Indirect Transfers and Retrospective Legislation in India

Uday Ved
7 December 2012
Controversy originated in the *Vodafone* transaction (2007)

- **HTIL (CI) (Seller)**
  - Cayman / Netherlands
- **CGP (CI)**
  - Cayman
- **Mauritius Cos**
  - Mauritius
- **HEL (IN)**
  - India
- **Vodafone (NL) (Buyer)**

- Taxability in India of gains arising on transfer of shares of CGP asserted by Indian tax authorities
...Indirect transfers - origins of the controversy

- Taxability of gains in India asserted on the basis of the following:
  - Transfer of shares in overseas parent results in 'indirect' transfer of shares in Indian subsidiary
  - There is a transfer of rights and entitlements in India such as 'management rights', 'controlling interest', 'economic interest' etc. situated in India by virtue of transfer of overseas shares

- Supreme Court's verdict in the Vodafone case (January 2012)
  - S. 9 not a look-through provision - No statutory basis for bringing 'indirect' transfers to tax
  - 'Rights and entitlements' flow from the transfer of shares and are not separate capital assets
  - Shares and the rights which emanate from them, flow together and cannot be dissected
Overview and Impact of Retrospective Amendments
Legislative Response

• Retrospective amendments made by the Finance Act, 2012

• Retrospective Amendments clarify:
  • the situs of shares/interest in certain foreign companies for sec. 9(1)(i)
  • the definition of "capital asset" under sec. 2(14)
  • the definition of "transfer" under sec. 2(47)
  • the meaning of the expression "through" in sec. 9(1)(i)

• Past notices etc. validated - Section 119 of the Finance Act, 2012
  • All notices, levies, demands, assessments etc. in respect of indirect transfers deemed valid notwithstanding any contrary judicial order
  • Notices etc. cannot be called into question on any ground
  • Amounts deposited /collected need not be refunded
Overview of amendments ...

Situs of shares/interest in certain foreign companies

Prior Legal Position:
Situs of shares is where the company is incorporated and where its shares can be transferred

Finance Act, 2012: (w.e.f. 1 April 1962)
Share/interest in a foreign company deemed to be situated in India, if the share/interest derives, directly or indirectly, its value substantially from the assets located in India

Definition of 'capital asset'

Prior Legal Position:
"Rights and entitlements" not identifiable or distinct capital assets from shares held

[Finance Act, 2012: (w.e.f. 1 April 1962)
Capital asset deemed to include any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever

© 2012 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. All rights reserved.
...Overview of amendments

**Definition of 'transfer'**

**Prior Legal Position:**
Shares and the rights which emanate from them, flow together and cannot be dissected

**Finance Act, 2012: (w.e.f. 1 April 1962)**
"Transfer" deemed to include disposing of or parting with an asset / interest or creating any interest in any manner, notwithstanding that such transfer of rights has been characterised as being effected /dependent upon /flowing from the transfer of shares of a company registered or incorporated outside India

**Meaning of 'through'**

**Prior Legal Position:**
"Through" did not mean "in consequence of"

**Finance Act, 2012: (w.e.f. 1 April 1962)**
The expression "through" deemed to mean "by means of, "in consequence of or "by reason of."
Some Concerns...

RETROSPECTIVE NATURE OF AMENDMENTS

• Retrospective applicability of amendments - a controversial issue
  • Parliament empowered to legislate with retrospective effect but not arbitrarily and unreasonably - Validity under challenge before the Calcutta High Court
  • Against international best practice
  • Impact on withholding obligations in respect of past transactions?

• Certainty in taxation - a key driver of India's investment climate
  • Negative impact of Retrospective amendments on investor confidence
  • Pose significant challenges from a tax planning and compliance standpoint

• Retrospective overruling of judicial precedents favouring taxpayers:
  • Potentially undermines rule of law in India
SCOPE AND APPLICABILITY OF AMENDMENTS

• Expanded definitions of 'capital asset' and 'transfer'
  • Uncertainty over subject matter of transfer under amended definitions
  • Concerns around determination of cost of acquisition and gains computation

• Explanation 5- Situs of shares
  • Lack of clarity on substantiality - 'Substantially the whole' or Substantial interest as defined in s. 2(22)(e) /40A(2) ?
  • No pro-rata approach- entire gains taxable
  • No exception for listed shares, sale of non-controlling blocks or group restructuring:
    • Smaller transactions also potentially covered
    • Commercial rationale / motive irrelevant
Some International Examples
Some International Examples...

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

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

**Peru**

- Provides objective criteria for taxation of Indirect' transfers
- Applies only when shareholding of more than 10% in the foreign entity holding Peruvian shares is transferred.
- Provides for pro-rata taxation of gains based on ratio of fair value of the Peruvian company to the value of the foreign company whose shares are being transferred.
The Shome Committee Recommendations
Shome Committee - the Background

• Concerns over the impact of retrospective amendments acknowledged by the Government

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

• Expert Committee constituted by the Government under the chairmanship of Dr. Parthasarathi Shome to examine the applicability of amendments on indirect transfers in the context of non-resident taxpayers

• Draft Report released on 9 October 2012 after detailed consultations with stakeholders
Key Recommendations...

- **On Retrospective applicability:**
  - Amendments on indirect transfers not 'clarificatory'-should apply prospectively
  - Retrospective amendments should be used in exceptional cases after exhaustive and transparent consultation with stakeholders, exclusively to:
    i. correct mistakes in the statute
    ii. remove technical defects; or
    iii. protect the tax base from highly abusive tax planning schemes
  - Retrospective amendments should not be used to expand the tax base

Are other retrospective amendments under the Finance Act, 2012 truly 'clarificatory'
...Key Recommendations...

- **On mitigating impact of retrospectivity***:
  - No proceedings to be initiated for failure to withhold tax on past transactions on the basis of the retrospective amendment
  - Representative assessee provisions not to be invoked on past transactions on the basis of the retrospective amendment
  - No interest on tax demands arising out of the retrospective amendment
  - No initiation of penalty proceedings

* If recommendation on prospective applicability are not accepted

Applicability to all retrospective amendments?
• On Applicability and Computation of Gains:

'Substantially' should be defined as a threshold of 50% of the total value

- Gains from transfer of shares in foreign companies to be taxable in India only if such shares derive 50% or more of their value from assets located in India
  (Explanation 5 to s. 9(1)(i))

- No basis for taxing all gains only because a majority of the foreign company's assets are located in India
  - Proportionate basis of taxation of gains to be adopted

- Fair Market value of assets to be used for determination of value

- Expanded definition of transfer under s. 2(47) not to apply where requirements of Explanation 5 to s. 9(1)(i) not satisfied
  - No general look through rule in all share transfers in foreign companies - Value test in Explanation 5 must be satisfied
please replace % with 'percent', please take care of the bulleting as commented on slide 4
POOJADHOOT, 11/9/2012
...Key Recommendations...

• On applicability of Tax Treaties:

• In cases where there is tax treaty with the country of residence of the non-resident transferor, gains will not be taxable in India unless:
  i. The treaty provides for capital gains taxation under Indian domestic law
  ii. The treaty specifically provides right of taxation to India on transfer of shares or interest of a foreign company or entity

• In line with Finance Minister's speech in Parliament on the Budget

• Applicability of expanded definition of 'transfer' to tax treaties not addressed
Key Recommendations

• Some Exclusions:

• Transfer should not be taxed if transferor (and associated enterprises) owns less than 26% of voting power/share capital in preceding 12 months.

• Exemption may be provided to foreign companies listed on a recognized stock exchange (under RBI norms) if its shares are frequently traded (as understood under the SEBI Takeover Code).

• Transfers under intra-group restructuring may be exempt provided that such transfers are not taxable in the jurisdiction where such company is resident.

• Dividend paid by a foreign company not to be deemed to accrue or arise in India under s. 9(1)(i) read with Explanation 5.

• Provisions not to apply to any investment made, directly or indirectly, in FII's.
Takeaways

• Recommendations - Far reaching and constructive

• However, some open items remain:
  • Multiple taxation - still a possibility
    o No provision for adjustment to cost of acquisition to protect double taxation of subsequent transfers.
  • Treaty applicability - potential re-characterization of share sale into transfer of constituent elements - express clarification necessary
  • Recommendations on retrospective application of withholding, representative assessee and penalty/interest provisions - applicability to other retrospective amendments?

• Future of validating provisions ins. 119

• Government decision on Recommendations awaited - Implementation may require legislative action
Thank You

Uday Ved
Tel : +91 (22) 3090 2130
Mob : +91 (0) 9820058327
email: uved@kpmg.com
The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2012 KPMG, an Indian Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International Cooperative ("KPMG International").