

16 July 2011

EY Tax Alert

Bombay HC rules on taxation of cross-border transactions involving India-Mauritius DTAA and indirect transfer of shares of an Indian company



Executive summary

This Tax Alert summarizes a recent ruling of the Bombay High Court (HC) in the cases of Aditya Birla Nuvo Ltd. (ABNL), Tata Industries Ltd. (TIL) and New Cingular Wireless Services Inc. (NCWS), wherein writ petitions had been filed challenging the various notices issued to them. The issue under consideration was taxability, under the Indian Tax Laws (ITL), of gains arising to NCWS, a US company, on transfer of shares of an Indian joint venture company (JVC) that was held by a wholly-owned Mauritius tax resident subsidiary of NCWS as well as of gains arising to NCWS on a subsequent transfer of shares of the Mauritius subsidiary that held the balance shares in the JVC.

Having regard to the facts and circumstances of the transaction, the HC held that the Tax Authority had a prime facie case for considering the gains as taxable in the hands of NCWS and, therefore, the notices issued by the Tax Authority for initiating proceedings to assess the gains/withholding tax are valid.

In its order, the HC has made observations which suggest that, even though the Mauritius entity was the legal owner of the shares, having regard to the facts and circumstances, the gains may have accrued to NCWS, an US entity, and, accordingly, the gains may not be eligible for protection under the India-Mauritius Double Taxation Avoidance Agreement (DTAA). With regard to the acquisition of shares of the Mauritius entity, the HC has observed that the transaction, prima facie, appears to be a 'colorable device' to acquire the shares of the JVC.

Facts and background

- ▶ In 1995, US-based AT&T Corp, through its subsidiary, AT&T Wireless Services Inc. (AT&T US), entered into a joint venture agreement (JVA) with the India-based Birla Group to form a JVC in India for providing wireless telecommunication services. With the change in the JV partners at various points in time, the name of the JVC also changed. The JVC is presently known as Idea Cellular Ltd.
- ▶ As per the JVA, AT&T US, as founder, was to own and hold 49% equity stake in the JVC. The equity shares subscribed by the founders could be issued in the name of a permitted 100% subsidiary of the founder. Accordingly, the shares in the JVC that were subscribed by AT&T US were allotted to AT&T Cellular Private Ltd., Mauritius (AT&T Mauritius), a 100% subsidiary of AT&T US. However, all rights in respect of the equity shares of the JVC, like voting rights, rights of management, right of sale or alienation etc., absolutely vested with AT&T US.
- ▶ In 2000, the Tata Group entered as a JV partner and, hence, a new Shareholders Agreement (SA) was entered into between AT&T US, the Birla Group and the Tata Group for holding proportionate shares in the JVC. Consequently, the original JVA was succeeded by the SA. This SA also proportionately reduced the powers of the founders to reflect the new tripartite arrangement.
- ▶ In 2004, Cingular Wireless LLC, US acquired the shares of AT&T Wireless from AT&T Corp and renamed it as New Cingular Wireless Services Inc., USA (NCWS).
- ▶ In 2005, NCWS decided to exit and, having received an offer from an unrelated party, was obliged under the SA to offer such shares to the Birla Group and the Tata Group (as they had the first right of refusal). Both of them accepted the offer.
- ▶ It was decided that ABNL, representing the Birla Group, would directly acquire its share of the shares in the JVC from AT&T Mauritius. It was expected that the capital gains on this transaction would be protected from capital gains tax in India by the favorable Article 13 of the DTAA.
- ▶ TIL, representing the Tata Group, would, thereafter, acquire the entire shares in AT&T Mauritius from NCWS, representing its stake in the JVC. Since the shares transferred would be that of AT&T Mauritius in Mauritius, this transaction was also considered as not taxable in India as it did not relate to transfer of any capital asset situated in India.
- ▶ Share Purchase Agreements (SPAs) reflecting the above were entered into by the purchasers (ABNL and TIL) with NCWS, jointly with AT&T Mauritius (the immediate shareholder of the JVC).
- ▶ ABNL applied to the Tax Authority for a no-objection to remit the entire consideration to AT&T Mauritius without withholding any taxes.

- ▶ ABNL argued that the shares were acquired from a tax resident of Mauritius holding a valid Tax Residency Certificate (TRC). Hence, capital gains arising on transfer of shares of the JVC should not be taxable in India by virtue of Article 13 of the DTAA. Reliance was placed on various administrative circulars^[1] and also on the decision of the Supreme Court (SC) in the case of Azadi Bachao Andolan^[2] to contend that, as AT&T Mauritius was holding a valid TRC, the DTAA should apply and, hence, no taxes should be required to be withheld. The Tax Authority agreed with ABNL and issued a nil withholding tax order. Sale consideration was paid to AT&T Mauritius. Thereafter, AT&T Mauritius immediately used the funds to pay dividends to NCWS and repay a debt from NCWS.
- ▶ Subsequently, the Tax Authority sought to tax the transaction in the hands of ABNL as a representative agent of the seller on the basis that the actual seller was not AT&T Mauritius but the US entity, NCWS (successor of AT&T US). Furthermore, the transfer was of the stake in the JVC and, hence, should be taxable in India even if the transfer related to shares of AT&T Mauritius outside India. Notices were also issued to the buyers for taxing them as taxpayers in default for failure to withhold taxes on the transaction/representative agent of the sellers. Assessment proceedings were also initiated directly against the alleged seller, NCWS.
- ▶ Against these various notices, writ petitions were filed by the parties before the HC. These writ petitions were collectively decided in this decision. The key issue was to determine whether any income chargeable to tax in India had accrued or arisen or deemed to have accrued or arisen in India on account of the exit of NCWS by transferring its stake in the JVC to TIL and ABNL, as explained above.
- ▶ In these circumstances, the prima facie view of the Tax Authority that the equity shares in the name of AT&T Mauritius were only as a permitted transferee of AT&T US under the JVA and that such allotment did not confer any beneficial ownership on AT&T Mauritius as expressly provided under the terms of the JVA, cannot be faulted.
- ▶ Even the substituted SA that was entered into with the entry of the Tata Group did not, in any way, impair or obliterate the ownership rights in the shares of the JVC vested in the JV partners, whether allotted prior to or subsequent to the SA. As per the JVA and the SA, the ownership of the shares was to vest in AT&T US.
- ▶ NCWS became a successor of AT&T US in this arrangement. Sale of shares in the JVC could be effected by AT&T Mauritius only with the consent of NCWS (as successor to AT&T US), pursuant to the JVA and, thereafter, the SA. That is why, in the SPAs under consideration, NCWS was a joint party with AT&T Mauritius. If AT&T Mauritius was, indeed, the owner of the shares in the JVC, there was no requirement for NCWS to be a party to the SPA.
- ▶ The provisions of the DTAA and administrative circulars explaining the provisions would apply only where investments are made by entities incorporated in Mauritius. It would have no relevance in the present case where investments in India were made by AT&T US under the JVA (as modified by the SA) through its permitted transferee, AT&T Mauritius. The decision of the

HC's ruling

Taxation of transfer of shares in the JVC by AT&T Mauritius

- ▶ The sequence of events indicates that it was AT&T US that carried on business in India and owned the equity shares of the JVC through AT&T Mauritius. Under the JVA, the obligation to subscribe and own shares of the JVC was on AT&T US.
- ▶ The fact that AT&T Mauritius made payments to the JVC towards equity shares would not make it the owner of the shares because, under the JVA, the JV partners alone were to subscribe and own the shares in the JVC. It is only because the JVA was implemented by the JV partners that shares were allotted to AT&T Mauritius. Apart from the JVA, there is no other document on record to show that AT&T Mauritius had independently entered into any transaction for acquiring the equity shares of the JVC. Therefore, it is evident that the payments made by AT&T Mauritius were for and on behalf of AT&T US.

^[1] Circular Nos. 682 dated 30 March 1994 and 789 dated 13 April 2000 issued by the Central Board of Direct Taxes

^[2] [263 ITR 706]

SC in the case of Azadi Bachao Andolan also would have no application.

- ▶ The argument that the amount received was not sale proceeds but represented the dividend income and return of loan advanced by AT&T US to AT&T Mauritius cannot, prima facie, be accepted. This is because, under the JVA, the liability to pay for equity shares was on AT&T US and if AT&T US discharged its liability by a device of advancing loan to AT&T Mauritius and paying through AT&T Mauritius, it was open to the Tax Authority to discard the device and take into consideration the real transaction between the parties.
- ▶ The SC decision relied on by ABNL: assets belonging to a wholly-owned subsidiary cannot be regarded as belonging to the parent company; the person whose name is entered in the register of members is to be regarded as the holder of shares; cannot be applied to the facts of the present case.
- ▶ Since AT&T Mauritius was not the 'owner' of shares in the JVC, the DTAA protection was not available. Prima facie, the transaction under the SPA was basically to transfer the entire right, title and interest in the JVC by NCWS (successor in interest of AT&T US).

Taxation as representative agent of the seller

- ▶ As per the provisions of the ITL, a taxpayer can be treated as a 'representative agent', with respect to income of a non-resident (NR), if it is deemed to accrue or arise in India.

- ▶ In the case of Eli Lilly ^[3], the SC had held that any income which accrues in India or is received in India will also qualify as income which is deemed to accrue or arise in India. In the present case, transfer of shares of the JVC constitutes transfer of a capital asset situated in India. Since this income is specifically enumerated under the deeming provision of the ITL, it would also be considered as income deemed to accrue or arise in India. Therefore, income to NCWS on transfer of shares of the JVC can be assessed to tax in India in the hands of ABNL, as a representative agent, under the provisions of the ITL.
- ▶ Issuing of a nil withholding certificate initially and, thereafter, treating ABNL as a representative agent was appropriate in the present case. This is because the same was obtained by 'suppressing material facts' before the Tax Authority by suggesting that the shares were held by AT&T Mauritius even when ABNL was very much aware of the entire background of the transaction.
- ▶ Withholding provisions and treatment as a representative agent operate in different fields and one does not preclude the initiation of the other. The former is as a payer of income to the latter, while the proceedings of a representative agent grant rights to ABNL to recover taxes paid on behalf of the principal (i.e., NCWS).
- ▶ Ordinarily, the Tax Authority must not proceed against the representative agent once proceedings are initiated against the NR.

^[3] [312 ITR 225]

However, in exceptional cases, like the present one, where the facts presented appear to have been suppressed, it is open to the Tax Authority to continue with parallel proceedings against ABNL, being a representative agent, and also against NCWS, being an NR, simultaneously. The ITL does not prohibit such action undertaken by the Tax Authority.

Taxation of transfer of shares in AT&T Mauritius

- ▶ TIL argued that the transaction envisaged under the SPA was for the purpose of acquiring shares of AT&T Mauritius and not the shares of the JVC. Furthermore, appropriate approvals had also been obtained from the regulatory authorities for acquiring the entire stake in AT&T Mauritius and, therefore, the Tax Authority should not question the genuineness of the transaction and the proceedings initiated should be dropped.
- ▶ The HC observed that, TIL, while exercising its right of first refusal as per the SA, had agreed to purchase shares in the JVC from NCWS. However, instead of purchasing the said shares, an SPA was subsequently entered into, whereby the entire stake in AT&T Mauritius was acquired. The question that arose was whether the transaction under the SPA was for acquiring the shares of the JVC as AT&T Mauritius was not holding any other asset.
- ▶ TIL cannot be said to be unaware of the fact that the shares in the JVC were beneficially owned by NCWS as TIL was also one of the parties to the SA. Furthermore, it was also agreed under the SPA to transfer such shares only after ABNL

acquired its stake, as explained earlier. All these aspects point out that the entire transaction was a 'colorable device' and, therefore, the Tax Authority's action of treating TIL as a representative agent for assessing the gains on the transaction was justified.

Taxability of the transaction in the hands of the recipient

- ▶ The Tax Authority initiated assessment proceedings directly on NCWS. The HC, after scrutinizing the SA as well as the SPA, held that the transaction, as depicted, does not appear to be bona fide as ABNL and TIL, in exercise of their rights of first refusal, had agreed to purchase the stake in the JVC. Thus, prima facie, the entire transaction under the SPAs entered into by NCWS was merely for transferring the right, title and interest in the JVC to the other JV partners. Therefore, the initiation of assessment proceedings by the Tax Authority was appropriate. However, NCWS was asked to prove the contrary by placing the relevant material facts during the assessment proceedings.

Authority for Advance Rulings appeared to have provided some degree of comfort on the eligibility of benefits under the DTAA based on a TRC, this HC ruling does seem to raise a number of questions which are likely to result in a fair bit of uncertainty for taxpayers. While one still awaits the Supreme Court ruling in the Vodafone case on indirect transfer of shares, the observations made by the HC in this ruling are likely to exacerbate the ambiguity that currently prevails on this matter. This development reinforces the need for taxpayers to exercise adequate caution while structuring cross-border M&A transactions involving India.

Comments

Taxation of cross-border acquisitions involving indirect transfer of shares of an Indian company as well as the use of the India-Mauritius DTAA for structuring acquisitions has been subject to controversy over the last several years. While some recent rulings by the

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