

Cross Border Transactions - Recent developments

- Rekha Bagry



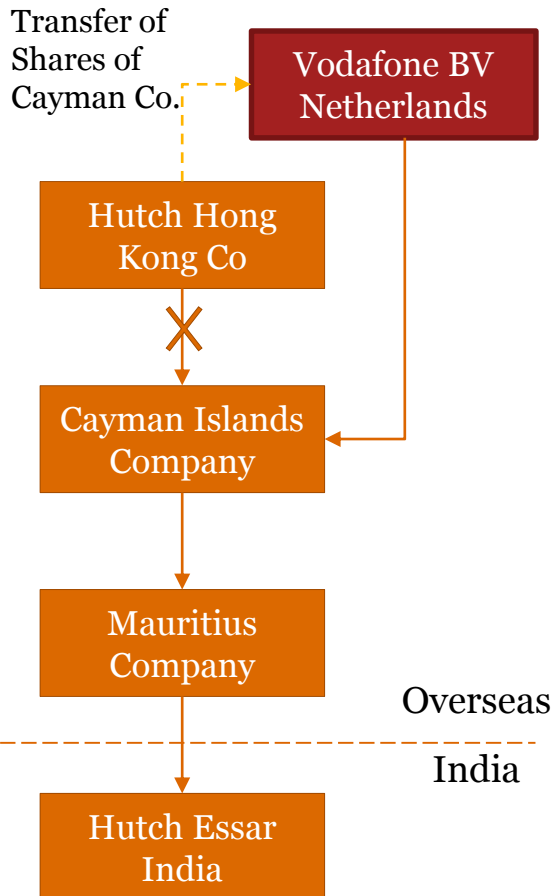
August 2016

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1.	Indirect Transfer
2.	Buy-back Tax
3.	General Anti-Avoidance Rules
4.	Place of Effective Management

Indirect Transfer

The Vodafone Controversy



Revenue

- Transaction designed to avoid Indian taxes
- Form of the transaction disregarded - corporate veil lifted
- Transfer of foreign company's shares resulted into transfer of assets located in India
- Controlling interest is a separate asset situated in India whose transfer gives rise to Indian tax
- Tax withholding obligations extend to non residents

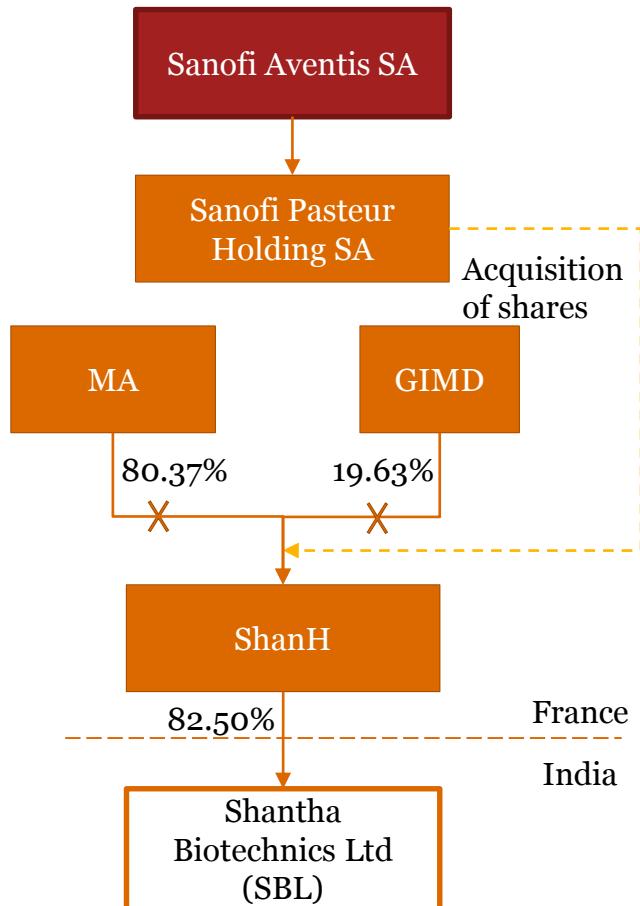
Tax Payer

- Multi-pronged commercial rationale behind tiered structures such as ring-fencing liability, mitigation of risk, enabling separate verticals, etc
- No provision for taxing 'indirect' transfers
- 'Rights and entitlements' flow from the transfer of shares and are not separate capital assets

Supreme Court Judgement*

- Transfer of shares in a foreign company does not lead to the transfer of assets situated in India
- Tax planning is legitimate if within the legal framework
- "Look at" test to be applied to determine true nature of transaction
- Legal form cannot be disregarded unless the transaction is a sham or tax avoidant
- Controlling interest is embedded in the shares and is not a separate asset

The Sanofi Case*



Revenue

- Transaction designed to acquire control, management and business interest of SBL
- MA and GIMD are the beneficial owner and ShanH is merely a nominee of MA
- Alienation of shares under Article 14(5) means direct and indirect alienation
- Alienation not defined under the Treaty, - to be imported from the IT Act
- Mode of disposal is immaterial – whether direct or indirect or deemed disposal

Tax Payer

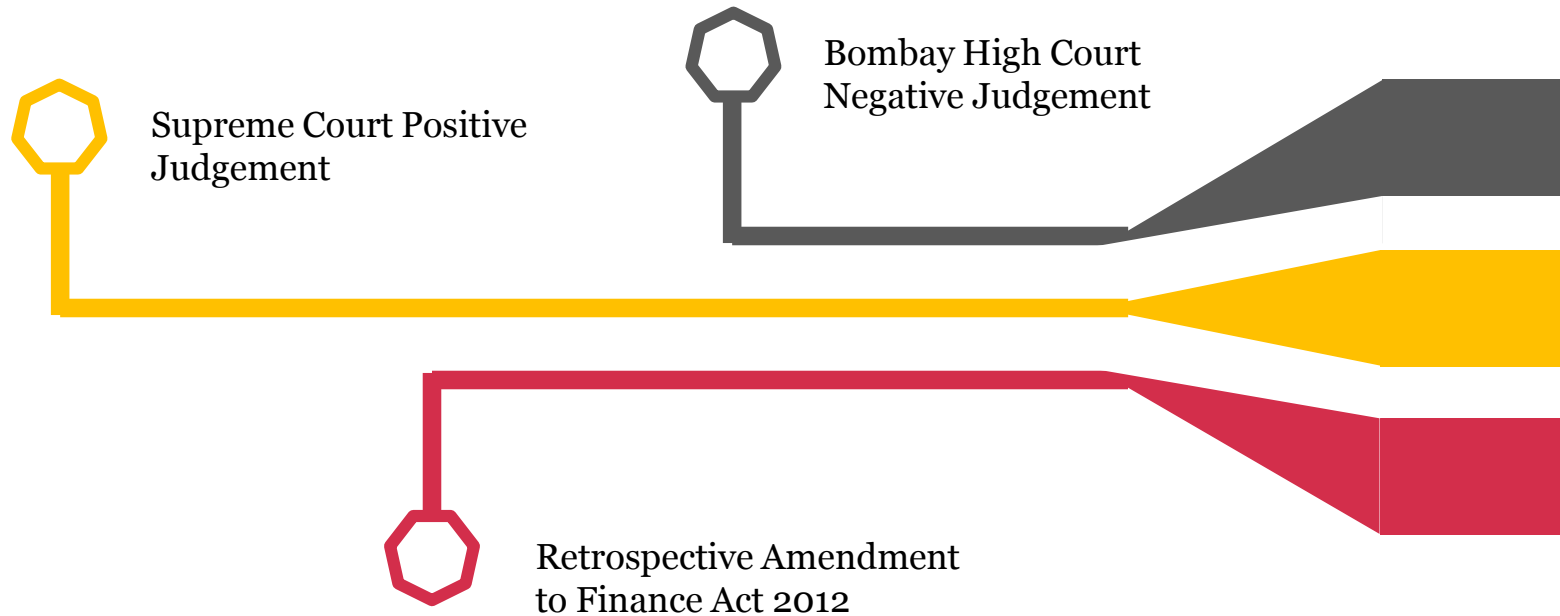
- Controlling interest is not a separate asset
- Even if Controlling interest is viewed as separate asset, it is taxable in France under Article 14 (6) as the situs is in France
- Justification/ commercial rationale to set up ShanH

High Court Judgement

- ShanH is not a sham or conceived only for Indian tax-avoidance, thereby no case of piercing corporate veil
- Controlling Interest is not a separate asset. Further, the computation mechanism fails to attribute the value of controlling interest in SBL by ShanH
- Retrospective amendments do not override the Tax Treaty

*[2013] 354 ITR 316 (Andhra Pradesh)

Amendment to Income Tax Act



Amendment to Income Tax Act

Prior Position		
Section 2(14)	Section 2(47)	Section 9
“Rights and entitlements” not identifiable or distinct capital assets from shares held	Shares and the rights which emanate from them, flow together and cannot be dissected	Situs of shares where the company is incorporated and where its shares can be transferred.
Amended Position		
Section 2(14)	Section 2(47)	Section 9
‘Capital Asset’ deemed to include any rights in or in relation to an Indian Company, including rights of management or control or any rights whatsoever	‘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 characterized as being effected or dependent upon or flowing from transfer of a share or shares of a company registered or incorporated outside India;	Situs of Shares of / interest in certain foreign companies: Deemed to be situated in India, if the share /interest derives, directly or indirectly, its value substantially from the assets located in India The expression “through” deemed to mean “by means of”, “in consequence of” or “by reason of”

Indirect Transfer of shares or interest in a foreign entity

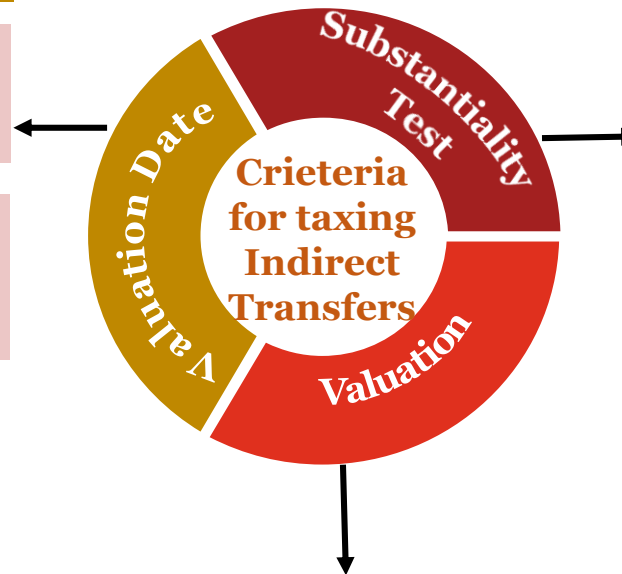
Specified Date

the last day of the accounting period of the entity preceding the transfer; or

Date of transfer, if the book value of assets has increased by 15% or more from the date above

Exemptions:

- Foreign amalgamation / demerger – conditions apply
- No transfer of right of management / control in target entity (Foreign or Indian; and Voting power/share capital / interest held by non residents (along-with AEs) < 5% in:
 - Indian entity or assets; or
 - Foreign entity holding Indian entity / assets



Derivation of substantial value from India: If the value of Indian Asset is

Exceeding INR 10 Cr; and

Representing at least 50% of value of all assets owned by the foreign entity

Value of Indian assets includes value of assets / operations located outside India

Enterprise value approach

Valuation to be determined by Merchant Banker or a CA

Gain in proportion to stake holding with Non residents to be taxed in India

- Transferor to file ROI and CA report (for correct computation)
- Indian entity to file Form 49D reporting Indirect Transfer
 - Penalty on Indian entity depending upon default:
 - 2% of the fair value of overseas transfer; or
 - INR 0.5 million

Indirect Transfer Provisions

Revolving Controversies

Methods for
determining fair
value

Valuation Date

Scope of
'substantially'

Transfer of
'controlling
interest'

Debt instruments
covered in
interest?

Applicability of
treaty provisions

Availability of
treaty benefits

Withholding tax
liability on past
transactions

Single stage levy

Intra-Group
Corporate
restructuring

Transactions in
listed securities

Rule 11 UC - Income attributable to assets in India

Gains attributable to
assets located in
India =
 $A * (B / C)$

A

- Capital Gain from transfer of shares of foreign entity computed in accordance with Indian laws, as if such share/ interest is located in India.

B

- Fair Market Value ('FMV') of assets located in India (as on specified date)

C

- FMV - Assets of the foreign company (as on specified date)

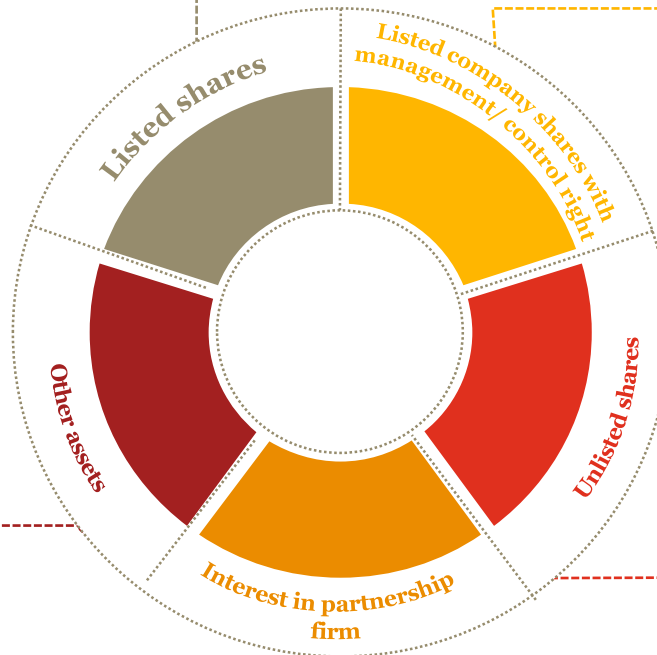
The Assessing Officer shall determine the income taxable in India on failure on part of the transferor to provide information required to determine income attributable to Indian assets

Rule 11 UB - Fair Market Value – Assets located in India

FMV = Observable price of such share on recognized stock exchange

(Higher of average of weekly high and low closing prices for 6 months preceding specified date or 2 weeks preceding specified date)

FMV = Expected price it can fetch in the open market (determined by merchant banker/ accountant) + Liability, if any, considered in such determination



$$FMV = (A + B) / C$$

A = Market capitalization (basis observable price on stock exchange)

B = BV of liabilities

C = Number of outstanding shares

FMV determined by a merchant banker or accountant as per internationally accepted pricing methodology + Liability, if any, considered in such valuation

FMV of partner's share = (Value determined by a merchant banker or accountant as per internationally accepted valuation methodology + Liability, if any, considered for such valuation) → apportioned to the partners in capital ratio till the extent of total capital, and then in asset distribution ratio or profit sharing ratio

Rule 11 UB - Fair Market Value – Assets of Foreign Company

*Transfer
between non
connected
persons*

*Other cases-
Share of foreign
company - listed
on specified date*

*Other cases-
Share of foreign
company -
unlisted on
specified date*

FMV

- FMV of all assets = A + B
- A = Market Capitalization of the foreign company or entity computed on the basis of the full value of consideration for transfer
- B = Book value of liabilities as on specified date, as certified by a merchant banker or an accountant

FMV

- FMV = A + B
- A = Market capitalization of foreign company (based on observable price on stock exchange where it is listed on a stock exchange)
- B = Book value of liabilities as on specified date

FMV

- FMV = A + B
- A = FMV of foreign company / entity & its subsidiaries (on a consolidated basis) computed by merchant banker or accountant as per internationally accepted valuation methodology
- B = Book value of liabilities as on specified date

Indirect Transfer Provisions

New Controversies after Final Rules, 2016

FMV of Indian assets
in multi-layered
structures

Availability of
information to
minority shareholders

Preference Shares –
whether capital or
liability?

Interpretation of
“enterprise value”



Reporting Requirement
even if covered under treaty
benefit?

Entities covered under treaty benefit are supposed to
file a Return of Income
Hence, reporting requirements should be adhered to



Is there any mechanism to
reconcile the variations in the
FMV value and the Deal price?

As per draft rules, the deal price is not considered
relevant for valuation.

The capital gains will be computed taking into
account the deal price and the proportion of such
gains taxable in India will be decided by the FMV
obtained as per the rules

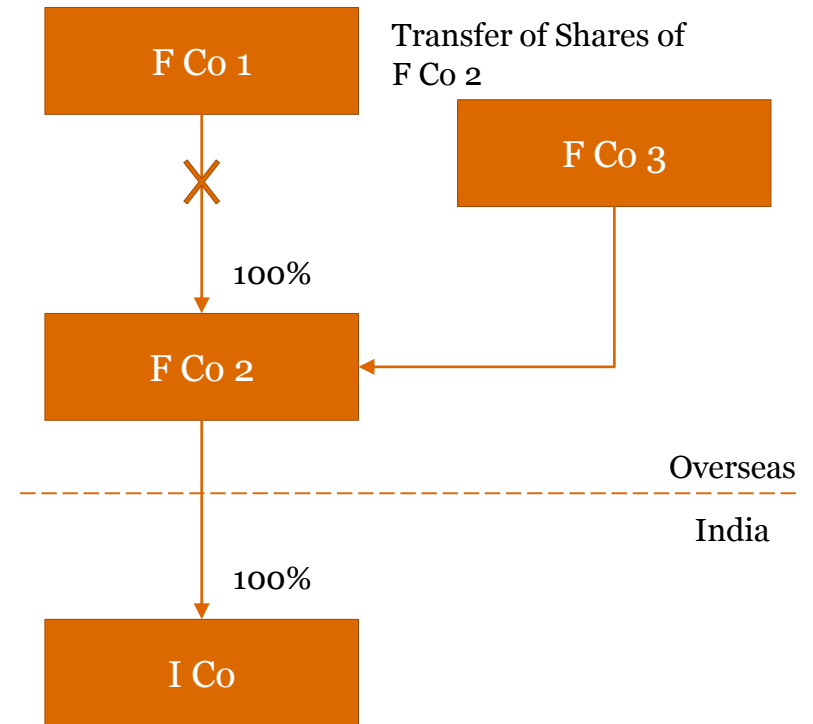
Case Study 1

Consider the following scenario:

- F Co 1 holds 100% in F Co 2
- F Co 2 holds 100% in I Co with some nominal cash
- The cost of F Co 2 shares for F Co 1 is INR 100 crores
- F Co 1 transfers the shares of F Co 2 to F Co 3 for INR 525 crores
- Gains = INR 425 crores



Whether indexation is available?



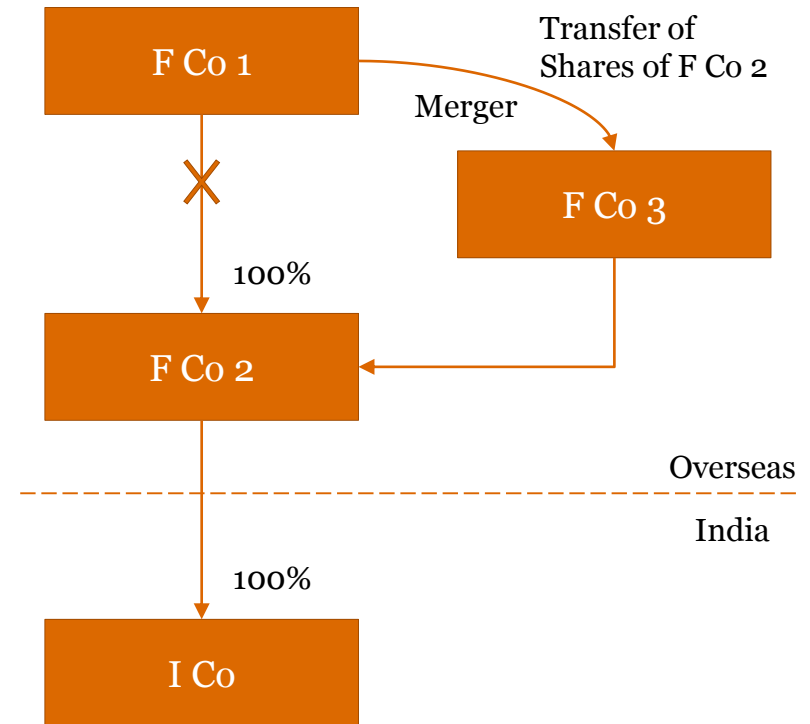
Case Study 2

Consider the following scenario:

- F Co 1 holds 100% in F Co 2
- F Co 2 holds 100% in I Co with some nominal cash
- Merger of FCo 1 into FCo 3
- Transfer of shares of F Co 2 to F Co 3 upon merger



Indirect Transfer of shares of I Co?



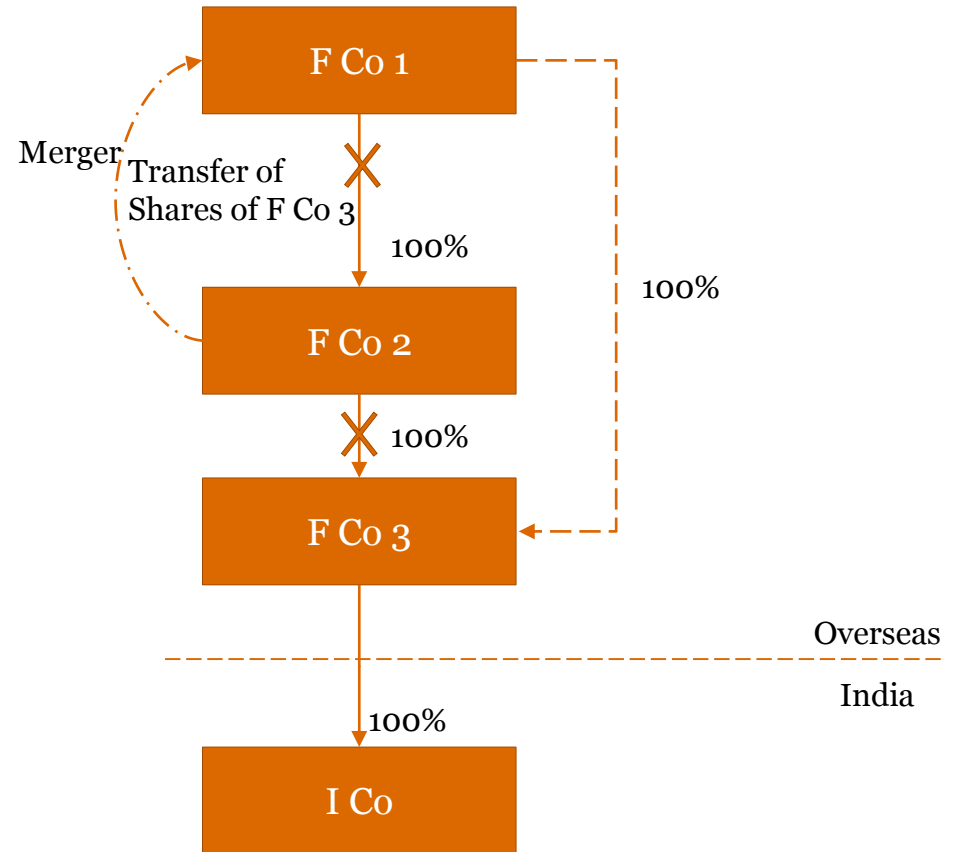
Case Study 3

Consider the following scenario:

- F Co 1 holds 100% in F Co 2
- F Co 2 holds 100% in F Co 3
- F Co 3 holds 100% in I Co
- Merger of F Co 2 into F Co 1
- Transfer of shares of F Co 3 to F Co 1 upon merger



Indirect Transfer of shares of I Co?



Buy-back Tax

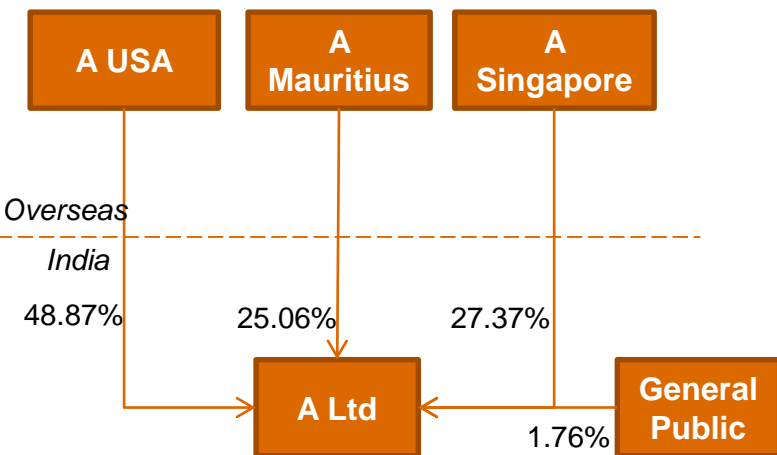
Background – Advance Ruling*

Brief Facts

- A Ltd. was held by A USA (48.87%), A Mauritius (25.06%), A Singapore (27.37%) and General Public (1.76%)
- A Ltd. declared dividends upto 2003; no dividends declared pursuant to introduction of dividend distribution tax ('DDT') in 2003
- A Ltd made a buyback offer in 2010; only A Mauritius accepted the offer
 - Even in buyback offer of 2008, only A Mauritius tendered its shares

AAR Ruling

- No dividends were declared by A Ltd. since 2003; reserves were allowed to be accumulated
- No proper explanation provided for non declaration of dividends
- Buyback of shares held by other entities may have been subject to tax; for A Mauritius, totally out of Indian tax net
- Arrangement to be treated as a distribution of profits to its shareholders which does not attract DDT; hence a colourable device
- Distribution to satisfy definition of dividend under the Act; hence taxable in India as per Article 10(2) of India Mauritius tax treaty



*A.A.R. No. P of 2010

Buy-back Tax

section 115QA

- Introduced w.e.f. 1st June 2013
- Levy tax @ 20% on distribution arrangement by way of buy back of shares of unlisted companies

Applicable on unlisted shares

- Section 115QA is applicable on unlisted shares.
- For listed shares, tax is computed in the hands of shareholders as capital gains.

Taxed on distributed income

- Buyback Tax= Consideration paid on buy back of shares **less amount received by the company** on issue of such shares

Exempt in the hands of shareholder u/s 10(34A)

- Akin to dividend, it is exempt in the hands of shareholders u/s 10(34A) of the Act

Buy-back Tax: Controversies

Applicability of Section 115QA on buyback prior to June 1, 2013

Determination of amount received by the company in different situations

Identification of shares to be bought back vis a vis issued

Applicability to Buy-back u/s Scheme of Arrangement?

Applicability of section 56(2)(viiia) of the Act

Clarification:
Not applicable

Amendment:
Applicable to
buyback under
any laws

Draft Rules
issued

Draft Rules - July 2016

CBDT has released the draft rules for determining the amount received by the company for the purpose of computing distributed income under different scenarios:

Shares issued upon subscription

Paid up amount, including premium, actually received by the company

Shares issued upon amalgamation

The amount received by the amalgamating company in respect of such share or shares

Shares issued upon demerger by resulting company

Amount received by demerged company in proportion to book value of assets transferred which bears to its net worth

Buy-back by demerged company

Amount received by demerged company less proportionate amount eligible for shares of resulting company .

Shares issued without consideration

NIL

Conversion of convertible debt instrument

Amount received in respect of the instrument so converted

Capital Repayment prior to buy back

The amount received by the company as reduced by the sum so returned

Residual category

Face value of share to be bought back

A few concerns...



Buy-back of shares issued for consideration other than cash?

- Co A transfers IP to Co B at FMV of INR 50 Crs.
- Co B issues 50 lacs shares of face value INR 10 each and records premium in its books
- Co B does buyback at INR 150 per share.
- ***Amount received?***



Buyback of shares post consolidation/split?

- Co A issues shares of face value INR 10 at INR 50.
- Co A does share split wherein the face value per share becomes INR 2 each
- Co A does buyback at INR 20 per share.
- ***Amount received ?***



Identification of shares to be bought back?

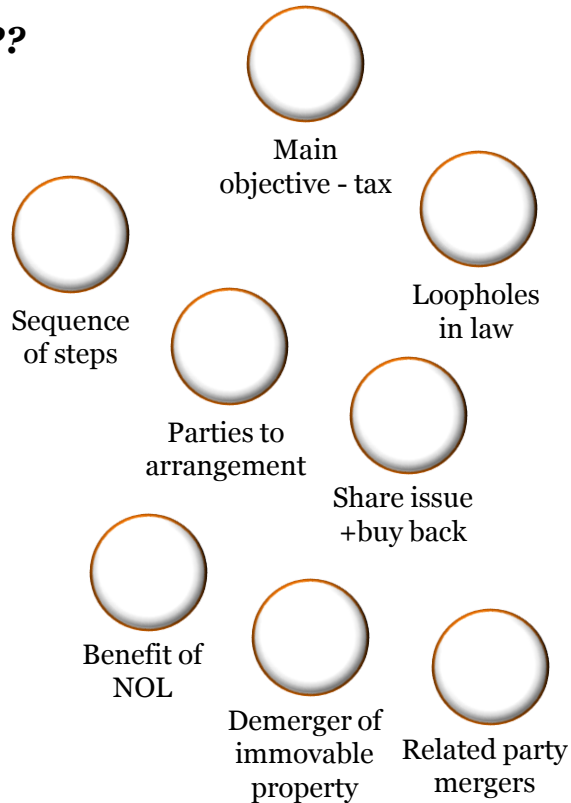
- Co A had issued shares in 3 tranches - INR 20, INR 40 and INR 50.
- Co A does buyback of shares
- ***Identification of shares?***

General Anti-Avoidance Rules (GAAR)

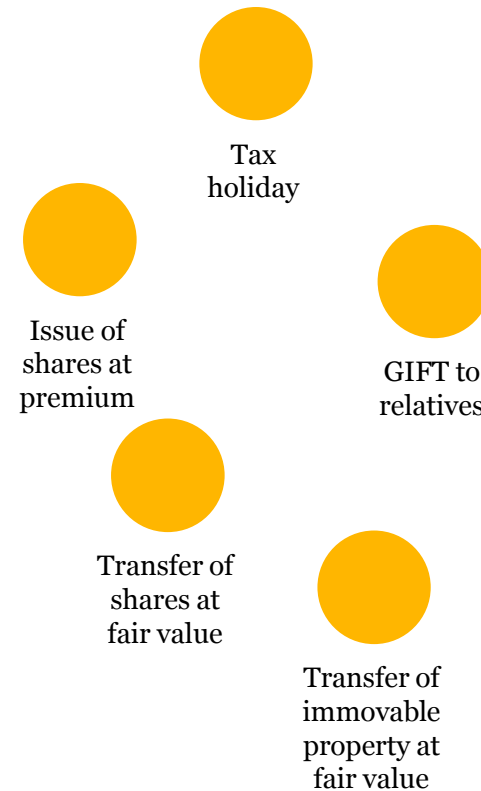
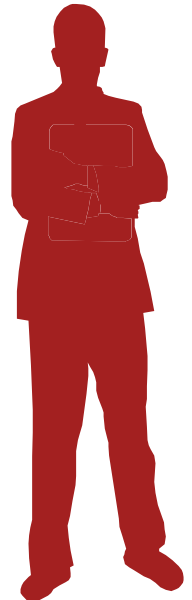
Avoidance v/s. Planning - the difference

Thin line

Avoidance ???



Planning !!!



Relevance of GAAR

1

Tax Evasion

- General term for efforts to not pay taxes by illegal means

Even otherwise prohibited – GAAR irrelevant

2

Tax Avoidance

- Legal utilization of tax regime to reduce tax payable
- Using loopholes and gaps in tax

GAAR applicable

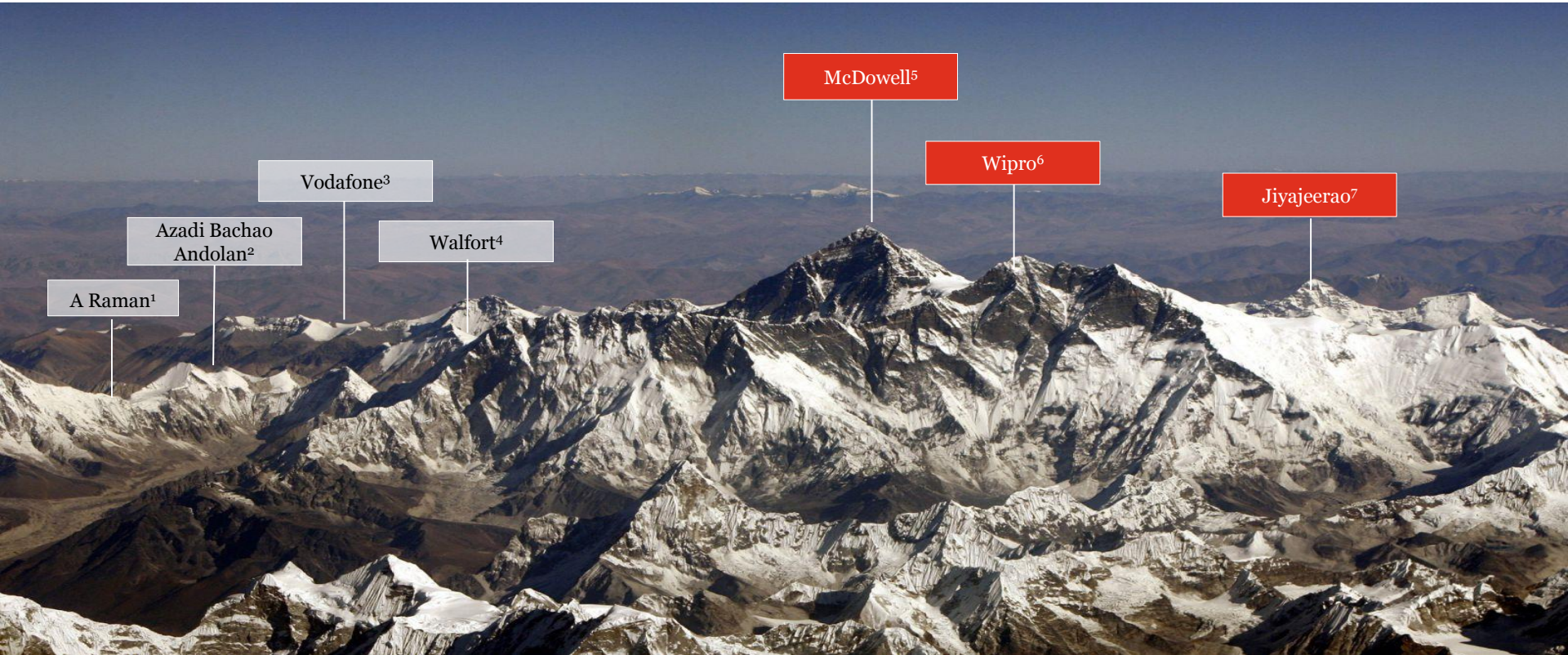
3

Tax Planning

- Looking at various tax options in order to determine when, whether and how to conduct transaction to reduce/eliminate taxes

GAAR v/s legal provision

Few Indian Rulings



1 [1968] 67 ITR 11 (SC)

2 [2003] 263 ITR 706 (SC)

3 [2012] 341 ITR 1 (SC)

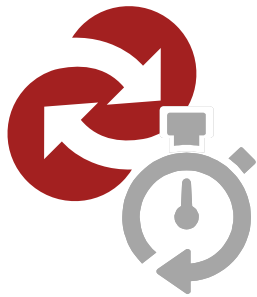
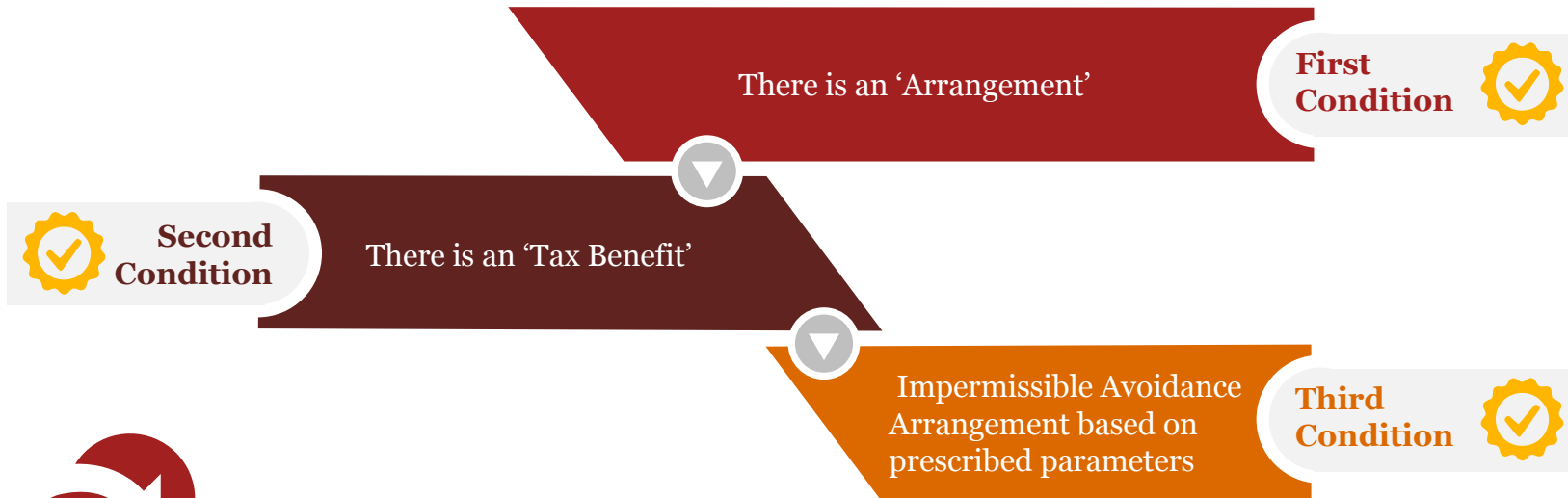
4 [2010] 326 ITR 1 (SC)

5 [1985] 154 ITR 148 (SC)

6 [2014] 227 Taxman 244 (Karnataka)

7 [1958] 34 ITR 888 (SC)

GAAR trigger points



Allows tax officer to invoke GAAR and declare transaction as Impermissible Avoidance Arrangement (IAA)

What is tax benefit



Reduction or avoidance or deferral of tax

1

Increase in refund of tax

2

Reduction or avoidance or deferral of tax as a result of treaty

3

Increase in refund of tax as a result of treaty

4

Reduction in total income or increase in losses

5

Parameters for determining tax benefit

Connected persons may be treated as one and the same

1

Accommodating party may be disregarded

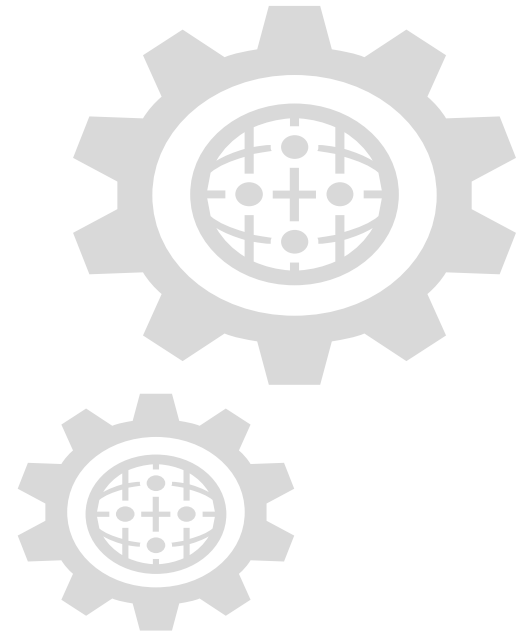
2

Accommodating party and any other party may be treated as one

3

Looked through disregarding corporate structure

4



Conditions for impermissible avoidance arrangement

Arrangement – Main purpose is to obtain tax benefit

AND

OR

Creates rights or obligations which would not ordinarily be created between dealing at arm's length

Results in misuse or abuse of the provisions of the Act

OR

Lacks commercial substance or is deemed to lack commercial substance in whole or in part

OR

Carried out by means or in a manner, which would not normally be employed for bona fide purposes

Lacks commercial substance

An arrangement shall be deemed to lack commercial substance if:

OR

Substance/ effect of arrangement as whole is inconsistent with or differs significantly from its individual steps or parts

OR

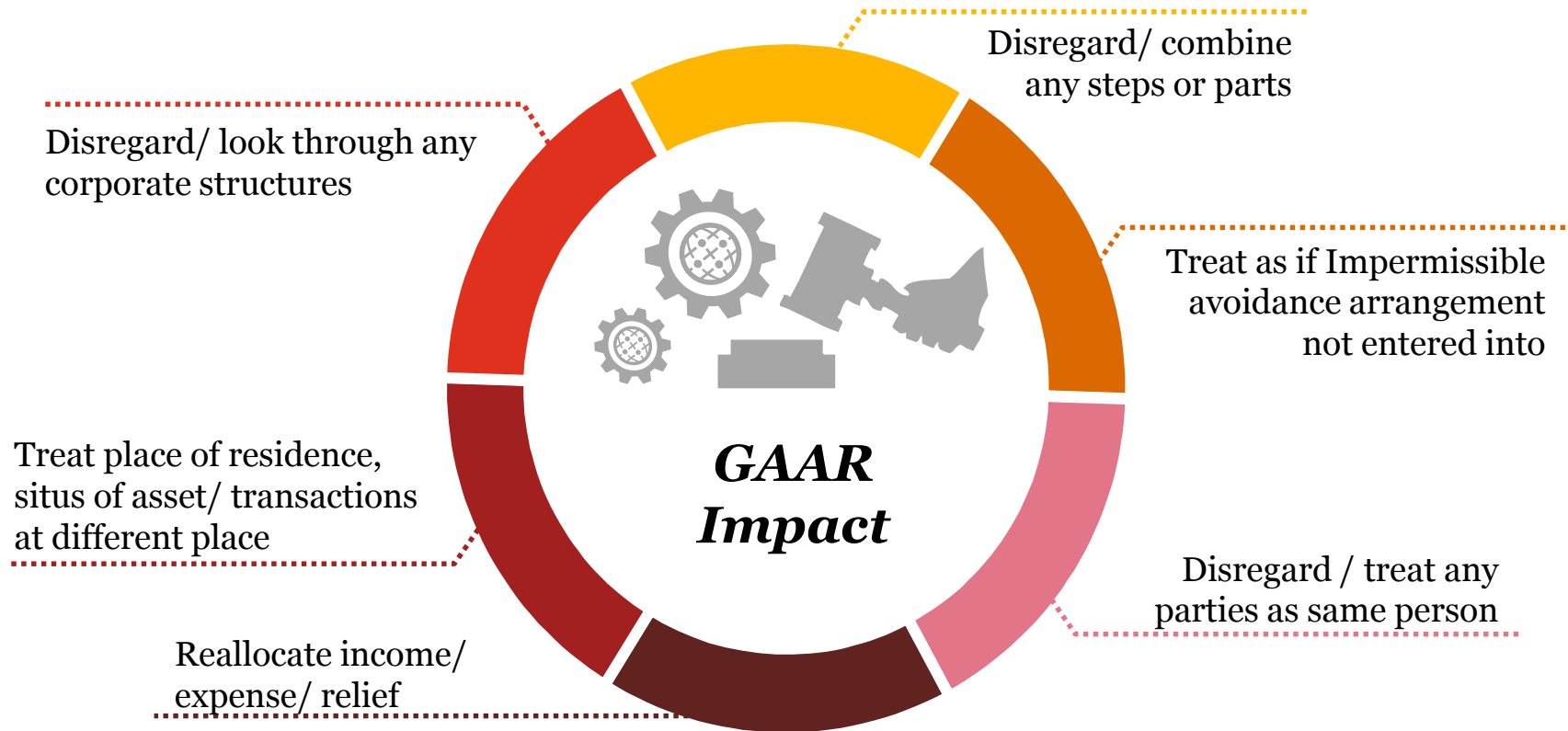
It involves or includes:

- Round trip financing
- Accommodating party
- Offsetting or self cancelling elements
- Transaction which disguises value, location, source, ownership or control of funds which are subject matter of transaction

OR

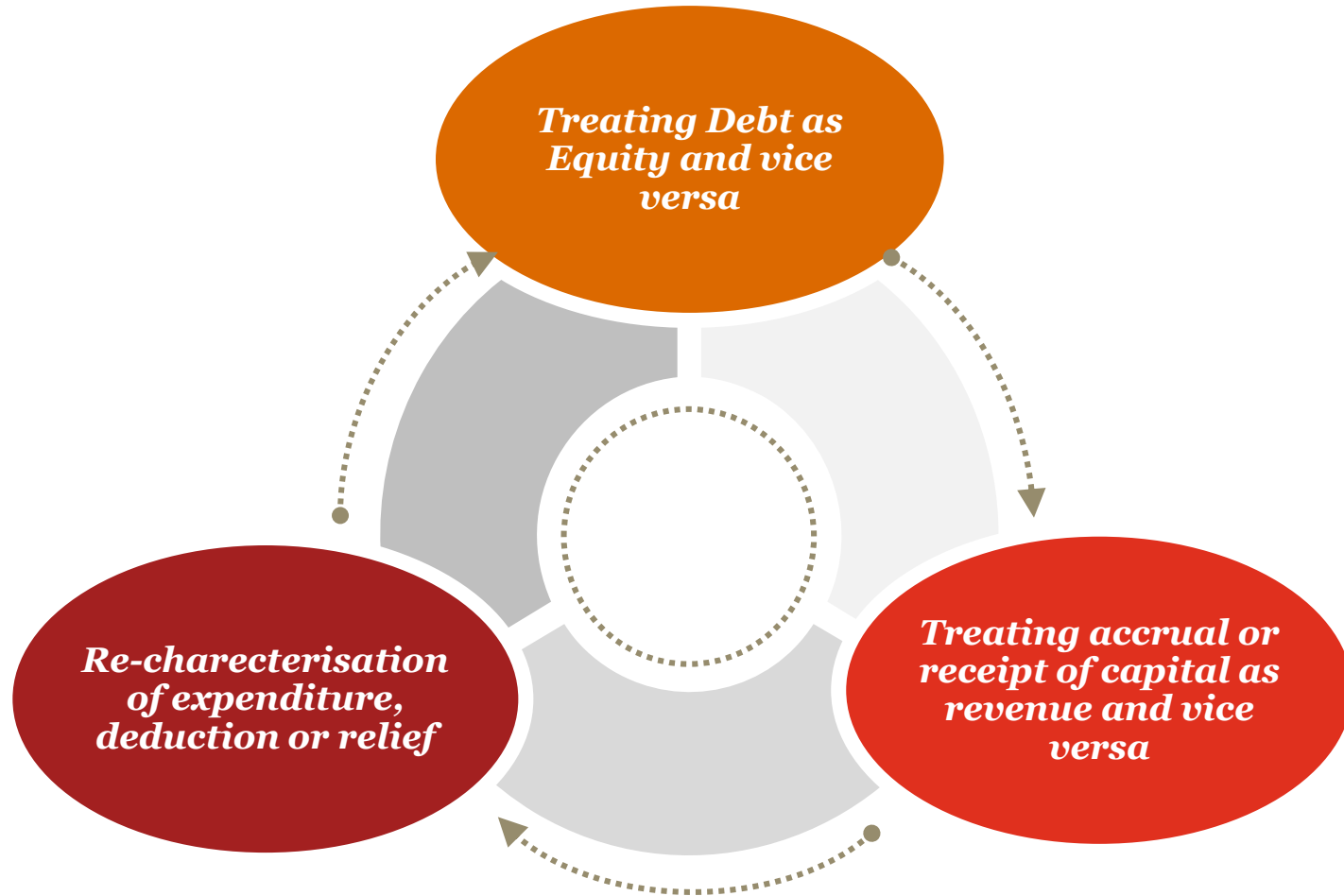
It involves location of an asset/transaction/place of residence of any party which would not have been so located for any substantial commercial purpose other than obtaining a tax benefit

Tax consequences



Tax consequences

Such manner of determination may include



Introduction of GAAR rules

Question...



Will it be deferred ?



Applicability –

From 1 April 2017



Coverage –

Only impermissible part of the arrangement



Grandfathering –

Income from **Transfer** of Investments prior to 31 March 2017



Exempt –

Certain specified investments*



Threshold –

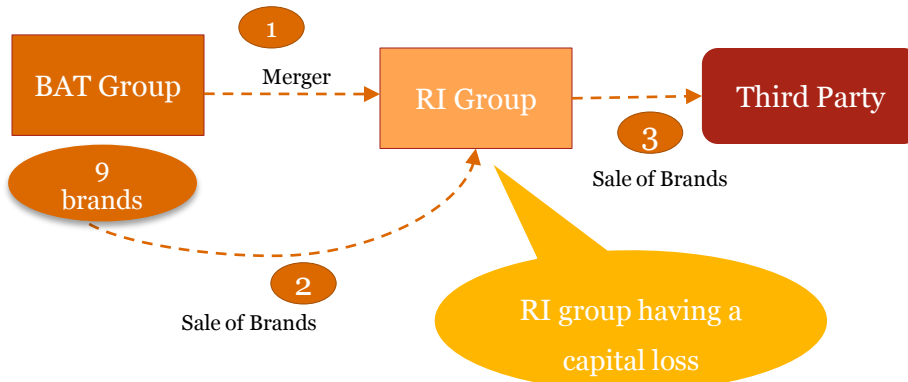
Tax Benefit on aggregate basis - INR 3 crores



* (A) Non-resident investments in offshore derivative instruments / through FII's

(B) FII's (being an assessee under the ITA) not availing treaty benefits having investments done with prior permission

British American Tobacco Services Ltd v Commissioner of Taxation*



Mechanics

1. Merger of BAT Group with RI Group
2. Sale of brands to RI group
3. Actual Sale of brands to third party at a same price

Tax benefit

- Rollover relief on capital gain in the hands for BAT and RI group as the company owning the brand in BAT group became the subsidiary of RI group
- RI Group have set off the capital gains against capital loss

Tax Authority's contention

- The Commissioner identified the scheme as consisting of:
 - The decision to interpose RI Group between BAT and third party in relation to the disposal of the 9 Brands from BAT to third party;
 - The disposal of the 9 Brands from BAT to RI Group and from RI Group to third party;
 - The making of the choices by BAT and RI group to obtain rollover in relation to the capital gains made by BAT as a result of the disposal of the 9 Brands to RI Group; and
 - The making utilization of loss capital loss of RI group
- BAT group could have directly sold to the third party but have structured the transaction to obtain tax benefit.

Tax Payer's contention

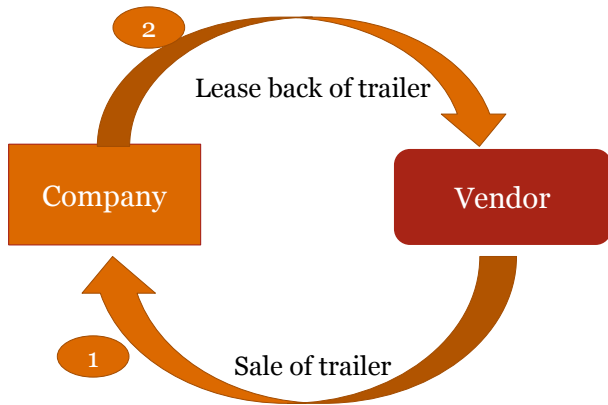
- Dominant purpose of the entire scheme is commercial to give effect to the entire part of the scheme and tax benefit was one step in wider scheme

Judgment

- Dominant purpose is to obtain the tax benefit and hence GAAR was applicable.
- Manner of scheme formulated and carried out explicable only by taxation consequences
- Correspondence mandated to complete merger prior to entering into any contractually binding arrangements for the sale of relevant brands which created the framework for claiming deferment of tax

*Australia -
(2010) FCAFC 130

The Queen v Canada Trust Co Mortgage Co*



Mechanics

1. Vendor sold the trailer to the company.
2. Company leased back the trailer to vendor

Tax Benefit

The Company is eligible for Capital Cost Allowance as the trailer is owned by the company
Deferment of payment of tax

Tax Authority's contention

The tax authority wants to apply GAAR as to deny the capital cost allowance

Judgment

In order to invoke GAAR there should be 3 requirements as under:

1. There must be a tax benefit from a transaction
2. Transaction has not been undertaken for bonafide purpose other than to obtain tax benefit
3. There must be abusive tax avoidance i.e. the transaction is contrary to the intention of statute

The burden is on tax payer whether transaction does not have tax benefit and transaction has been undertaken for bonafide purpose.

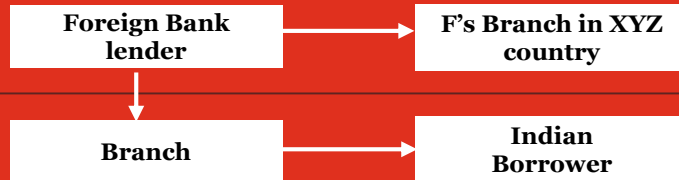
However, the tax authority has to prove that the transaction is contrary to the intention of statute.

If the transaction is accordance with the purpose of the statute then GAAR cannot be applicable. "The courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue.

Case Studies...

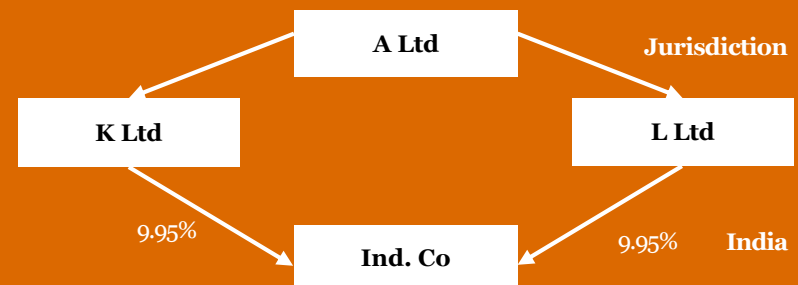
Facts

- “F’s” branch in India arranges loan for Indian borrower
- The loan is later assigned to “F” bank’s branch in XYZ country to take benefit of withholding provisions of the India-XYZ treaty
- **GAAR to be invoked**
- **Tax motivated transaction**



Facts

- India-F treaty provides that gains arising from sale of shares will be taxable in India if transferor holds more than 10% in Ind Co.
- A Ltd invests in Ind Co. through K Ltd and L Ltd each holding 9.95%. Subsequently, K Ltd and L Ltd sell shares in Ind Co. and claim treaty benefit.
- **Tax motivated – Abuse of Treaty - GAAR invoked.**
- **No significant change in the economic condition of A Ltd by creating 2 subsidiaries**



Case Studies...

Facts

- A Ltd invests 1 crore in shares and after a year FMV of shares become 11 crores.
- To avoid MAT on Long Term Capital Gains on sale, A Ltd forms partnership firm with a nominee and transfers shares at cost price
- Partnership firm subsequently disposes the shares without any tax cost and gains arising is distributed to A Ltd by dissolving the firm which is again exempt
- **Tax motivated - Transactions undertaken in Abnormal Manner – GAAR invoked**



Transfer of shares at cost price
Shares sold at fair price

Facts

- Y Ltd enters into a composite agreement with Ind Co. (unrelated party) for set up of power plant in India. Contract split into 3 parts –
- v' USD 10 million for design outside India (taxable in India)
- v' USD 70 million for offshore supply of equipment (not taxable in India as no PE) and
- v' USD 20 million for local installation (taxable in India)
- FMV ascertained - Offshore design under-invoiced and off-shore supply over invoiced
- **Tax motivated – Not at arm's length - GAAR invoked**

Prices to be reallocated based on TP Regulations



Place of Effective Management (PoEM)

Indian PoEM – Evolution Backdrop

Delhi Tribunal¹ had analyzed facts to determine residential status of Singapore Incorporated Company under the Indian Income-tax laws

Parameters / Fact Pattern	Decisive factor
Shareholding composition - Indian residing in India (99%) and Singaporean residing in Singapore (1%)	X
Place where one or more director(s) normally resides - India	X
Place of convening Board meetings and taking key decisions - Singapore	✓
Place where decisions pertaining to business taken - Singapore	✓
Place where the business is actually conducted - India	X
Authority to operate Singaporean bank account - Indian director	X
P&L statement of Singapore Co. does not reflect any administration / rent & employee costs (Administration done by Indian Parent).	X
Place of signing & maintenance of financials, minutes to meetings, etc. - Singapore	✓

Held: control and management of Singapore Co was not wholly in India

¹Radha Rani Holdings v. ADIT [2007] 16 SOT 49 (Delhi Tribunal)

PoEM – Paradigm Shift in Residency Test

The erstwhile law	<p><u>Foreign Co. becomes tax resident in India only if :</u></p> <ul style="list-style-type: none">– <u>Control and management</u> of company’s affairs situated wholly in India
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A higher threshold – Even if “part” control & management overseas no tax residency in India

Union Finance Act, 2015	<p><u>A Foreign Company can be resident in India if:</u></p> <ul style="list-style-type: none">– Its place of effective management (‘PoEM’) is in India <p>PoEM means a place where <u>key management and commercial decisions</u> that are <u>necessary</u> for the <u>conduct of the business</u> of an <u>entity as a whole</u>, are, <u>in substance made</u></p>
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- *Decision Test*
- *Necessity Test*
- *Pervasiveness Test*
- *Substance Test*

Determination of PoEM is subjective based on facts (evidenced by the relevant documentation) – in its current *avatar* and without adequate ring fencing can have unintended consequences

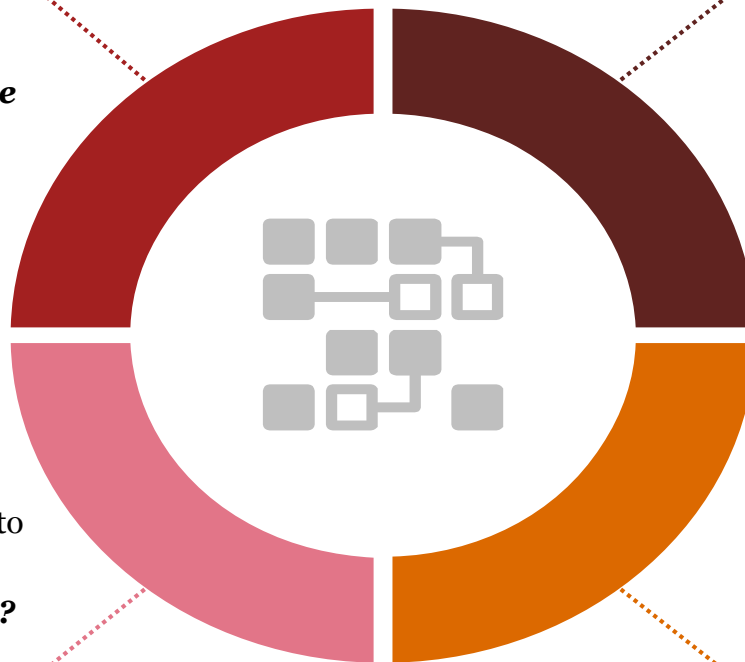
PoEM – Impact on ‘Indian Resident Foreign Co’

Cash flow Impact

- **40% tax on global income**
- **MAT on book profits ?**
- **Disallowance** due to WHT non-compliance

Other Impact

- Double taxation & **Foreign Tax Credit** availability ?
- **WHT provision** applicable to residents may apply ?
- **Ability to approach AAR ?**



Compliance Impact

- **Advance tax, Tax Return, WHT return filings**
- **Transfer Pricing** compliance
- Maintenance of prescribed **books of accounts**

Carve Outs

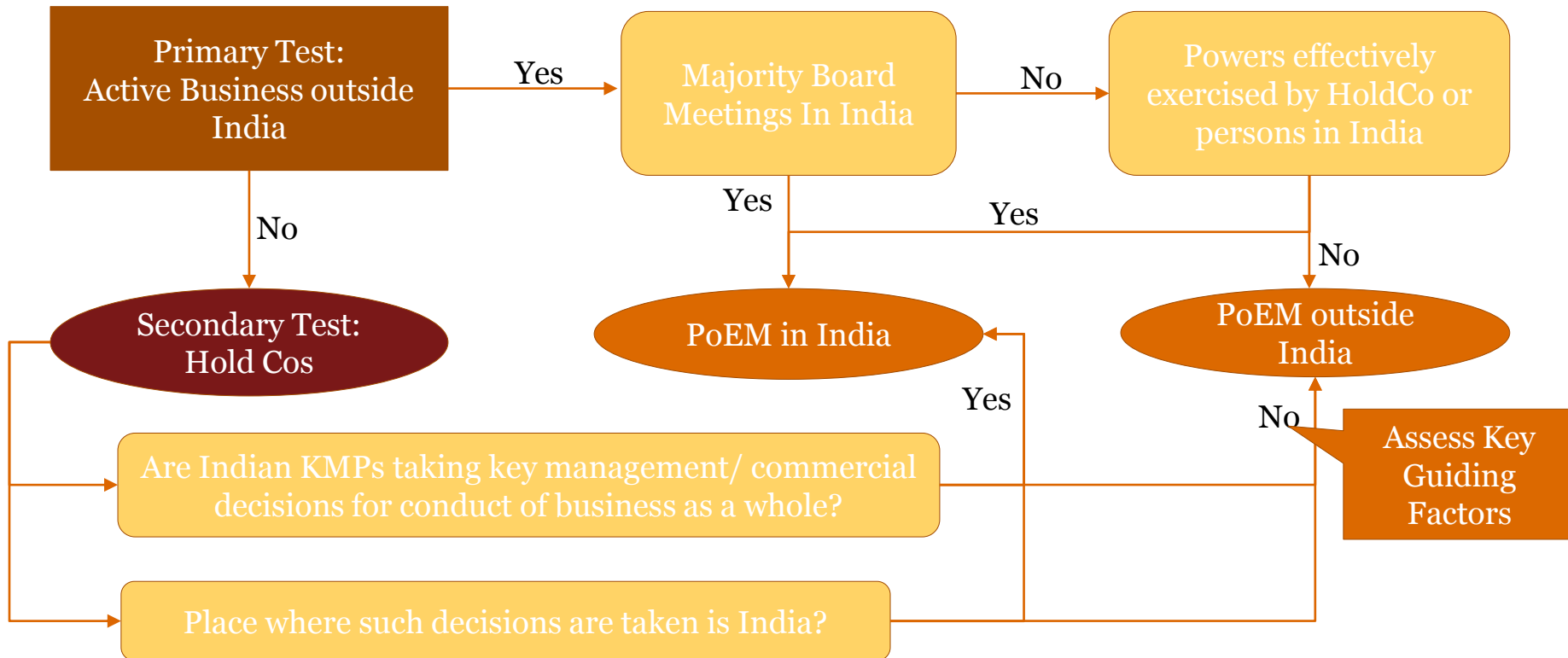
- **DDT not applicable**
- **Concessional tax @ 15%** on dividend from overseas entity

Draft guidelines issued by CBDT on 23 December 2015 for determination of POEM

Government to notify enabling transition provision for 1st time POEMED foreign Company

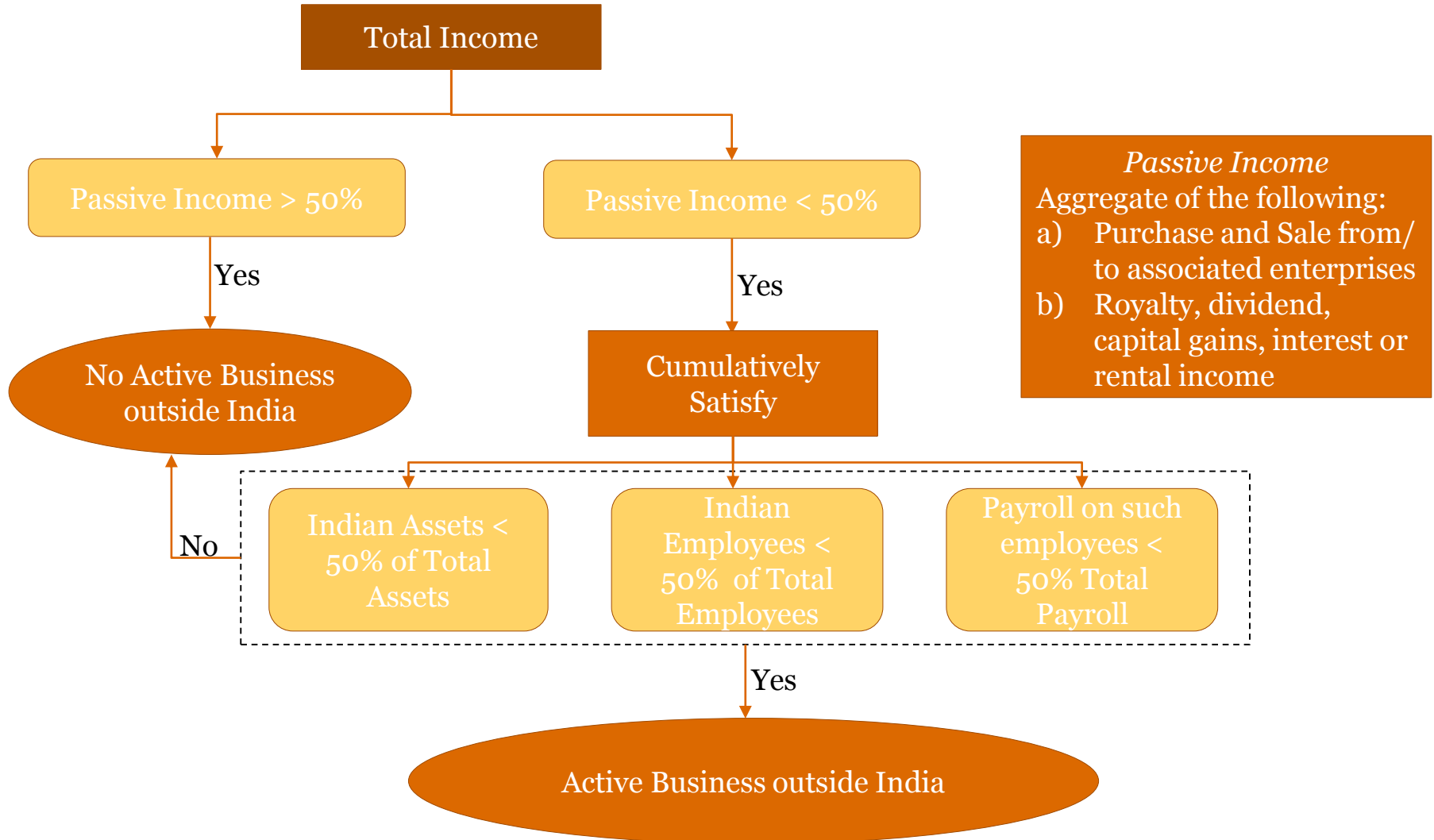
Determination of PoEM- Guiding Principles - draft

Substance over Form to be judged based on facts and circumstances of each case



To check where decisions are taken rather than implemented - *Management, strategic and commercial decisions of overseas entities in substance to be made outside India*

Active Business Test : Definition



“No automatic PoEM” Scenarios



PoEM – In summary

Key Highlights

Substance over form

Only “one” place of effective management

To be determined on year to year basis

Active v/s passive company determination

Based on facts and circumstances

1

POEM if situated in more than one country - ***POEM of foreign company presumed to be in India*** if it is predominantly situated in India

2

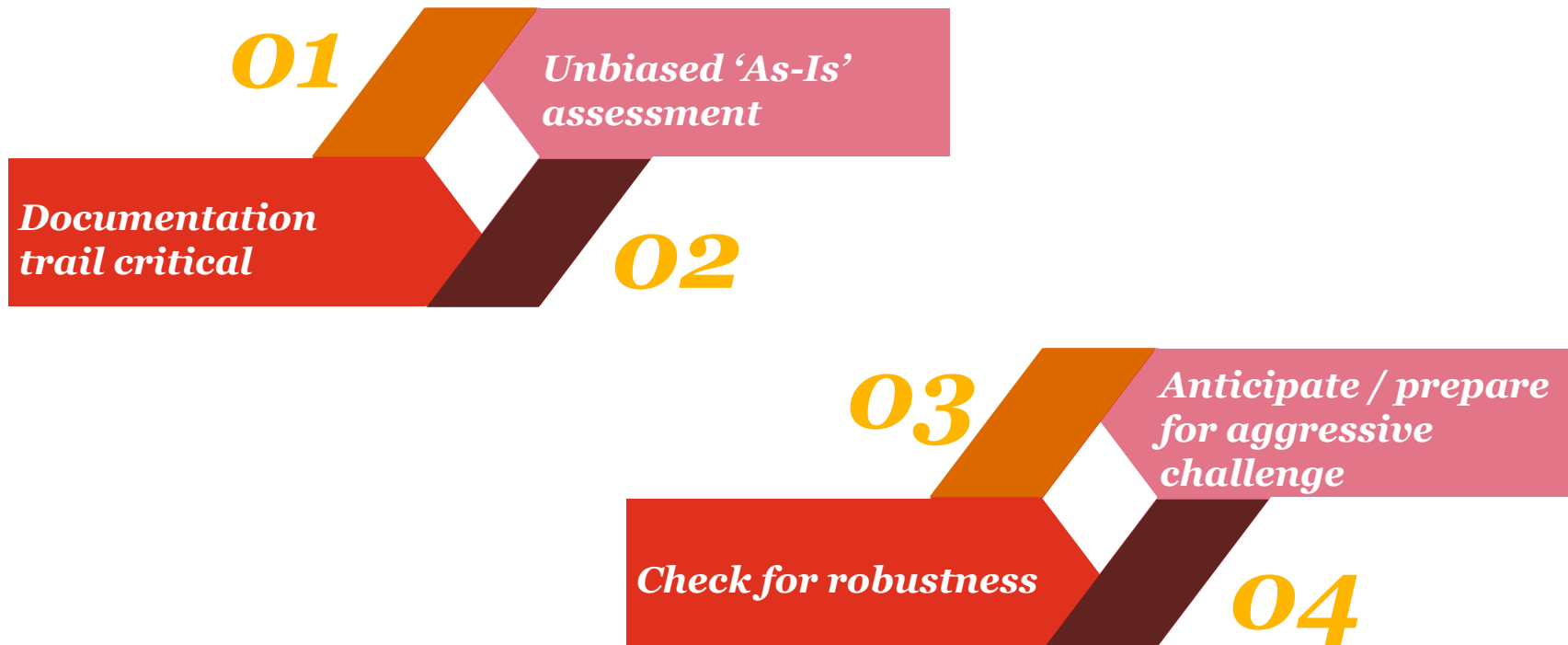
Reference to be made to jurisdictional Tax Officer to refer to principal Commissioner or the Commissioner of tax for purpose of initiating POEM;

3

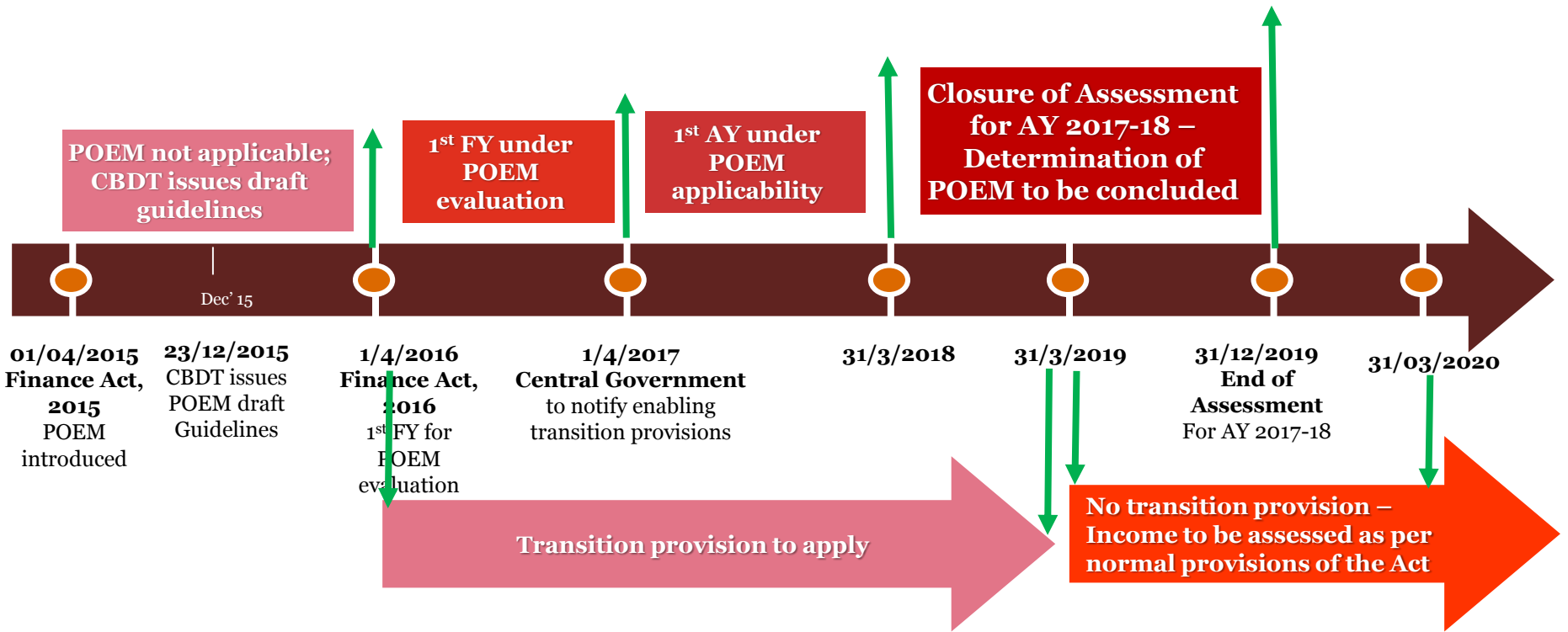
Opportunity of being heard to be provided to such foreign company

Determination to be based on all relevant factors and not isolated facts – snapshot approach not to be adopted

PoEM Assessment

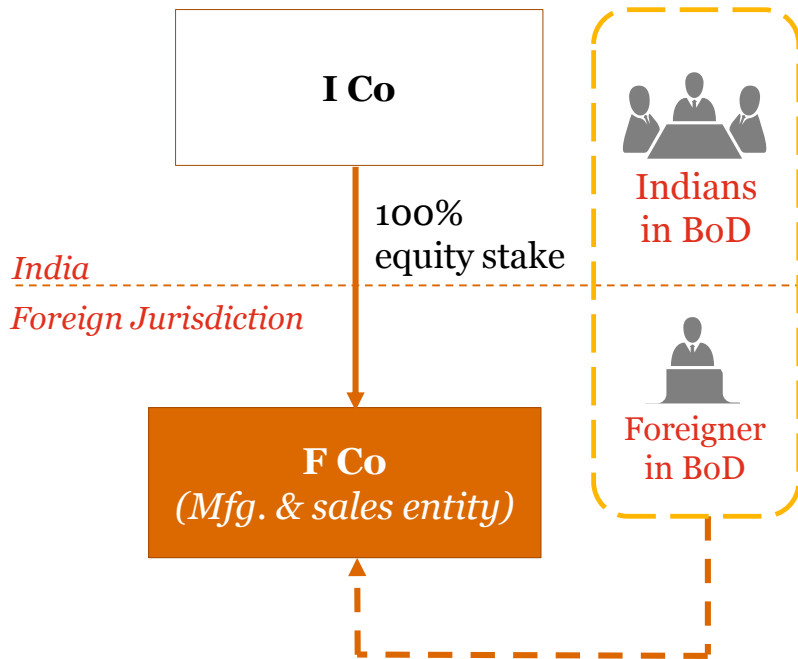


Union Finance Bill, 2016 – Transition Provisions



Need to analyze the transition provisions !

Case Study 1: Overseas Op Co – Board Composition & Meetings

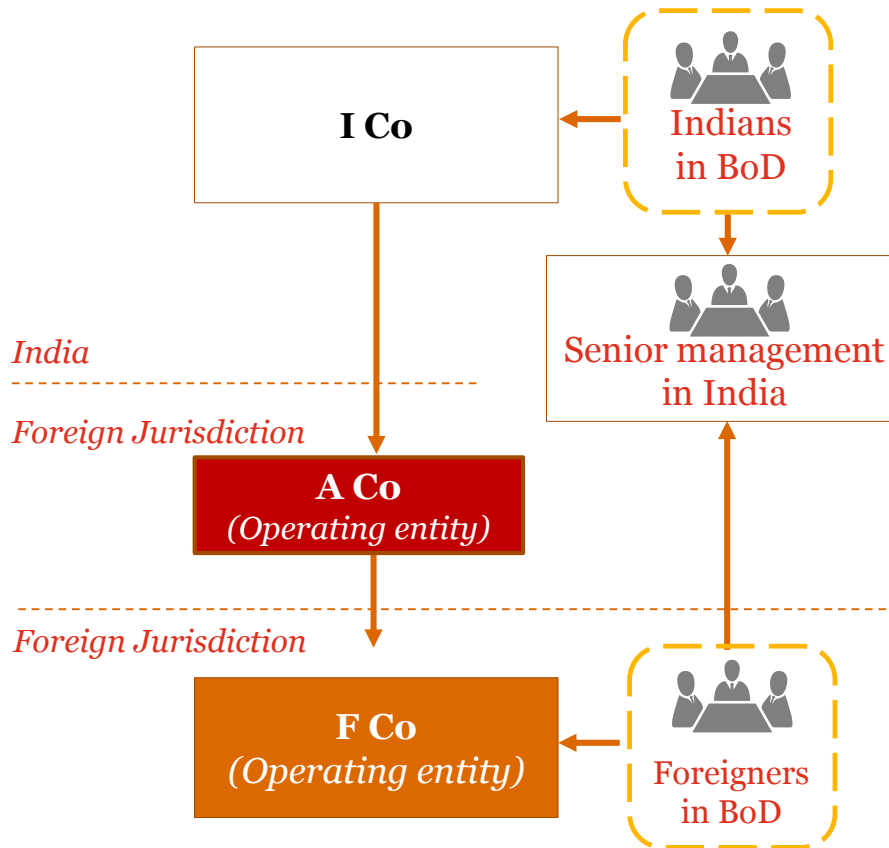


- 3 out of 4 directors (including Managing Director) on Board of F Co are Indian residents
 - 4th director is designated as Executive Director
- 6 Board meetings held of F Co – 4 outside India and 2 in India
- Pre-board meetings between directors took place in India

Whether pre-board meetings in India would have an impact on POEM of F Co ?

What if majority Indian directors attend Board meetings through VC in India ?

Case Study 2: Overseas Op Co – Senior Management in India

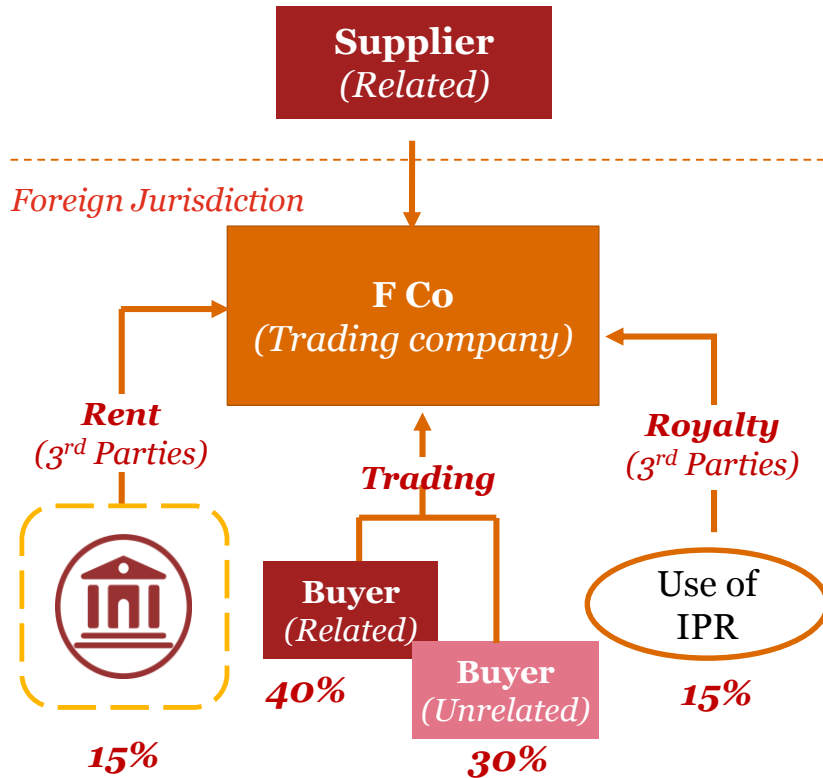


- I Co and F Co have independent distinct Boards
- Group structure has common centralized Senior Management (MD, CEO, CFO) based in India
- Senior Management provides directions to the Board of F Co
 - MD / CEO travel extensively

Whether directions by Senior Management results in POEM in India ?

Would F Co Board members' profile be relevant ?

Case Study 3: Overseas Trade Co - Substantial RPTs



- F Co. engaged in business operations (percentage to total business income)
- F Co has substantial executive presence outside India

Whether income arising from genuine business operations with unrelated parties included in 'Passive Income' ?

Senior Management is based in India with regional roles as well as local roles (under dual employment) ?

Thank You

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