Tax Hotline

October 15, 2012

NO RETRO-TAX ON OFFSHORE M&A, RECOMMENDS SHOME COM

Relief for Vodafone, Safe Harbors for PE and Foreign Listed Cos et al

Last week, the Ministry of Finance released the much awaited report on retroactive amendments relating to taxation of indirect transfer of shares / assets in India ("**Report**"). Prepared by an Expert Committee appointed by the Prime Minister of India and chaired by Dr. Parthasarathi Shome ("**Committee**"), this Report follows close on the heels of an earlier report on the Indian general anti-avoidance rule ("**GAAR**"), which recommended the deferral of GAAR by 3 years (Read our hotline on the GAAR report here).

Both these reports, along with the recent announcements on liberalization of foreign investment into the multi-brand retail[1], insurance and aviation sectors, may be seen as part of a coordinated effort to assuage foreign investors' concerns with India's uncertain regulatory and tax environment.

The Report makes important recommendations in aid of rendering the indirect transfer provisions fair and workable and inter alia recommends that the indirect transfer provisions should only be applied prospectively. Safe harbours are also suggested for portfolio investments, PE investors, foreign listed companies and group restructuring.

BACKGROUND

To rewind to the origins of the controversy preceding the Report, the Indian revenue authorities had initiated high profile litigation against Vodafone in relation to the purchase by Vodafone of an offshore company which indirectly held assets in India. Claims were initiated on the basis that Vodafone had failed to withhold Indian taxes on payments made to the selling Hutch entity.

The Supreme Court of India delivered a judgment in favour of Vodafone[2] in January this year, stating inter alia that no Indian tax was required to be withheld on a transfer of offshore assets between two non-residents.

Shortly thereafter, the Finance Act, 2012 introduced Explanation 5 to Section 9(1)(i) of the Income Tax Act, 1961[3] ("**ITA**"), "clarifying" that an offshore capital asset would be considered to have a situs in India if it substantially derived its value (directly or indirectly) from assets situated in India. The amendment is currently retroactively applicable from 1961. Several other "clarificatory" amendments were also introduced to the definitions of "capital asset", "transfer" and the withholding tax provision, to bring offshore indirect transfers within the Indian tax net. However, important issues were left unconsidered including questions relating to the applicability of indirect transfer provisions to listed companies, issues on the attribution of value, adjustment of cost of acquisition, availability of treaty benefits and foreign tax credits, etc.

Considering the sharp decline in foreign direct investment (almost 65% in the April – June 2012-13[4]), largely attributable to the unstable legal and tax regime in India, the Prime Minister set up the Committee to engage with stakeholders and examine the implications of the new rule to tax indirect share transfers. The Committee recommended significant dilution of the scope of the provisions with a view to make it less burdensome on investors.

KEY RECOMMENDATIONS

- **Retrospective applicability**: Contrary to the position taken by the Government, the Report states that the provisions relating to indirect transfer are not clarificatory in nature and hence should be applied in a prospective manner. The Committee has also set out guiding principles in respect of retrospective amendments, which the Government will be well served to follow. The Committee has stated that retrospective amendments should not be made to expand the tax base as that would affect certainty and rule of law. Further, it has been suggested that retrospective application of tax

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law should not occur as a matter of practice, but only in rarest of rare cases after the exhaustive and transparent consultation with stakeholders who would be affected.

- **Withholding tax obligations**: The Committee has recommended that where the tax is sought to be retrospectively applied, the withholding tax obligation should not be retrospectively applied for payments that have already been made. It has further been recommended that such a payer of previous payments should not be treated as a representative assessee, nor should interest or penalty be leviable on such previously made payments. This, if implemented, would specifically impact taxpayers such as Vodafone who were potentially covered by the retrospective amendments.
- **What constitutes an indirect transfer:** The Committee has recommended some measures to fine tune the application of the indirect transfer provisions, where such provisions are applied on a prospective basis. The Committee has noted that the amendments potentially cover indirect transfers in two ways – first, by relocating the situs of the offshore asset to India under section 9(1)(i), and second, by the amendment to the definition of transfer and capital asset, which includes indirect transfer of an interest in a capital asset. It has been recommended that the two should not be parallelly applied. Other recommendations:
    - Transfer of "interest" It has been stated that the expression "*share or interest in a company or entity registered or incorporated outside India*" should mean to include only shares or interest which result in ownership, capital, control or management but should exclude mere economic interest in the share. Further, the term 'interest' has been clarified to have a meaning similar to a share *i.e. having ownership, control or management rights*. This clarification is to ensure that situations such as subscription to units of a mutual fund set up abroad or interest of a lender are not considered to be brought within the ambit of the amendment. This should also address concerns of the PE industry where limited partners may hold an economic interest but not have control or management rights in the underlying property. What continues to be left open is the question of what should constitute "capital", "control" or "management", as separate from "ownership", and what degree of control or management would be required to result in the share or interest being considered to have a situs in India.
    - Meaning of "transfer": Another important clarification is in the context of the term "transfer". The amendment to the indirect transfer provisions had sought to widen the meaning of the term "transfer" to include creation of an interest. In this regard, the Committee has in its Report stated that the widening of the definition may potentially cover unintended activities like pledge/mortgage of property of the foreign company having assets located in India. It has therefore recommended that the widened definition of "transfer" should be read in the context of other relevant provisions rather than on a stand-alone basis.
- **Threshold test on substantiality and valuation**: The Committee while looking at the words '*substantially*' and '*assets located in India*' has firstly recommended '*substantially*' to mean a 50% test whereby at least 50% of the total value should be derived from assets located in India. Further, to this extent, the value of the shares of the Indian company (and not the assets of the Indian company) should be taken into consideration to determine whether the 50% test has been met. This would imply that in a situation where the Indian company has assets situated outside India, even that would be taken into consideration since it will be included within the value of the shares of the Indian company.
- Separate tests have been prescribed for service based companies (the discounted cash flow valuation) and other companies (which would be valued on the basis of net asset value). It is also stated that such value should be determined at the time of the last balance sheet date with appropriate adjustments made for significant disposal/acquisition, if any, between the last balance sheet date and the date of transfer. How this would apply in practice may still require some consideration. For example, what weightage would be accorded to the customer contracts / IP at the parent company level which may be loss generating, even though the Indian subsidiary may be remunerated on a cost plus basis?
- **Look through approach**: In determining the meaning of the phrase, "*directly or indirectly*", the Committee has recommended a "*look through*" approach. This essentially means that the intermediaries between the foreign company and assets in India should be ignored for the purpose of valuation of shares of the foreign company.
- **Attribution of value**: The Committee has recommended that a proportional basis of taxation should be adopted for the purpose of calculation of the tax liability of the transfer of shares of a foreign company (covered by the amendment) in India. Thus, in this regard the Committee recommended that only that portion of the gains should be taxable in India which is proportional to the total gains which the Indian assets bear to the global assets.

KEY EXEMPTIONS

- **Threshold Exemption**: The amendment in its current form could attract potential taxation of shares of a foreign company having its substantial assets in India even to the extent of transfer of a single share. The Committee has recommended that persons holding less than a specified percentage (of 26% ownership of voting power / share capital) should be excluded from the purview of the indirect transfer tax. To this extent, the indirect transfer provision would apply in cases where the transferor has a direct / indirect voting power or share capital in the immediate holding company (that holds the shares of the Indian company) of more than 26% during the preceding 12 month period. The rationale for the 26% threshold stems from Indian corporate law provisions which allow a 26%

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shareholder to block special resolutions and is in the nature of negative control. It is also pertinent to note that the 26% threshold computation also includes holdings by associated enterprises (related parties) and to this extent there is an aggregation that is set out.

- **Listed securities exemption:** The Committee has recommended, in line with the recommendations for listed securities in the GAAR Report, that income arising from sale of listed securities should not be subject to capital gains tax provided that the following two conditions are fulfilled:
  - The foreign company is listed on a 'recognized foreign exchange'; and
  - The shares of the foreign company are 'frequently traded shares'[5]
- **Business reorganizations exemption**: In case of business reorganizations in the form of demergers and amalgamations, the Committee has recommended that intra-group restructuring involving the transfer of an asset in India should not be taxed in India provided that such transfers are not taxable in the jurisdiction where such company is resident. For this purpose, the Committee has recommended that intra group restructuring be:
  - A merger or a demerger as defined under the ITA where there is continuity of at least 3/4th shareholder.
  - Any other form of re-structuring within the group (associated enterprises) subject to 100% shareholder continuity.

  The rationale behind this is that, any foreign business restructuring does not intend to have a significant impact on the ownership of the company and related enterprises and thus, no additional tax burden should be placed on the business in such a scenario. This is in line with the realization principle that unless there is an actual realization of capital gains, the same should not be subject to taxation.
- **Exemption for P-Notes:** The Committee has recognized the issues in indirect transfer taxation on Foreign Institutional Investors ("**FIIs**") as FIIs are multi-tier structures that may make either direct or synthetic investments (P-Notes and offshore derivative instruments). Applying the indirect tax provisions in its current form, in case of such investments, tax may be levied at multiple levels. Further, the frequency of the transfers or redemptions are also fairly high. Thus, the Committee has recommended that a circular may be issued in this regard, clarifying that investments made by FIIs into India shall be taxed only at the hands of the FIIs along with a specific exception for the case of P-note holders.
- **Treaty benefits in context of indirect transfer tax on non-residents:** The Committee has also recommended that, in cases where capital gains arise to a non-resident on account of transfer of shares or interest in a foreign company, and if such non-resident is from a jurisdiction which has a Double Taxation Avoidance Agreement ("**Tax Treaty**") with India, then no tax should be applicable in India. The exceptions to this are that the Tax Treaty (i) provides a right of taxation of capital gains to India based on its domestic law; or (ii) the Tax Treaty specifically provides right of taxation to India on transfer of shares or interest of a foreign company or entity. Therefore, the treaty benefits that would apply in case of investors from certain jurisdictions such as Singapore or Mauritius would apply even in an indirect transfer context.

SOME THOUGHTS

In spite of being a largely laudable analysis, the Report continues to leave open some open points:

- **Rethink indirect transfer rule.** Several prominent jurisdictions such as the United States, United Kingdom, New Zealand, Australia and Singapore do not ordinarily tax transfer of shares of domestic companies by foreign investors. Most countries do not tax foreign investors on transfer of shares of a foreign company. China and Brazil which are the few exceptions may tax such transactions only in cases of abuse. It is therefore necessary for India to reconsider whether it is appropriate to tax offshore share transfers, especially considering the difficulties in compliance and enforcement.
- **Adjustment of basis/ cost of acquisition**: The mechanics for adjustment of cost price continues to be an open issue. For example, if an offshore company derives substantial value from an Indian entity, and tax is paid on transfer of the offshore company on account of the value derived from India, what should be the treatment in India when it is the Indian company which is subsequently transferred? While this adjustment is likely to require a legislative amendment to be put in place, the question is unaddressed under the current Report.
- **Cascading taxes in multi-layered structures**: An additional issue that has not been considered by the Committee is the potential double taxation that can happen, especially in multi-layered structures. In this regard, the Committee has failed to provide for provisions dealing with adjustment of basis or cost of acquisition in certain cases. For example, if Company A holds the shares of Company B which holds the shares of India Co., in this case if there is a transfer of shares of Company A, the same will be subject to tax on the full value of gains and if immediately thereon Company B sells the shares of India Co., there is another layer of double taxation that is imposed on what can potentially be the same gains. The computation mechanism based on the principle of proportionality as discussed in the Report does not address such issues.
- **Foreign Tax Credit**: Although the Committee has considered the impact of triangular situations and stated that India should allow Tax Treaty benefits to non-residents from treaty countries in indirect transfer situations, it does not adequately consider that India would not be a party and may have no role to play in a treaty involving the disposition of a non-Indian asset by a non-resident. The availability of foreign tax credits for Indian indirect taxes is questionable. In fact, countries such as

the United States have specifically stated that they will not grant credit for such taxes as they do not believe them to be rightfully levied. This would be a significant impediment for foreign investors who may not obtain a credit for taxes paid in India due to the amendment as it seeks to erode the tax base of the foreign country where the foreign company / investor is located and most countries may not provide a credit for such taxes paid in India. This may effectively increase the cost of doing business for a foreign investor and may deter them from investing in India.

- **Valuation Issues**: While the Report does take steps to provide clarity on the manner in which valuation should take place, it is open ended in setting forth certain parameters and does not deliberate much on the methods of calculation that should be adopted with respect to such valuation. This is likely to be the cause of some controversy. In addition, as discussed above, the question of attribution does not appear to have been adequately dealt with, as there may be situations where the offshore transferred entity is in fact a loss generating entity, although the Indian company may be profitable.
- **Enforceability of indirect transfer provisions**: It would have been helpful if the Report examined the extent of enforceability of the indirect transfer provisions, considering that this has been one of the most significant difficulties and criticisms of these provisions in a rapidly globalizing world that continues to work within the traditional limits of enforcement jurisdiction prescribed by international law.

As outlined above, there may still be implementation issues with the said provisions. Further, the view that indirect transfers can be taxed if more than 50% of the assets are located in India is at divergence with established practices in most countries (which restrict such provisions to transfer of immovable property). At a time when India is looking to increase foreign investment, questions need to be asked as to whether this would tantamount to best practice. The Committee has, no doubt, cleared the air by providing additional clarity and diluting the indirect transfer rule. However, it is probably necessary for India to fundamentally reconsider, in light of international best practices, whether transfer of foreign shares should be ever be taxable.

- The International Tax Team

You can direct your queries or comments to the authors

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[1] Read our Hotline on liberalization of foreign investment into the multi-brand retail here

[2] Read our Hotline on the Supreme Court judgment of the Vodafone case here

[3] 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;

[4] http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/40T_BUL101012F.pdf

[5] Regulation 2(j) of Securities And Exchange Board Of India (Substantial Acquisition Of Shares And Takeovers) Regulations, 2011 provides “frequently traded shares” as shares of a target company, in which the traded turnover on any stock exchange during the twelve calendar months preceding the calendar month in which the public announcement is made, is at least ten per cent of the total number of shares of such class of the target company:

Provided that where the share capital of a particular class of shares of the target company is not identical throughout such period, the weighted average number of total shares of such class of the target company shall represent the total number of shares;
