determined in such manner as may be prescribed;.'

[15] The relevant portions of s. 47 of the ITA in this regard read as follows:
'47. Nothing contained in section 45 shall apply to the following transfers:–
…
(viab) any transfer, in a scheme of amalgamation, of a capital asset, being a share of a foreign company, referred to in the Explanation 5 to clause (i) of sub-section (1) of section 9, which derives, directly or indirectly, its value substantially from the share or shares of an Indian company, held by the amalgamating foreign company to the amalgamated foreign company, if –
(A) at least twenty-five per cent of the shareholders of the amalgamating foreign company continue to remain shareholders of the amalgamated foreign company; and
(B) such transfer does not attract tax on capital gains in the country in which the amalgamating company is incorporated;
(vicc) any transfer in a demerger, of a capital asset, being a share of a foreign company, referred to in the Explanation 5 to clause (i) of sub-section (1) of section 9, which derives, directly or indirectly, its value substantially from the share or shares of an Indian company, held by the demerged foreign company to the resulting foreign company, if –
(a) the shareholders, holding not less than three-fourths in value of the shares of the demerged foreign company, continue to remain shareholders of the resulting foreign company; and
(b) such transfer does not attract tax on capital gains in the country in which the demerged foreign company is incorporated:
Provided that the provisions of sections 391 to 394 of the Companies Act, 1956 (1 of 1956) shall not apply in case of demergers referred to in this clause;'

indirect transfer provisions in case of dividends received from a foreign company. The CBDT noted that indirect transfer provisions sought to clarify the source rule of taxation pertaining to income arising from indirect transfer of assets situated in India. It was therefore clarified that the declaration of dividend by a foreign company would not be taxable in India as it does not have the effect of transferring underlying assets located in India. Thus, dividends declared and paid by a foreign company outside India in respect of shares which derive their value substantially from assets situated in India would not be deemed to be income accruing or arising in India by virtue of indirect transfer provisions.[16]

Reporting requirements: Pursuant to the introduction of reporting requirements under section 285A by the 2015 Act as discussed above, rules in this regard were prescribed vide notification No. S.O.2226(E) dated 28 June 2016 which inserted Rule 114DB of the Income Tax Rules, 1962, that provide for very onerous reporting requirements which among others include details of the holding structure, the intermediate companies and other documentation which the Indian concern may not be able to legally obtain. Further, the transaction has to be reported within ninety days of the completion of the transaction if the transaction involves the transfer of control or management. In other cases, the transaction has to be reported along with the filing of the annual returns.

Valuation rules: Vide the same notification No. S.O.2226(E) dated 28 June 2016 detailed valuation rules were prescribed by the Government for the limited purposes of determining the fair market value of the Indian assets to establish breach of the indirect transfer thresholds. The specific valuation rules prescribe the adding back of any liabilities that were deducted while calculating the fair market value through other internationally accepted methods. This was to ensure that there was no reduction of the fair market value of the Indian assets through any increases in the liabilities of the concerned entities. Further, separate rules and methods have been prescribed with respect to each asset class such as listed shares, unlisted shares, interests in a partnership and other capital assets, both in India and abroad making it very complicated and cumbersome to comply with.

Further, such valuations have to be conducted as on the 'specified date' prescribed in the ITA which is one of the following dates:

(1) The last day of the previous accounting period for the concerned entity. Which means that it would depend on the accounting period for the concerned foreign entity and not 31st March as per Indian law; or
(2) The date of the transaction, if the difference in the book value between the date of transfer and as on the last date of the previous accounting period is more than 15%.

This essentially means that parties have to do multiple rounds of valuations of different kinds to even assess whether the indirect transfer thresholds are breached. At the very minimum, from a conservative perspective, the following valuation reports would be required:

(1) A valuation report assessing book value as on the last date of the previous accounting period;
(2) A valuation report assessing the book value as on the date of the transaction;
(3) A valuation report assessing the value of Indian assets as per indirect transfer valuation rules as on the specified date based on reports provided under (1) and (2) immediately above;
(4) A valuation report of the foreign entity and its global assets as per indirect transfer valuation rules as on the specified date based on reports provided under (1) and (2) above.

Such an exercise is cumbersome, expensive and practically unworkable as well since should the indirect tax be applicable, then tax will have to be withheld at the time of payment of consideration on the date of transfer itself. However, it is impossible to understand the value of the Indian assets in comparison to the foreign assets on the date of the transfer if the specified date happens to be the date of the transfer due to a more than 15% difference in the book value of the assets of the company. Therefore, it would be impractical to expect the buyer to withhold the proportionate amount of tax on the date of the transfer if it happens to be the specified date.

For the sake of completeness, it is to be noted that once the indirect transfer provisions are found applicable, the Income Tax Rules, 1962 state that tax has to be paid in proportion to the Indian assets which form part of the global pool of assets as certified by a local accountant in India.

Circular 41 of 2016: While the amendments introduced by the 2015 Act brought some relief from the harshness of the operation of the indirect transfer provisions, there remained substantial lack of clarity with regard to the scope of the said provisions. Some of the key issues that came to the fore as a result of the CBDT's clarifications are discussed below:

(1) **Multiple levels of taxation on the same income:** Various offshore funds register with the Securities and Exchange Board of India (hereinafter 'SEBI') as Foreign Portfolio Investors (hereinafter 'FPIs') to

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[16] CBDT, Circular No. 4 of 2015, at 2.

gain exposure to listed Indian securities. Such funds often adopt open-ended structures, allowing for frequent subscriptions and redemptions by investors in the fund.

In order to address the queries raised and to examine the issues raised by stakeholders, particularly private equity/venture capital funds and FPIs, the CBDT constituted a working group. On 21 December 2016, the CBDT issued Circular No. 41 of 2016 (hereinafter 'Circular 41') to issue clarifications on the applicability of the indirect transfer provisions.

The CBDT herein followed an extremely literal approach to the reading of the indirect transfer provisions, which did little to assuage the concerns of various stakeholders. The CBDT clarified that where De Minimis Thresholds are satisfied, redemption by investors of their shares in the fund will be taxable in India unless the investors are covered by the Small Shareholder Exemption even if the fund has paid applicable taxes on its transactions in India.[17]

When the FPI has already paid Indian taxes on its transactions, subjecting gains derived by investors upon redemption leads to economic double taxation of the same income. Moreover, the clarification exposed the anomaly that gains derived by the investors are subject to taxation, when the FPIs themselves may be exempt under Indian tax law.[18] Further, if investors are subject to tax in their home jurisdictions on the redemption gains, there could be further layers of tax, especially if there are limitations on availment of tax credits.

The problems highlighted above are especially true of master-feeder structures,[19] where feeder funds pool their monies into a master fund in a particular offshore jurisdiction, which in turn invests in India. Redemption requests by shareholders satisfying the Small Shareholder Exemption can set in motion a series of capital redemptions and multiple levels of taxation. Circular 41 clarified that if an ultimate shareholder satisfies the Small Shareholder Exemption, he would not be subject to taxation on indirect transfers.[20] However, in order to satisfy the requests of such a shareholder, feeder and master funds may be required to undertake capital redemptions and be subject to multiple levels of taxation on indirect and direct transfers respectively.

Therefore, Circular 41 failed to assuage concerns on the issue of multiple levels of taxation on the same income. The impact of Circular 41 in this regard has been partially mitigated due to amendments introduced in the 2017 Budget as discussed later below.

(2) **Corporate reorganizations:** Since the definition of 'transfer' includes an extinguishment of rights or sale of an asset, shares of a foreign company in this case, it would mean that at the time of a re-organization a holding company that owns subsidiaries that derive its value from assets in India would be subject to indirect transfer tax at the time of its merger or re-organization as it extinguishes its rights with respect to the subsidiary's shares. Additionally, the shareholders of the holding company would also be subject to indirect transfer tax since their rights in the shares of the holding company would be extinguished in the case of a re-organization or merger.

Circular 41 clarified that the exemption under section 47 (viab) of the ITA only applies to income upon indirect transfers earned by foreign amalgamating companies and does not extend to shareholders of an amalgamating foreign company.[21] Circular 41 also clarified that the exemption available to amalgamations under section 47(viab) is restricted to foreign corporate entities and does not extend to foreign non-corporate entities.[22]

Therefore, both foreign non-corporate entities and their investors can be subject to indirect transfer provisions. As such, for an offshore fund merging into another offshore fund, the investors of the former fund may not rely on section 47(viab) and could be subject to indirect transfer provisions. Similar would be the case in any other corporate re-organization.

(3) **Withholding and retrospectivity:** CBDT was asked to clarify whether FPIs could be treated as being in default for failure to withhold tax when such FPIs, in accordance with the position of law as existing at the time of redemption/transfer, did not withhold tax on payments to meet redemption requests. In this regard, it is pertinent to note that the Shome Report had recommended that no person should be treated as being in default

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[17] CBDT, Circular No. 41 of 2016, at 1. For a detailed analysis of Circular 41, reference may be made to Nishith Desai Associates, *India's Tax Regulator 'Clarifies' Indirect Transfers: Adds to the Morass of Investor Woes*, http://www.nishithdesai.com/information/news-storage/news-details/article/indias-tax-regulator-clarifies-indirect-transfers-adds-to-the-morass-of-investor-woes.html (accessed 30 July 2017).

[18] E.g. long term capital gains arising from the sale of equity shares listed on a recognized stock exchange in India are typically exempt from income tax, subject to the satisfaction of certain conditions, including the payment of securities transaction tax.

[19] Master-feeder structures and the issues highlighted above can operate even in non-FPI contexts. E.g. in the case of private equity / venture capital funds investing in unlisted Indian securities.

[20] CBDT, Circular No. 41 of 2016, at 2.

[21] *Ibid.*, at 3.

[22] *Ibid.*, at 4.

> for failure to withhold with respect to income becoming chargeable on account of retrospective amendments carried out through the 2012 Act.[23] These recommendations were made on the basis that any alternate course of action would result in the imposition of a burden of impossibility of performance and cause undue hardship to the taxpayer. However, the CBDT, in response to the query, merely stated that the provisions of the ITA shall apply,[24] therefore scarcely providing any clarification or comfort.

Circular 41, instead of addressing the concerns of various stakeholders, reinforced the harshness of the operation of the indirect transfer provisions. Post issuance of Circular 41, CBDT received representations from various stakeholders, including FPIs and venture capital funds, wherein they expressed their dissatisfaction, especially with the failure to address the issue of potential multiple taxation of the same income. Therefore, the CBDT issued a press release dated 17 January 2017 communicating that pending a decision on the matter, Circular 41 has been kept in abeyance since.

6 Finance act, 2017

Considering that the CBDT's clarifications on the applicability of indirect transfer provisions had stirred up a hornet's nest, there was an expectation that the Finance Minister would announce measures providing for greater clarity on the issue. Typically, announcements made on the fiscal policy front in the budget are incorporated through legislation in the Finance Act for the particular financial year.[25]

Pursuant to announcements made in the Finance Minister's speech, the Finance Act, 2017 has introduced two provisos to Explanation 5 stipulating that the indirect transfer provisions shall not apply to investments made, directly or indirectly, by non-residents in foreign institutional investors (for income arising between the financial years 2011–2012 to 2014–2015) registered with SEBI and to investments made by non-residents, directly or indirectly, in Category I and Category II FPIs.[26]

While providing welcome relief to the aforementioned specified categories of foreign investors, the amendment has not provided relief to affected groupings including Category III FPIs, private equity and venture capital investors. While the Finance Minister's speech indicated that a clarification would be issued exempting offshore redemptions arising out of taxable redemptions/sales in India, and thereby alleviating the issue of multiple levels of taxation, the fine print of the Finance Act, 2017 does not provide any such exemption. Further, no clarification in this regard has so far been issued even post the enactment of the Finance Act, 2017. The Finance Act, 2017 has also not clarified on transactions such as offshore mergers, demergers or re-organizations which result in the indirect transfer provisions being triggered.

7 Select case law on indirect transfer provisions

7.1 *Sanofi*

Soon after the enactment of the 2012 Act, the High Court of Andhra Pradesh, in *M/s. Sanofi Pasteur Holding SA v. Department of Revenue*[27] (hereinafter '*Sanofi*'), was confronted with the question of whether indirect transfer provisions would prevail in the context of tax treaty provisions. The Revenue here sought to claim over INR 1,058 Crores (approximately USD 164.8 million). The impugned transaction, between three French entities, involved the acquisition by Sanofi Pasteur Holding SA (hereinafter 'Sanofi Pasteur') of the entire share capital of ShanH SAS (hereinafter 'ShanH') from Meriuex Alliance (hereinafter 'MA') and Groupe Industrial Marcel Dassault (hereinafter 'GIMD') in July 2009. ShanH held about 80% of the shares in an Indian concern, namely Shanta Biotechnics Limited (hereinafter 'SBL') and hence the question of indirect transfer arose.[28]

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[23] *Supra* n. 10, at 64–65.

[24] CBDT, Circular No. 41 of 2016, at 6.

[25] The Finance Minister's speech for the Indian Union Budget for the financial year 2017–2018 (1 Apr. 2017–31 Mar. 2018) was delivered on 1 Feb. 2017. Thereafter, the Finance Act, 2017 has been passed. For a detailed analysis of the Union Budget 2017–2018, reference may be made to Nishith Desai Associates, *India Budget Analysis 2017–18*, http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/india-budget-analysis-2017-18.html?no_cache=1&cHash=220b45800a7409f2a176d3f5bae6f155 (accessed 30 July 2017).

[26] The FPI regime traces its source to the SEBI (Foreign Portfolio Investors) Regulations, 2014, which has repealed the erstwhile foreign institutional investor regime (also under SEBI's purview) under the SEBI (Foreign Institutional Investors (Regulations), 1995, with the regimes serving as the primary means for institutional investors to gain access to listed securities in India.
Category I FPIs typically consist of government and government-related investors such as central banks, governmental agencies, sovereign wealth funds or international and multilateral organizations or agencies. Category II FPIs typically consist of broad-based funds, university funds, pension funds etc. Category III FPIs, the only category not covered by the exemption currently, consist of persons who are neither Category I FPIs nor Category II FPIs, typically charitable foundations, corporate bodies, trusts, individuals and family offices.

[27] *M/s. Sanofi Pasteur Holding SA v. Department of Revenue, Ministry of Finance* [2013] 354 ITR 316 (AP).

[28] *Ibid.*, at para. 1.

The Revenue, *inter alia*, argued that the acquisition amounted to an indirect transfer of the shares of SBL, and income arising to the sellers therefrom was therefore chargeable by virtue of the indirect transfer provisions. The High Court examined the construct of Article 14 of the tax treaty between India and France (hereinafter 'India-France DTAA'), which deals with taxation of capital gains. As per Article 14(5) of the India-France DTAA, gains arising from the alienation of shares, not being shares of a company the property of which consists directly or indirectly principally of immovable property, representing a participation of at least 10% in a company which is resident of a contracting state may be taxed in that state. Further, Article 14(6) governs residuary situations stating that gains from alienation of property other than those mentioned in Articles 14 (1), 14(2), 14(4) and 14(5) shall be taxable in the contracting state where the alienator is resident.[29]

The High Court observed that as per India-France DTAA, while the transfer of shares of an Indian company by a company resident in France is taxable both in France and India, transfer of shares of a company not resident in France or India can only be taxed where the alienator is resident. Despite arguments by the Revenue with respect to a lack of substance at the French company level, the High Court went on to hold that transfer of shares of a French entity with underlying Indian assets should not fall under Article 14(5) of the India-France DTAA as Article 14(5) does not have a 'see through approach'. Accordingly, the court held that such a transfer should also fall under Article 14(6) and be taxable only where the alienator is resident, i.e. France.

Thus, *Sanofi* is an authoritative ruling supporting the position that the indirect transfer provisions under the ITA do not override those contained in India's tax treaties. It is also further relevant to distinguish situations that would fall under the scope of Articles 14(5) and 14(6). This becomes crucial when dealing with question of indirect transfer that arise with respect to other tax treaties that have similar language. Generally, most treaties have similar language with the main exceptions being the tax treaties with US and United Kingdom.

7.2 *Cairn*

The latest decision relating to indirect transfer is the ruling of the Delhi Bench of the Income Tax Appellate Tribunal (hereinafter 'ITAT') upholding a tax demand of approximately INR 10,247 crore (approximately USD 1.6 billion) against Cairn UK Holdings Limited (the ruling hereinafter being referred to as '*Cairn*').[30] The dispute pertains to certain corporate restructuring transactions carried out between 2006 and 2007 within the Cairn group for the consolidation of the group's Indian businesses. The impugned transaction involved the transfer of shares in Cairn India Holdings Limited (hereinafter 'CIHL'), a Jersey resident which in turn held various of the group's Indian subsidiaries (and therefore CIHL's shares derived their value substantially from assets located in India), by Cairn UK Holdings Limited (hereinafter 'CUHL') to Cairn India Limited (hereinafter 'CIL'), an Indian resident.

The ITAT upheld the retrospective application of the levy and confirmed the tax demand on the basis of the indirect transfer provisions under the ITA. However, the ITAT provided some relief to CUHL by holding that it was not liable to pay penal interest on the principal amount for late payment of taxes which becomes payable by virtue of the confirmation of applicability of indirect transfer provisions.[31] It is also useful to note that as per Article 14 of the tax treaty between India and the UK, save for a few exceptions in respect of air transport and shipping, each State is permitted to tax capital gains as per its domestic law. Therefore, the relief afforded to the taxpayer under the India-France DTAA in *Sanofi* as discussed above could not be availed by CUHL in *Cairn* with respect to the tax treaty between India and the UK.

The *Cairn* ruling has brought to the fore the issue of retrospective application of the indirect transfer provisions and highlighted the harshness of the manner in which they operate. Considering that the ITAT was not empowered to go into the constitutionality of the provisions, it is probable that *Cairn* does not represent the final position on the matter and that

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[29] The relevant portions of Art. 14 of the India-France DTAA read as follows:

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 Contracting State. For the purposes of this provision, immovable property pertaining to the industrial or commercial operation of such company shall not be taken into account.
5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing 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 mentioned in paragraphs 1, 2, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.'

[30] *Cairn UK Holdings Limited v. Deputy Commissioner of Income Tax (International Taxation)* – Circle 1(2)(1) New Delhi, ITA No. 1669/Del/2016 (Assessment year 2007–2008). It is important to note that the ITAT is not empowered to go into issues of validity of the amendments introduced by the 2012 Act, especially with relation to the retrospective application. It is also pertinent to note that CUHL has challenged the validity of the retrospective application of the amendments before the International Court of Justice under the Agreement between the Government of India and Government of United Kingdom of Great Britain and Northern Ireland for the Promotion and Protection of Investments and that the matter is accordingly sub-judice. For a detailed analysis of the ITAT decision in *Cairn*, reference may be made to (a) Nishith Desai Associates, *Retrospective Capital Gains Tax on Indirect Transfers: The Ghost of the Vodafone Case Revisits Cairn (UK)*, http://www.nishithdesai.com/information/news-storage/news-details/article/retrospective-capital-gains-tax-on-indirect-transfers-the-ghost-of-the-vodafone-case-revisits-cairn.html (accessed 30 July 2017); and (b) Ameya Mithe, Joachim Saldanha & Mansi Seth, *India's Retrospective Indirect Transfer Tax: The Cairn Tax Saga and Beyond*, 86(12) Tax Notes Int'l 1099, 1099–1105 (19 June 2017).

[31] *Cairn UK Holdings Limited v. Deputy Commissioner of Income Tax (International Taxation)* – Circle 1(2)(1) New Delhi, ITA No. 1669/Del/2016 (Assessment year 2007–2008), at para. 41.

they might come up for examination by the higher judiciary. That being said, the ruling has contributed to the tax uncertainty and magnified investor discomfort regarding the operation of the provisions.

The *Cairn* ruling also goes to show that there remain unresolved issues due to the manner in which the indirect transfer provisions have been drafted, and even the solutions and/or concessions being fashioned by the legislature do not adequately address the mismatch between the legislative intent and the ultimate consequences. Below, the authors seek to analyse certain ambiguities in the language of the indirect transfer provisions, which could be the seeds to future disputes.

8 Illustration to Demonstrate Applicability of Indirect Transfer Provisions

In the illustration provided in Figure 2 above, the authors attempt to highlight the different nuances involved in the applicability of indirect transfer provisions in real world situations:

(1) Mau Co holds two Indian subsidiaries directly and two more Indian subsidiaries indirectly. Since the total value of the Indian companies amounts to INR 20 Crores (approximately USD 3.1 million), the de minimis threshold for applicability of indirect transfers is breached (which is INR 10 Crores i.e. approximately USD 1.5 million) and therefore transfer of shares of Mau Co would be subject to indirect transfer tax. Further, only Ind-Holdco I and Ind-Holdco II would be subject to reporting obligations under section 285A.

(2) Shares of UK Co II derives only INR 6 Crores (approximately USD 0.9 million) worth of value from underlying Indian assets and therefore falls below the de minimis threshold. Hence, transfer of these shares should not attract indirect transfer tax.

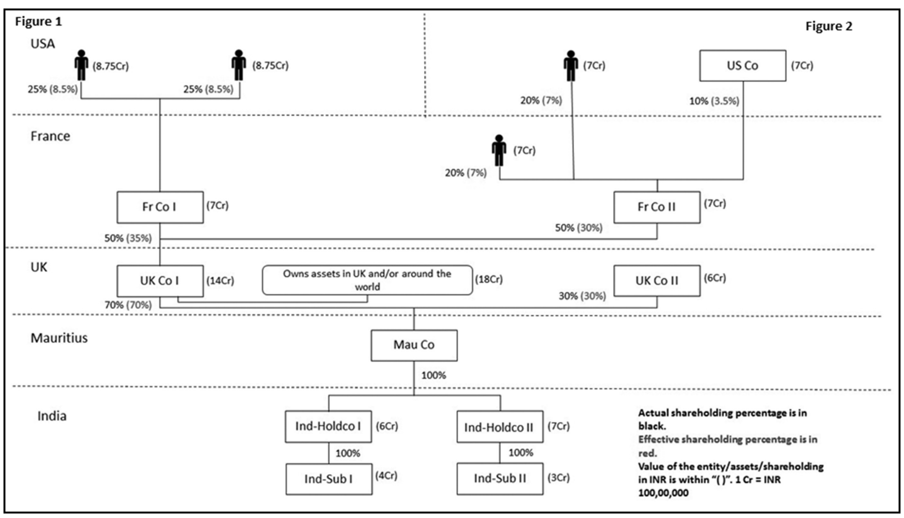
(3) Shares of UK Co I derive INR 14 Crores (approximately USD 2.2 million) worth of value from underlying Indian assets and therefore breaches the de minimus threshold. However, since it has more than INR 18 Crores worth of assets outside India, it derives more than 50% of its value from non-Indian assets. Hence, transfer of shares of UK Co I should not attract indirect transfer tax.

(4) Shares of Fr CoI, Fr Co II and US Co should not be subject to indirect transfer tax as the value they derive from underlying Indian assets is less than the de minimis threshold. However, even if the value derived was higher than the de minimis threshold, while the individuals would be subject to indirect transfer tax, as they own more than 5% of the voting powers or share capital effectively in Mau Co, US Co could still claim to fall under the small shareholder exception. Additionally, while the French resident individual could potentially claim treaty benefits, based on the Sanofi case explained below, the residents of UK or US do not have a favourable DTAA in this regard.

Further, despite US Co having less than 5% of the effective shareholding or voting powers in Mau Co, if it has any contractual management rights with respect to Mau Co, or any other contractual rights that effectively allow it to exercise control over Mau Co, then the small shareholder exception should not apply to it.

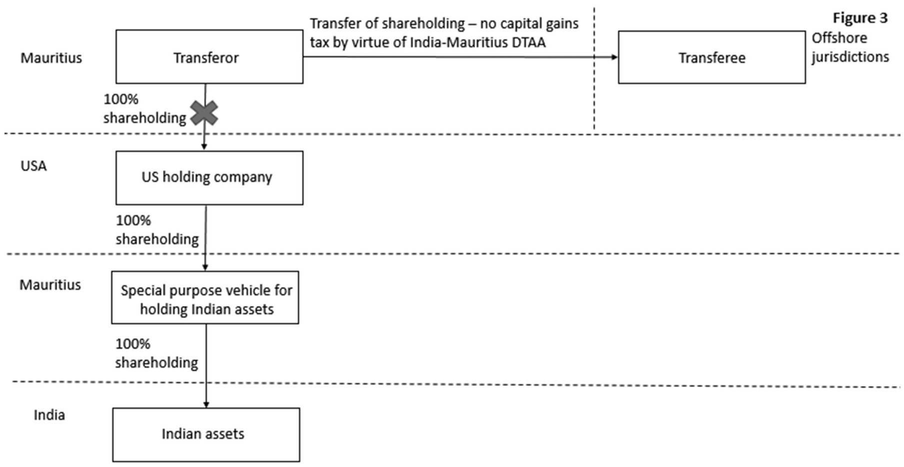
9 Certain Unresolved Ambiguities in Indirect Transfer Provisions

(1) **Operation of tax treaties:** *Sanofi* highlighted the manner in which provisions of tax treaties can be

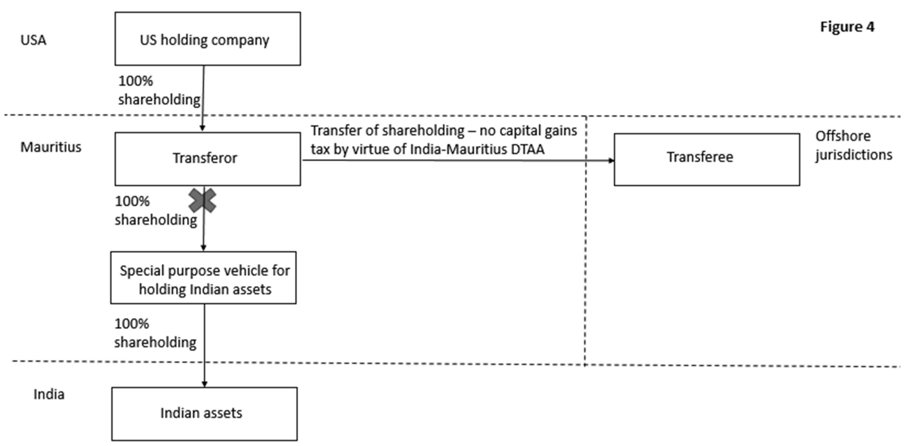


employed to overcome the applicability of the indirect transfer provisions under the ITA. Many other tax treaties which India has entered into, including the popular tax treaty between India and Mauritius (hereinafter 'India-Mauritius DTAA'), allow for residence based taxation with respect to property other than shares of a company resident in a contracting state. For example, Article 13(4) of the India-Mauritius DTAA deals with capital gains arising from 'other property' i.e. property not specifically dealt with in the other provisions of Article 13. With respect to shares, Article 13 only deals with shares of a company resident in a contracting state.[32] Therefore, it is possible to take a view that for a Mauritius resident holding shares in a company which is not resident in India (including shares in another Mauritius resident company), income arising upon alienation of such shares can be considered to be income arising from 'other property' and hence taxable in Mauritius i.e. residence of the alienator even if such shares derive their value substantially from Indian assets. The following diagrams Figure 3 and Figure 4 depict structures in which the treaty (the authors have considered the India-Mauritius DTAA for the purposes of the diagrams) could possibly be leveraged in the manner described above to overcome the applicability of indirect transfer provisions.

Scenario 1



Scenario 2



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32 The relevant portions of Art. 13 of the India-Mauritius DTAA read as follows:
'3A. Gains from the alienation of shares acquired on or after 1st April 2017 in a company which is resident of a Contracting State may be taxed in that State.
…
4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 3A shall be taxable only in the Contracting State of which the alienator is a resident'.

It is unclear whether the legislature while enacting the indirect transfer provisions contemplated the application of the residual clause(s) of capital gains provisions in tax treaties to overcome the indirect transfer provisions.[33] Further, structures such as the ones depicted above are also open to examination from the perspective of the general anti-avoidance rules provisions under the ITA (**GAAR**) which have come into effect from 1 April 2017.

(2) **Corporate reorganizations:** As discussed above, the CBDT, in Circular 41, has clarified that the relevant sub-clauses in section 47 of the ITA which provide exemptions from the applicability of indirect transfer provisions in the case of amalgamations or demergers (as the case may be), do not extend to the shareholders of the entities undergoing the relevant corporate reorganization.[34] The problematic conclusion arising from the CBDT's clarifications is that while entities undergoing re-organization may be exempted from the applicability of indirect transfer provisions, shareholders of such entities may not be so exempt. The anomalous manner of the application of the exemptions around corporate reorganizations, which are otherwise tax neutral, enhances the possibility of a dispute around the applicability of the indirect transfer provisions.

(3) **Income from other sources**: Section 56(2)(x) of the ITA taxes, save for certain limited exemptions, as 'income from other sources' the receipt of money or property without consideration or with inadequate consideration.[35] The provision includes within its ambit receipt of shares for less than fair market value. While such taxability is understandable when there is a nexus to India (in terms of residence of the parties involved and/or situs of capital asset), a seemingly unintended extension of the provision arguably brings within India's tax net the transfer of shares of a foreign company between tax non-residents of India at less than fair market value if such shares derive value substantially from assets located in India. This is made possible due to the deeming fiction introduced by the indirect transfer provisions in the ITA. This unexpectedly affects, potentially adversely, the freedom of contract of two offshore persons entering into an otherwise completely offshore-based transaction. In the absence of a clarification, such as the one that the CBDT has issued in the context of dividends through Circular 4, the extension of section 56(2)(x) to offshore transactions can be fraught with issues.

(4) **Fragmentation of holdings**: As discussed above in section 8 above, it may be possible to fragment holdings in a manner to fall below the de minimis thresholds and avoid the applicability of indirect transfer taxes. However, there may be minor concerns surrounding the manner in which the tax authorities may interpret Explanations 5 and 6, particularly that fragmentation is not possible, that indirect transfer would arguably apply to all holding companies so long as the underlying asset is more than INR 10 Crores (approximately USD 1.5 million). This would mean that, in the illustration provided as Figure 2 above, the effective value derived from underlying assets could be less than INR 10 Crores (approximately USD 1.5 million) (as in the case of the French and US residents) and yet indirect transfer provisions would apply since the value of the underlying Indian assets is above the de minimis threshold (value of Indian assets in the illustration is INR 20 Crores i.e. approximately USD 3.1 million).

(5) **Tax on notional capital gains:** The Finance Act, 2017 introduced a new provision section 50CA which deems the sale price of an unlisted share to be the fair market value, as computed in accordance with the prescribed rules. Assume that a share was bought at INR 100 (approximately USD 1.56) and that it is being sold today at INR 120 (approximately USD 1.87). Normally, capital gains would have been payable on the gain of INR 20 (approximately USD 0.31). However, if as per the prescribed rules, the fair market value is determined at INR 160 (approximately USD 2.49), then irrespective of the fact that the shares are actually sold at INR 120 (approximately USD 1.87), tax will have to be paid on a notional gain of INR 60 (approximately USD 0.93). While this was brought in to bring about consistency in the capital gains section of the ITA,

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[33] It is worth mentioning here that India has, in 2016, renegotiated popular treaties with Mauritius and Singapore to amend the construct around capital gains taxation from residence-based to source-based. However, these changes do not extend to the residuary clauses in capital gains provisions of these treaties, which continue to provide for residence-based taxation of capital gains which are not specifically dealt with in preceding paragraphs of the respective capital gains provisions.

[34] CBDT, Circular No. 41 of 2016, at 3.

[35] The relevant portions of s. 56(2)(x) of the ITA read as follows:
'(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head 'Income from other sources', namely:–
…
(c) any property, other than immovable property, –
(A) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;
(B) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration:
.'

this may not have been intended to apply in an indirect transfer situation. However, by virtue of this section, once a share of a foreign company is deemed to be a capital asset situated in India, the sale price will be deemed to be the fair market value irrespective of the actual sale price. This section further complicates a complex situation and now the parties will have to undertake an additional valuation exercise as per special rules prescribed to calculate fair market value for this purpose, over and above the valuation reports required to assess applicability and the proportionate amount of indirect transfer tax.

(6) **Stock market transactions on foreign exchanges:** Indirect transfer tax has had the unintended effect of having an impact on the transaction of shares of a foreign company in a foreign exchange, when such foreign company derives substantial value from underlying Indian assets. For a shareholder to fall outside the small shareholder exception, such shareholder needs to have more than 5% of the capital or voting rights of such company or any right in the management or control of such company at any point in time in the twelve months preceding the actual transfer. Thus, this is an aspect that shareholders need to be cognizant of as it could have significant implications especially to individual investors or high net worth individuals who are not fully informed and are trading such shares on stock exchanges around the world. It is also pertinent to note that the frequency and volume of trade on stock exchanges may make already onerous reporting obligations on Indian concerns under section 285A of the ITA exponentially more difficult to comply.

10 Conclusion

Indirect transfer provisions were introduced as a reaction to a Supreme Court verdict and the continuous stream of issues, clarifications and amendments to plug the loopholes confirm the same. With the progress of time, the situation does not appear to be heading towards a resolution and in fact seems to be evolving in a more complicated direction. This is primarily due to the unintended effects of new provisions being introduced and the harshness in the original legal fiction.

However, as stated and demonstrated above, the final word is not out yet on the validity of the amendment introducing indirect transfer provisions. Although, it is likely to take years for the matter to be heard and finally decided, in the interim, there are still structuring possibilities to explore, to reduce or to mitigate exposure to the uncertainty created by the indirect transfer provisions.

Businesses and individuals should tread carefully and ensure that GAAR under the ITA are not triggered while attempting to mitigate the risks associated with indirect transfers. The future in this respect, in the short and medium term, looks difficult but manageable until final clarity is provided by either the Government, the legislature or the courts.

Further, recently the United Nations, International Monetary Fund, Organization for Economic Co-operation and Development and World Bank Group issued a discussion draft to achieve international consensus with respect to taxation of offshore indirect transfers.[36] While the article primarily deals with indirect transfer of immovable assets, the article has specifically discussed Vodafone case as well. Most importantly it observes that while unilateral responses to the issue of taxation of indirect transfers, such as the introduction of indirect transfer provisions in the ITA, are understandable, such measures risk introducing incoherence and further uncertainty in an already uncertain international taxation system.

Keeping this in mind, and the fact that India has been driving the Base Erosion and Profit Shifting project with the Organization for Economic Co-operation and Development, it is hoped that the Indian government will mitigate the harsh operation of the indirect transfer provisions in line with developing global approaches to this issue.

Notes

[36] United Nations, International Monetary Fund, Organization for Economic Co-operation and Development and World Bank Group, *Discussion Draft: The Taxation of Offshore Indirect Transfers – A Toolkit*, http://www.oecd.org/tax/discussion-draft-toolkit-taxation-of-offshore-indirect-transfers.pdf (accessed 7 Aug. 2017).