Recent AAR Rulings - Indirect Transfer of Shares: The Controversy Continues

In recent years, tax authorities have started taking aggressive positions on the issue of income arising on indirect transfer of Indian company shares. In other words, tax authorities are adopting a position that income arising on sale of shares of Special Purpose Vehicle (SPV) holding Indian company's shares is taxable in India as by transferring SPV's shares, ultimately shares of underlying Indian company are getting transferred. In recent times, this issue has stirred much controversy in the cases of Vodafone, Aditya Birla Nuvo, E*Trade, etc. In this article, we have analysed two recent rulings of Authority of Advance Rulings (AAR) on the above mentioned issue of indirect transfer. The AAR rulings in this article are applicable only to the applicants and tax department but they do have persuasive value before the courts and tax authorities. Going forward, the proposed Direct Tax Code (DTC) does contain provisions for taxing indirect transfers. In addition, the DTC also seeks to introduce provisions of General Anti Avoidance Rules ('GAAR') that seek to deny tax benefits arising from a transaction which lacks commercial substance or results in misuse of the DTC. The provisions of GAAR would also override the tax treaties. Read on…

(Contributed by the Committee on International Taxation of the ICAI. Comments can be sent to citax@icai.org)

The Indian economy growing at around 7% is currently one of the fastest growing economies of the world. The liberalisation and economic reforms process initiated by the Indian government in 1991 after completing two successful decades has leapfrogged the country on path of growth and development.

Since 1991, investors from various countries have invested in Indian economy which offers them vast growth potential. Accordingly, with advent of foreign investors, there have been numerous transactions of inbound structuring of investments into India through special purpose vehicles (SPVs) located in tax friendly jurisdictions.

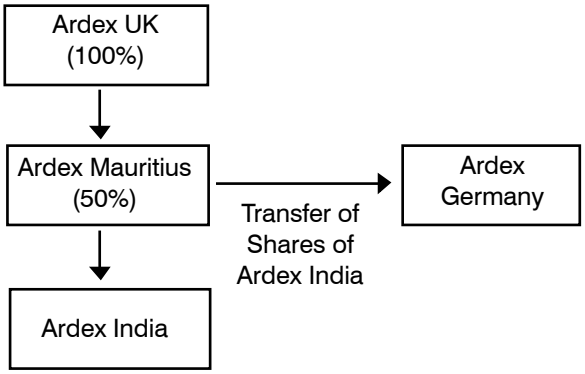
In recent years, tax authorities have become increasingly aware of the above structure and have started taking aggressive positions on the issue of income arising on indirect transfer of Indian company shares. In other words, tax authorities are adopting a position that income arising on sale of shares of SPV holding Indian company's shares is taxable in India as by transferring SPV's shares, ultimately shares of underlying Indian company are getting transferred.

In recent times, this issue has stirred much controversy in the cases of Vodafone, Aditya Birla Nuvo, E*Trade, etc. In this article, we have analysed two recent rulings of Authority of Advance Rulings (AAR) on the above mentioned issue of indirect transfer.

1. Ardex Investments Mauritius Limited – AAR No. 866 of 2010

Facts of the case:

- Ardex Investments Mauritius Limited ('Ardex Mauritius'), incorporated in Mauritius was a wholly owned subsidiary of Ardex Holdings U.K Limited ('Ardex UK').
  Ardex Mauritius held 50% equity share capital in Ardex Endura (India) Private Limited ('Ardex India').
- Ardex India was engaged in the business of manufacturing flooring adhesives.
- Ardex Mauritius proposed to sell its 50% stake in Ardex India to its other group company Ardex Beteiligungs – GmbH Germany ('Ardex Germany') at fair market value.
- The transaction is pictorially represented as under:



Questions raised before the AAR

- *Whether capital gains on proposed transfer of shares of Ardex India by Ardex Mauritius would be taxable in India under the India Mauritius DTAA?*
- *Whether Ardex Mauritius would be entitled to receive sale proceeds from Ardex Germany without deduction of tax at source?*
- *Whether Ardex Mauritius is required to file its return of income in India in respect of proposed transfer of shares to Ardex Germany?*

Contentions of the tax authority

- Ardex Mauritius was the wholly owned subsidiary of Ardex UK and it did not have any income in prior years. The only asset held by Ardex Mauritus was investment in Ardex India.
- Hence, the sole purpose for incorporating Ardex Mauritius was to hold shares of the Indian company on behalf of the parent company.
- The source of all funds for Ardex Mauritius was its holding company and further, the decision to sell shares of Indian company was taken by Ardex UK with Ardex Mauritius expected to follow the decision.
- Ardex UK incorporated the Mauritius company only to take advantage of beneficial capital gains provisions under the India-Mauritius tax treaty.
- In the above circumstances, corporate veil had to be pierced and upon piercing the corporate veil, it was clear that as Ardex UK had invested funds for purchasing shares of Ardex India, it was the beneficial owner of shares. Hence, gains arising on sale of shares of Ardex India was taxable as per India-UK treaty and not as per India-Mauritius treaty.

Applicant's Contentions

- Ardex Mauritius [earlier known as Norcros Investments (Mauritius) Limited] was created in 1998 by another UK company named Norcros (Holdings) Limited for holding shares in BAL Building Adhesives India Private Limited (currently known as Ardex India).
- In November 2001, with a view to expand its business, Ardex group decided to acquire Norcros Investments (Mauritius) Limited. Thus, Ardex UK never created Ardex Mauritius.

In a short span of 15 days, the AAR gave two different views on similar facts. In one case, the AAR held that the corporate veil need not be lifted as the transaction is covered by the Supreme Court judgment in the case of Azadi Bachao Andolan whereas in the subsequent judgment, the AAR lifted the corporate veil and distinguished the Supreme Court judgment in the case of Azadi Bachao Andolan by relying on the earlier judgment of McDowell and other English case laws on the subject.

- Further, Ardex Mauritius had made the investment in Ardex India as share certificates were issued in the name of Ardex Mauritius. Further the decision to transfer the shares of Ardex India to Ardex Germany was taken by the board of directors of Ardex Mauritius and not by Ardex UK.
- As the subsidiary was a separate legal entity, the beneficial ownership of shares held by it also vested in the subsidiary. Hence, there was no justification to pierce the corporate veil as contended by the tax authorities.
- Ardex Mauritius was a tax resident of Mauritius and the tax residency certificate issued by the Mauritian tax authorities in respect of the same was a sufficient evidence to justify the same. Reliance in this regard was placed on the SC decision of Azadi Bachao Andolan (263 ITR 706) and AAR judgment in the case of E-Trade Mauritius (324 ITR 1)

Ruling of the AAR

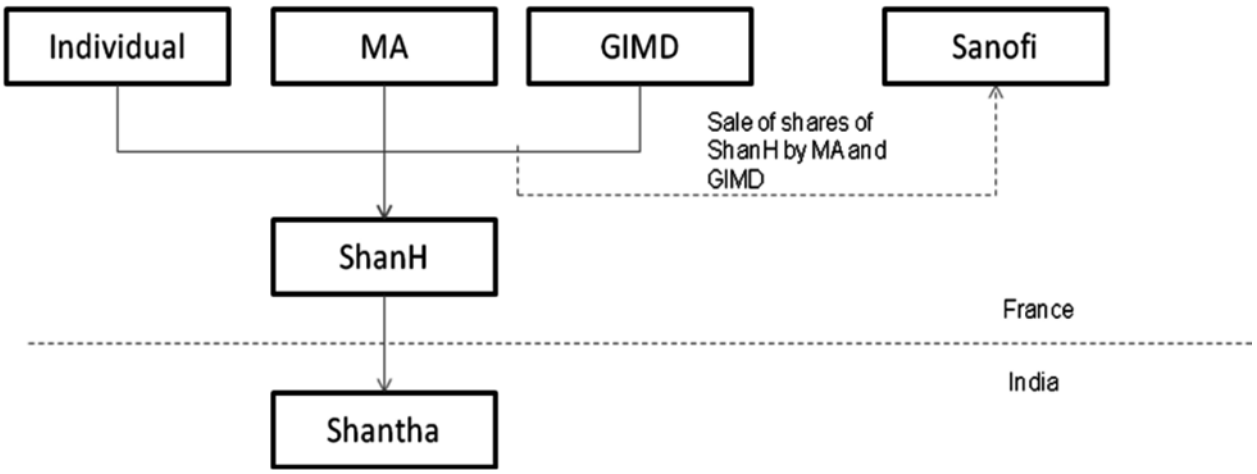
- The AAR agreed that funds for acquiring the shares of the Indian company were sourced from UK company. However, the first purchase was done in the year 2000 and the shareholding had steadily increased in 2001, 2002 and 2009. Thus, the arrangement had not come into existence all of a sudden. It such a situation, the theory of beneficial ownership could not be invoked to come to a conclusion that the holder of shares in the Indian company is the UK company.
- Also shares were held for a considerable length of time (for more than ten years) before they were sold, hence, it may not be possible to go into the inquiry that who made the original investment and the consequences arising therefrom.
- Further, the current transaction was not a case of so called gift or transfer of shares without consideration but involved sale of shares at market rate.

It would also be pertinent to note the judgment of AAR in the case of E*Trade Mauritius Ltd. (324 ITR 1) wherein the AAR after relying on the Supreme Court judgment of Azadi Bachao Andolan held that legal structure of Mauritius company cannot be ignored. Accordingly, the AAR held that capital gains arising on sale of shares of an Indian company by Mauritian company would accrue to Mauritius company and not to its US parent.

- The AAR held that even if it is contended that the Mauritius company was formed to take advantage of the India Mauritius Treaty, in view of the Supreme Court decision in the case of Azadi Bachao Andolan (supra), the same cannot be viewed as objectionable treaty shopping.
- Thus, the AAR held that the above transaction of sale of Ardex India' shares by Ardex Mauritius would be governed by India – Mauritius treaty and not India – UK treaty. Accordingly, the AAR held that capital gains arising on sale of shares of Ardex India by Ardex Mauritius would not be chargeable to tax in India in view of the Article 13 of India Mauritius tax treaty. Hence, Ardex Mauritius will be entitled to receive the sale proceeds without deduction of tax at source.
- However as the transaction of sale of shares of Indian company was otherwise chargeable to tax in India, Ardex Mauritius would be required to file its return of income in India.

2. Group Industrial Marcel Dassault and Merieux Alliance – AAR No. 846 of 2009 and 847 of 2009

Facts of the case



- Group Industrial Marcel Dassault ('GIMD') and Merieux Alliance ('MA') [collectively referred here as Applicants] are companies incorporated in France.
- MA on 31st October, 2006 incorporated a wholly owned subsidiary in France named ShanH. Thereafter on 6th November, 2006 MA entered into a share purchase agreement for acquiring shares of Shantha Biotechnics Limited ('Shantha'), an Indian company. ShanH was shown as permitted assignee for the above shares acquired of Shantha.

Recently, Bombay High Court in the case of Aditya Birla Nuvo after observing specific facts and circumstances of the transaction held that tax authorities have a prima facie case for lifting the corporate veil and considering taxing capital gains arising on sale of shares of an Indian company by Mauritius company in the hands of its US parent. The Bombay High Court after analysing contracts, agreements and operations of Mauritius company observed that it was US parent company and not its Mauritius subsidiary which was beneficial owner of the shares of Indian company and accordingly, gains arising on sale of shares of Indian company by Mauritius company may not be covered by provisions of India-Mauritius tax treaty.

- Subsequently, in March 2007, GIMD acquired 20% shares of ShanH from MA. Thus, GIMD and MA collectively held ShanH which in turn held shares of Shantha. Thereafter, another individual also purchased few shares of ShanH from GIMD and MA.
- In 2009, MA and GIMD transferred their shareholding in ShanH to another French Company Sanofi Pasteur Holding ('Sanofi').
- A survey under Section 133A of the Act was conducted in the office premises of Shantha. The tax officer subsequently issued a show cause notice under Section 195 of the Act asking Sanofi to show cause as to why it should not be treated as an assessee in default under Section 201(1) of the Act in respect of payments made to MA and GIMD for acquiring shares of Shantha through transfer of shares of ShanH.
- In view of the above facts, MA and GIMD approached to AAR for determining whether sale of shares of ShanH to Sanofi is liable to tax in India.

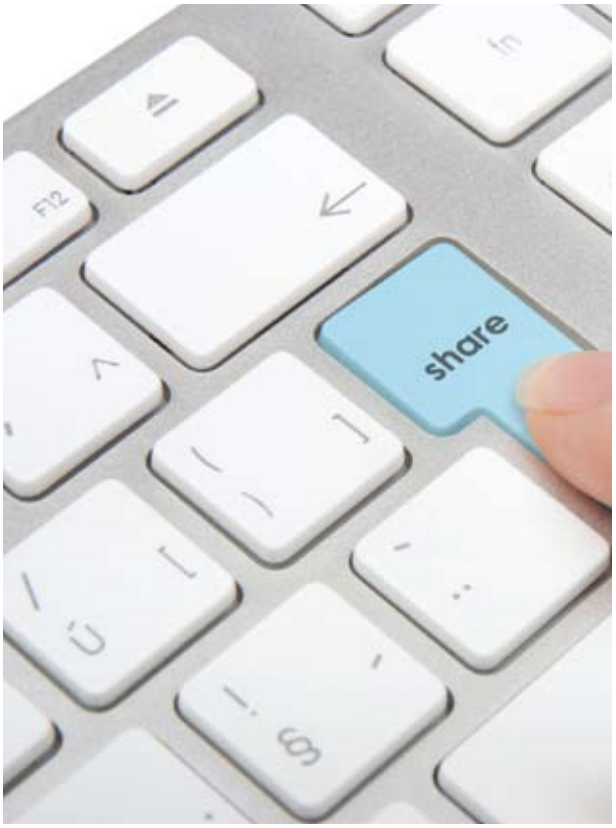
Questions raised before the AAR

- *Whether capital gains arising on sale of ShanH's shares by the Applicants to Sanofi are liable to tax in India in view of the India France Tax Treaty?*
- *Whether the transfer of controlling interest is liable to be taxed in France under Article 14(6) of the India France Tax Treaty?*

Contentions of the Applicants

- The transaction involved transfer of shares of a ShanH a French Company to another French

Going forward, the proposed Direct Tax Code (DTC) does contain provisions for taxing indirect transfers. In addition, the DTC also seeks to introduce provisions of General Anti Avoidance Rules ('GAAR') that seeks to deny tax benefits arising from a transaction which lacks commercial substance or results in misuse of the DTC. The provisions of GAAR would also override the Tax treaties. tax treaty.



company and accordingly, capital gains arising on sale of shares can be taxed only in France as neither the applicants nor Sanofi are tax residents in India. The said transaction cannot be taxed either under the Income Tax Act or under the tax treaty. Thus, as shares of Shantha were not being transferred, there were no tax implications in India.

- Setting up a subsidiary for making acquisitions was a legal permissible route and a known method of business.
- There is no treaty shopping or tax evasion as capital gains arising on the said transaction are chargeable to tax in France. Further in view of the Supreme Court decision of Azadi Bachao Andolan, and the tax residency certificate produced, it was not possible to ignore the existence of properly incorporated companies and tax the said transaction in India.
- The fact that asset of the company is located in another country is irrelevant as the India – France tax treaty does not contain any 'see through' provision
- The shares of company being sold is a company incorporated in France in which the applicant held more than 10% and hence, as per provisions of Article 14(5) of the India – France tax treaty, capital gains are liable to taxed only in France. Additionally, as per provisions of Article 14(6) of the India – France tax treaty, as the company is resident in France, the transaction would be taxable in France.

Tax Authority's Contentions

- AAR was barred from admitting the application as withholding tax proceedings were already initiated and an order was passed under Section 201 of the Act treating Sanofi as an assessee in default.
- As per provisio to Section 245R(2) of the Act, AAR will not allow the application if the question raised in the application relates to transaction which is designed prima facie for the avoidance of the income-tax. In the instant case, as the entire transaction was designed to avoid tax in India, in terms of proviso to Section 245R(2) of the Act, AAR was barred from admitting the application.
- ShanH was created only for the purposes of dealing with the assets of Shantha and its creation was merely to avoid tax that may be due while dealing with shares of Shantha. Hence, although ShanH was created on 31st October 2006, the share purchase agreement was entered by MA and not ShanH on 6th November, 2006.
- ShanH had no office and employees. Thus, ShanH had no other business and it held no assets other than shares in Shantha. MA had appointed one of its own director as a director in ShanH. Further, MA also had a right to nominate directors on the board of Shantha.
- The word 'alienation' is a of wide import and read with the words participation of at least 10% in a company, it would mean that conveying of such rights of participation would also attract tax in India, if the interest of participation is of an Indian company.
- Transfer of the right of participation in an Indian company even by a non-resident, outside India which allows the transfer of participation interest in an Indian company would be taxable in India as per paragraph 5 of Article 14 of the Convention. Participation in a company, would mean, the right

to vote, the right to nominate Directors, control and management, day to day decision making and right to get distribution of profits. As all these rights in respect of the Indian company, Shantha are with MA or with MA and GIMD, the transfer is taxable in India in terms of paragraph 5 of Article 14.

- Section 9 of the Act and provisions of tax treaty also permit a see through of the transaction to ascertain its true purpose.
- Thus, as assets and shares of an Indian company are being indirectly transferred, gains arising on the said transaction would be taxable in India as per Article 14(5) of the India-France tax treaty.

Ruling of the AAR

- Withholding proceedings are not conclusive and are only preliminary in nature. Hence, initiation of withholding proceedings under Section 201 of the Act against Sanofi would not bar AAR from entertaining the application for advance ruling.
- Even after the application is admitted, at the time of final hearing, objection against the maintainability of the application can be taken by the revenue authorities and the AAR is required to consider the said objection.
- Even though, gains arising from sale of shares of ShanH are taxable in France, the question for tax avoidance has to be considered under India tax laws. Hence, argument of the Applicant that as capital gains tax on the transaction has already been paid in France where companies have been incorporated, there can be no tax avoidance cannot be accepted as the tax avoidance has to be seen from Indian viewpoint.
- ShanH had no other business and its only assets were shares of the Indian company. Hence, by selling shares of ShanH, in reality, the underlying assets and control of the Indian company were transferred.
- Accordingly, if the transaction is accepted at face value, the control over the Indian assets and business can pass from hand to hand without incurring any tax liability in India.
- The AAR observed that the Supreme Court judgment in the case of Azadi Bachao Andolan was not the final word and relied on earlier Supreme Court judgment in the case of McDowell & Co. (154 ITR 148) along with the line of reasoning adopted by English courts in Ramasay and subsequent decisions.
- The entire chain of transactions beginning from incorporation of ShanH till transfer of its shares to Sanofi were pre-determined to deal with assets and control of Shantha without actually dealing with its shares, assets or business. Thus, this scheme had to be seen as one for avoiding payment of taxes on capital gains, which would otherwise arise if the shares of Indian company were transferred.
- Thus, AAR held that as the entire transaction is intended to avoid payment of capital gains tax in India, following the Supreme Court decision in the case of McDowell and as per clause (iii) of the provisio to Section 245R(2) of the Act, it declined to give a ruling on the questions raised in the application.
- However, for the purpose of completion of proceedings, the AAR proceeded to answer the questions raised in the application.
- The AAR further held that in the instant case, the transaction involves alienation of assets and controlling interest of an Indian company. Accordingly, as transactions are part of scheme for tax avoidance, the scheme had to be ignored and gains from the transaction were taxable in India.

The AAR rulings in this article are applicable only to the applicants and tax department but they do have persuasive value before the courts and tax authorities. The issue of indirect transfer of shares has been argued in detail in the case of Vodafone before the Supreme Court for which hearings have already been concluded. Hence, we hope that after the judgment of Supreme Court is delivered in the case of Vodafone, the issue of indirect transfer of shares would settle and till that time, the issue of taxability of indirect transfer of assets will continue to remain a contentious one baffling both the tax department as well as the taxpayers.

- On a literal interpretation of Article 14(5) of India – France tax treaty, as the company was resident of France, the gains would be taxable in France. However, upon purposive construction of the said article, the AAR held that as the essence of transaction was change in controlling interest of an Indian company having assets, business and income in India, capital gains arising therefrom is taxable in India.

Way Forward

Thus, in a short span of 15 days, the AAR has given two different views on similar facts. In one case, the AAR held that the corporate veil need not be lifted as the transaction is covered by the Supreme Court judgment in the case of Azadi Bachao Andolan whereas in the subsequent judgment, the AAR lifted the corporate veil and distinguished the Supreme Court judgment in the case of Azadi Bachao Andolan by relying on the earlier judgment of McDowell and other English case laws on the subject.

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