

Taxation of Cross border M&A- A paradigm shift?

Richie Sancheti and Hanisha Amesur***

Introduction

Following global cues, M&A activity in India had reduced significantly by the final quarter of 2008. The year 2010 however has seen India emerging as an attractive destination for international investors. The cumulative amount of equity inflows, under the direct investments (FDI) route from April 2010 to July 2010, stood at US\$ 7,592 million, according to the data released by the Department of Industrial Policy and Promotion (DIPP).¹

The attractiveness of India is considered its domestic market potential, cost effectiveness, historically good returns on investment, the predominance of English as the language of business, and the well-established rule of law. However, it should also be borne in mind that perhaps second only to the ability to generate high internal rate of return (IRR), the next issue that holds a private equity investor's attention is a stable business environment that the investee company's jurisdiction affords. This includes the position of law governing transactions and certainty in tax regime.

The spate of proposed legislations on corporate and tax laws that seek to redraw the Indian regulatory framework and extend boundaries on the investments front, does not do so without causing complications. Of course, much would depend on how the legislations are finally enacted. The Companies Bill allows for merging with offshore entities, resulting in the concerned foreign entity holding Indian assets. Permanent establishment issues assume consequence here. Further, the Direct Taxes Code introduces General Anti Avoidance Rules (GAAR) that allow the income-tax authorities



Richie Sancheti

* Richie Sancheti is a member of the International Tax Practice group at Nishith Desai Associates, a research-focused global organization providing strategic, legal and tax counselling.

** Hanisha Amesur is a member of the International Tax Practice group at Nishith Desai Associates, a research-focused global organization providing strategic, legal and tax counselling.

to disregard transactions or entities and to re-characterize instruments or reallocate income between parties. This presupposes an arrangement as impermissible if it has been entered into with the objective of obtaining a tax benefit and lacks commercial substance.

This article assesses some of the recent tax rulings along with proposed legislations that seem to change the regulatory and tax landscape for foreign investments into India. The article also attempts to highlight some of the key issues that arise in withholding tax obligations taking the recently pronounced rulings in *Vodafone* and *GE India Technology Centre Pvt. Ltd.* as cases in point.

Tax framework for inbound investments

Under the Indian Income-tax Act, 1961 (“**Tax Act**”), non-residents would be taxable in India only to the extent of their Indian-source income, (being income received, accrued or deemed to have accrued or been received in India). Tax implications on such income would have to be determined in light of the provisions of the Tax Act, read with the provisions of the applicable double taxation avoidance agreement (or tax treaty).

While setting up investment structures, the benefits that may be derived from tax treaties of intermediary jurisdictions should be thoroughly examined. Certain treaties such as those signed with Mauritius and Singapore allow eligible investor entities the flexibility to have their capital gains taxed in the investors’ jurisdiction. Certain other treaties such as the Cyprus treaty allow interest payouts to the foreign lender to be taxed at a lower rate than prescribed under the Tax Act.

Position of law on tax withholding obligations

Under section 195 of the Tax Act, a person responsible for making a payment to a non-resident that is **chargeable to tax** under the Tax Act, is under an obligation to withhold tax at the applicable rates. Further, section 195(2) provides that, if any, person responsible for making a

payment chargeable under the Tax Act to any non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, the payer may make an application to the tax officer to determine the appropriate proportion of the income so chargeable and thereafter tax is required to be deducted at source on such appropriate income. Therefore, a withholding tax certificate under this section is specifically required when an apportionment (for instance to reduce expenses) is to be made to reduce the income chargeable to tax in India.

For the purposes of section 195, the situs of the payment or the source of the payment is not a relevant consideration. While applying the provisions of section 195, whether the payment is made within India or outside India, the same would be subject to withholding obligations.

The various Courts in India have given their diverse views on the applicability of section 195 of the Tax Act. The Supreme Court of India in the case of *Transmission Corp'n. of A.P. Ltd. v. CIT*,² has held that the main consideration would be whether or not the sum paid to a non-resident **is chargeable to tax under the provisions of the Tax Act**. Unless payments are not explicitly declared exempt under the provisions of the Tax Act, the person making the payments would be under an obligation to withhold tax at source and the payer could free himself from the liability to withhold tax only if he obtained the assent of the tax officer under section 195(2). The tax treaties are entered into under the provisions of the Tax Act, which specifically provide that between a tax treaty and the Tax Act, a taxpayer can opt for whichever is more beneficial to him.

Subsequently, the Karnataka High Court in the case of *CIT v. Samsung Electronics Co.*³ delivered a judgment that unsettled the position as commonly understood regarding the applicability of section 195 of the Tax Act. The High Court arrived at a view that section 195 not being a charging provision, the tax officer could not embark on an exercise to determine the actual nature of the income or the tax liability of the non-resident assessee. They concluded that the resident payer’s liability to withhold tax springs into action the

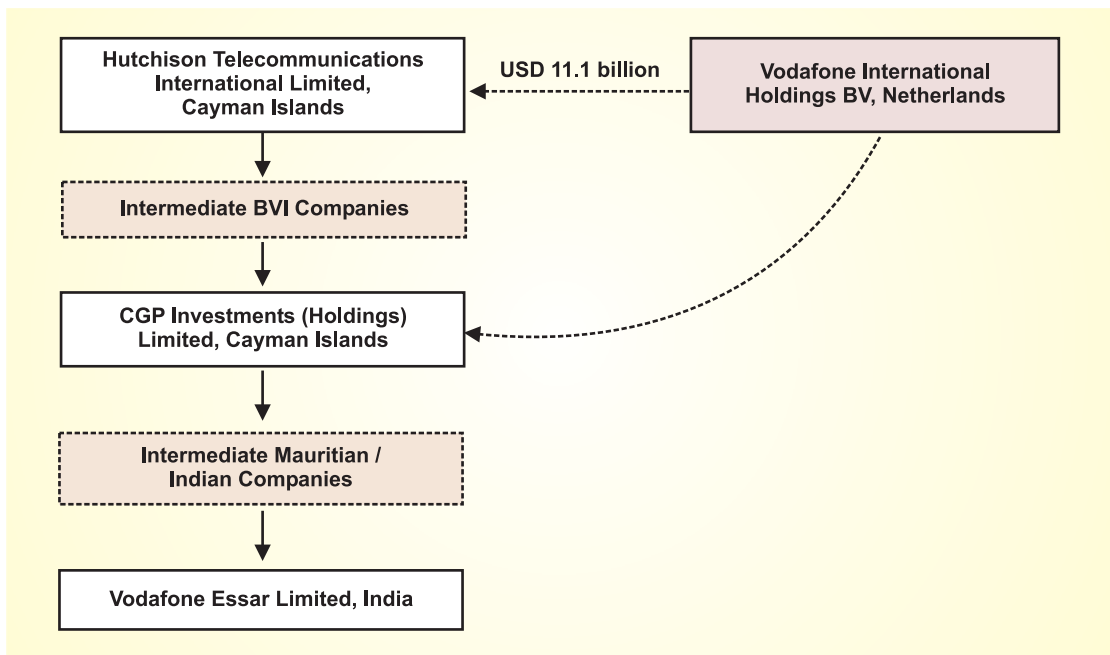
moment there is a payment to be made to a non-resident, if such a payment is *per se* income in the hands of the recipient. The Court observed that such payer would be relieved from his obligation to withhold tax either wholly or partially, only upon making an application to the tax officer under section 195(2) of the Tax Act and demonstrating that the entire payment does not partake or only partially partakes the character of income. The High Court observed that in a case where payments are being made for the import of certain goods, the entire costs of the goods by itself may not constitute income in the hands of the non-resident. It is only the income component as may be determined in the manner provided under the Tax Act which should be subjected to the withholding provisions. However, in such a case too it must be borne in mind that an application under section 195(2) is not an exercise for assessment of income of the non-

resident or the actual tax liability thereof since the scope of the Assessing Officer’s powers is restricted to determine only the percentage of the payment that bears the character of income.

Recent rulings and implications there-under

The Bombay High Court in its recent order upheld the tax department’s jurisdiction to proceed against Vodafone on its USD 11.1 billion acquisition of Hutchison’s Indian telecom operations. As a matter of brief background, the transaction under consideration involved Vodafone International Holdings BV, Netherlands entering into a sale purchase agreement with Hutchison Telecommunications International Limited, Cayman Islands, for acquiring Cayman-based CGP Investments.

A simplified structure for the transaction could be understood as follows -



The decision of the Court in Vodafone accepts the principle that income earned by a non-resident from an offshore transaction cannot be taxed in India, unless the assets transferred have sufficient territorial nexus with India. The court stated

that the taxpayer is under no obligation and does not invite a ‘moral dilemma’ or the risk of legal invalidation, as long as the structures/ transactions are designed legitimately and utilized for a *bona fide* purpose, even if the consequences

of such structure lead to legal mitigation of tax incidence. This of course is subject to the absence of statutory provisions to the contrary in the fiscal laws applicable to such transaction. Quite correctly, the court also acknowledged that a company had a distinct and separate legal entity from its shareholders and the business of the company should not be held synonymous to the business of the shareholder.

If viewed from section 195 perspective, the much talked about Vodafone ruling also leads to an interesting issue – whether section 195 could be invoked in respect of payments made by a non-resident and the power of the tax authorities to compel a non-resident to withhold taxes on payments made to another non-resident. This could further lead to a substantive question as to whether the offshore transaction is chargeable to tax or not. Section 195 should not *per se*, lead to an enquiry into the concerned non-resident's presence in India and scope of activities being carried out.

The Supreme Court, recently, in the case of *GE India Technology Centre Pvt. Ltd.*⁴, pronounced a judgment in a batch of appeals over-ruling the judgment of the Karnataka High Court in the case of *CIT v. Samsung Electronics* and laid down the law on application of withholding tax at source provisions in the Tax Act. In this ruling, the Court held that in determining whether there is a withholding tax obligation, the benefits under the concerned tax treaty would also have to be taken into consideration and where by virtue of the concerned tax treaty, the income is not taxable in India, there should not be any withholding tax obligations. In respect of sale of shares of an Indian company by a Mauritius company, the Supreme Court in the case of *Azadi Bachao Andolan*⁵ has held that the capital gains tax benefit under the India-Mauritius Tax Treaty would apply so long as the Mauritius company has obtained a tax residency certificate from the Mauritius Tax Authorities.⁶

Thus, in a case where a Mauritius resident is realising capital gains from the sale of shares of an Indian company as opposed to a multi-layered structure, the same should not be

chargeable to tax in India and, hence, the provisions of section 195 should not as such apply. It is pertinent to note that applicable provisions of Indian exchange control laws require that where a remittance has to be made to a non-resident from India, such remittance would only be made subject to payment of taxes. The banker making a remittance either would require a section 195 certificate or would require a certificate from a chartered accountant stating the fact that taxes payable, if any, have been paid. However, with that being said, parties to a transaction pursuant to rulings in *E*Trade Mauritius Limited*⁷ and *Vodafone* have become vary and, at times, the buyer of shares insists on either a 195 certificate or a strong tax indemnity or a tax insurance or necessary escrow arrangements. In the alternative, approaching the Authority for Advance Ruling (AAR) is a facility available to non-residents to determine their Indian tax liability.

Takeaways/Key Points

The ruling in *GE India* does clarify that no taxes need be withheld if the underlying income is not chargeable to tax, it does however leave one loose end. The ruling indicates that the payer (*i.e.* the purchaser) should approach the tax authorities in order to determine the withholding tax liability in case of **doubt**. While the position in the judgment is very clear, one can't help but wonder if this will create further ambiguity by an Indian payer alleging 'doubt' in case of future payments. The intent however seems to have been made clear by the Supreme Court that based on the principle of proportionality such exercise is only to be undertaken in case of composite payments and not otherwise.

The *Vodafone* order reinforces the need for offshore sellers to ensure that the exit structure takes into account diverse legal concerns ranging from the enforceability of tax indemnities to the ring fencing of potential legal risks. It would also entail a coordination between the formal terms of the agreements and various disclosures or filings made before public authorities. The Court has also reiterated the common law principle that a share is a distinct capital asset in its own right. It is a fundamental principle that the

business and assets of a corporation are not the business and assets of its shareholders. The mere fact that the shares of a foreign company are acquired would not lead to any transfer of interests in its underlying subsidiary companies.

Globally, there is a fight for capital and given the present scenario in financial markets where most of capital surge is predominantly foreign institutional investors (FII) led, it is imperative that private equity and strategic investors be encouraged as they bring stable long-term capital. The recent rulings may discourage foreign

investments into India by sending negative signals in terms of consistency of the regulations and the regulators' willingness to attract foreign investment. The aggressive stance towards global transactions adds an additional element of risk and a perception of unpredictability. Going forward, future transactions would be governed by the Direct Taxes Code which, in its current shape, clearly provides for circumstances under which an indirect transfer could be subject to Indian taxes. However, this should not apply to transactions already consummated under the current position of law (being the Tax Act).



1. Based on information provided in "Fact Sheet On Foreign Direct Investment (FDI) From August 1991 to July 2010" and could be accessed at http://dipp.nic.in/fdi_statistics/india_FDI_July2010.pdf
2. [1999] 239 ITR 587 (SC)
3. 320 ITR 209
4. Civil Appeal Nos. 7541-7542 of 2010
5. *Union of India v. Azadi Bachao Andolan* 263 ITR 706 (SC)
6. Circular No. 789, dated April 13, 2000 clarifies that capital gains derived by a Mauritius resident from the sale of shares of an Indian company, in accordance with the Treaty are taxable only in Mauritius. The circular further indicates that a certificate of residence issued by the Mauritian tax authorities would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the treaty.
7. *E*Trade Mauritius Limited v. ADIT* [WP. No. 2134 of 2008].