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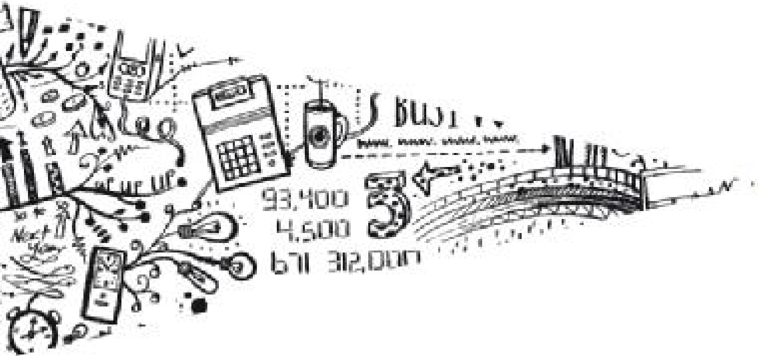
EY Tax Alert

AAR holds indirect transfer of Indian shares is taxable on grounds of tax avoidance



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Executive summary

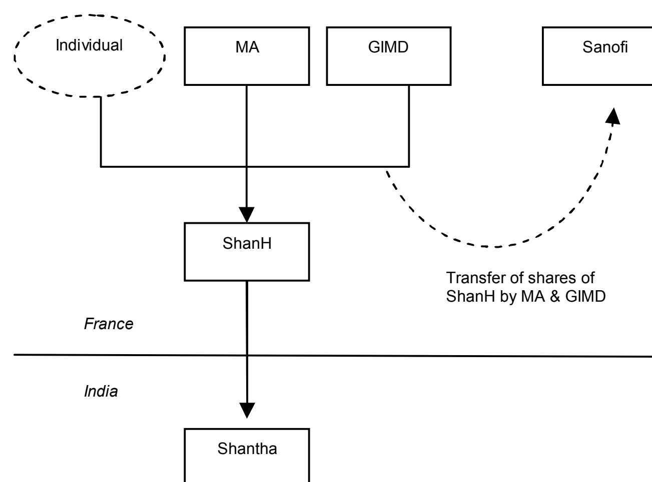
This Tax Alert summarizes a ruling of the Authority for Advance Rulings (AAR)[1] in the case of Mereiux Alliance (MA) and Groupe Industrial Marcel Dassault (GIMD) (collectively referred to as 'Applicants') on the issue of taxability of indirect transfer of shares of an Indian company. The shares of an Indian company were held by a French subsidiary of the Applicants. The French subsidiary held no assets other than the shares in the Indian company. The Applicants transferred the shares of the French subsidiary to Sanofi Pasteur Holding (Sanofi), a third party buyer, and sought a ruling from the AAR on whether the sale of shares of the French subsidiary to Sanofi was taxable in India. The AAR held that the transfer of shares of the French subsidiary was a scheme for avoidance of Indian tax that could potentially have arisen if the shares of the Indian company were sold to the buyer. In substance, it was a transfer of various rights, assets and controlling interest in the Indian company. The capital gains arising from the transaction was liable to tax in India under the provisions of the India-France Double Taxation Avoidance Agreement (DTAA). Even though a literal reading of the DTAA would allow India to tax only gains arising from alienation of shares of an Indian company, going by a purposive interpretation of the DTAA, one would need to ignore the tax avoidance scheme and consider the gain as taxable in India.

[1] [TS-700-AAR-2011](AAR No 846 & 847 of 2009)

Background and facts

- The Applicants were companies incorporated in France. MA incorporated a wholly-owned subsidiary (ShanH) in France. With a view to invest in India, MA entered into a share purchase agreement, in 2006, with shareholders of Shantha Biotechnics Ltd. (Shantha), an Indian company. MA acquired 80% shares of Shantha in the name ShanH. The due diligence of the above transaction, funding of consideration and payment of stamp duty were done by MA.

- Over the years, GIMD and another foreign individual acquired shares in ShanH from MA. Thereafter, in 2009, MA and GIMD transferred their shareholding in ShanH to Sanofi, a French company (Transaction), for commercial reasons of a strategic alliance in relation to activities in India.



- The Tax Authority was of the view that the Transaction resulted in transfer of majority controlling interest in Shantha and initiated proceedings against Sanofi for failure to withhold taxes under the Indian Tax Laws (ITL) on payments made by it to MA and GIMD.

- The Applicants claimed that the subject matter of the transfer was the shares of ShanH (a French company) and not the shares of the Indian company. In 2009, the Applicants approached the AAR for ascertaining the tax liability, if any, in the Transaction and the application was admitted by the AAR. The Tax Authority had challenged the AAR's jurisdiction to hear the issue and a writ petition was filed before the Andhra Pradesh High Court (HC). The HC upheld the admission of the application by the AAR.

- Even though the AAR admitted the application, the AAR clarified that it could revisit the question of maintainability of the application during the course of proceedings, on merits.

- Pursuant to the above, the AAR has now ruled over the following issues raised by the Applicants:
  - Whether capital gains arising from transfer of shares of ShanH are taxable in India under the ITL or the DTAA.
  - Whether the Transaction can be seen as transfer of controlling interest in India and whether it is liable to be taxed in India under the DTAA.

- As per the DTAA, capital gains arising from alienation of shares held by a resident of France, representing participation of at least 10% in an Indian company, would be taxed only in France.

Furthermore, gains from alienation of any other asset by a resident of France are taxable only in France.

Applicants' arguments

- The Transaction involved transfer of shares of a French company. Any attempt to tax this Transaction in India was not sanctioned by the ITL and certainly not by the DTAA.
- In view of the Supreme Court (SC) decision in the case of Azadi Bachao Andolan[2], it was not permissible to ignore the corporate structure of ShanH, the Tax Residency Certificate produced and the recognition of the Transaction even by the Government of India and proceed to tax the underlying Transaction.
- There was no treaty shopping or tax evasion involved since the capital gains were taxable in France under its domestic laws and all that was being sought for was a ruling on the interpretation of the relevant article in the DTAA.
- A taxing statute has to be interpreted strictly. 'Underlying assets' and 'controlling interests' are not concepts that can come into reckoning while interpreting a taxing statute.
- The setting up of a subsidiary company for making fresh acquisitions was a legal, permissible and known-method of business. It was a legitimate business route to transfer the shares of ShanH by Sanofi which resulted in transfer of control of the affairs of Shantha to Sanofi.

[2] [263 ITR 706]

Tax Authority's contentions

- The AAR was barred from pronouncing a ruling on the matter since the withholding tax proceedings against Sanofi were pending and the Transaction was, *prima facie*, a tax avoidance scheme.
- ShanH was only a paper company having no office, no employees, no business and it held no other assets than the shares in Shantha. MA appointed its own Director as a Director in ShanH and MA assumed the right to nominate the Members on the Board of Shantha as well. ShanH was created merely for the purpose of dealing with the assets of Shantha and for avoiding tax liability that may have arisen on dealing with shares of Shantha.
- 'Alienation' is a word of wide import. Under the DTAA, alienation of shares is coupled with the participation of at least 10% in a company, which implies that conveying of such rights of participation would also attract tax in India if the interest of participation is of an Indian company.
- 'Participation' in a company would mean the right to vote, to nominate Directors, control and management, day-to-day decision making and the right to get distribution of profits. All these rights in Indian company, Shantha, were with MA and GIMD, which were transferred.
- The Transaction of transfer of shares of ShanH by the Applicants to Sanofi was, in reality, a transfer of the assets, bundle of rights and controlling interest in Shantha, which were taxable in India.

Ruling by the AAR

On maintainability of the application

- Pending withholding proceedings or even an order passed under tax withholding provisions of the ITL were preliminary and not conclusive and would not be a bar for entertaining an application for an advance ruling.
- The argument put forth by the Applicants was that the Transaction was taxable in France and, hence, there was no tax avoidance. Even if the above is acceptable, the AAR can still examine whether the scheme is designed, prima facie, for avoidance of Indian tax.

On tax avoidance

- The SC decision in the case of Azadi Bachao Andolan, even though binding on the AAR, may not be the final word given in the situation.
- The SC, in the case of Azadi Bachao Andolan, considered the effect of its earlier decision of the Constitutional Bench in the case of McDowell & Co. v. Commercial Tax Officer[3] wherein an attempt at tax avoidance was held as unacceptable. In the case of Azadi Bachao

[3] [154 ITR 148]

Andolan, the SC proceeded on the basis that the earlier views were that of one of the judges and not that of the Constitutional Bench. This appears to be incorrect on a close reading of the McDowell decision.

- For a *prima facie* determination of whether there was an attempt to avoid tax, the AAR is not piercing the veil of the corporate entity but is only examining whether there were any steps taken which may have business purpose but were clearly a device to avoid tax liability.

- A usually adopted business scheme can be treated as an unacceptable attempt of tax avoidance in the circumstances, depending on the effect of the scheme as a whole on the liability of the entity to be taxed.

- Reliance was placed on various English Courts' decisions and it was observed that if the purpose of a transaction was to create a legal smoke screen to avoid payment of legitimately due tax, the effect of the transaction had to be considered in the context of a taxing statute, notwithstanding its reality or validity.

- The series of transactions, right from the incorporation of ShanH, was a preordained scheme to avoid payment of capital gains tax in India, which would otherwise arise if shares of the Indian company were transferred. Such an attempt is frowned upon by the SC in Mc Dowell's case and by various English Courts.

- By accepting such attempts in the context of the taxing statute, it would open the door for the passing of the assets and control of an Indian company repeatedly without the shares of the Indian company being touched.

- The Transaction involved is not one to be taken at face value since it is one intended to avoid payment of tax on capital gains in India.

On corporate veil and controlling interest

- It is not necessary to ignore the existence of ShanH to come to a conclusion that what is put up is a façade in the context of tax laws.

- MA had acquired a controlling interest in Shantha through its subsidiary ShanH. Since ShanH had no business or other assets, except the shares in Shantha, what was being transferred by the Transaction were the underlying assets, business and control of the Indian company.

- The transfer of shares of ShanH may have commercial and business validity but that does not prevent examination of the efficacy of the Transaction in the context of the ITL or the DTAA. As observed, the Transaction of transfer of shares of ShanH is a scheme for tax avoidance and the same has to be ignored.

- As the Transaction is a scheme for avoidance of Indian tax, the AAR may decline to rule on the questions. However, since the AAR had admitted the application, it would consider the questions on merits for completion of proceedings as well as in the eventuality that the SC (in case the ruling on tax avoidance was challenged before the SC) were to disagree with the conclusion.

- A literal construction of the DTAA leads to the conclusion that transfer of shares in ShanH would be taxable only in France. However, a purposive construction of the DTAA would lead to a conclusion that capital gains from the Transaction would be taxable in India. As the Transaction was part of a scheme for tax avoidance, the scheme has to be ignored. The gain from the Transaction is, therefore, taxable in India. The conclusion is based, not on a literal interpretation of the DTAA, but a purposive construction. Consequently, the question as to whether controlling interest constituted a separate asset was not required to be answered.

Comments

The issue of taxability of indirect transfer of Indian shares has been a contentious issue in recent times. The matter is currently pending before the SC in the Vodafone case[4]. In addition to the issue of taxability of indirect transfers, the present ruling raises a number of other controversial issues such as approach to tax treaty interpretation, application of tax avoidance principles in general and, specifically, in the context of tax treaties and jurisdiction of the AAR to pronounce a ruling on merits once it determines that the application is not maintainable. One would hope that some of the above issues, which have the potential for creating uncertainty and ambiguity for foreign investors on taxability of their transactions, would reach finality once the SC pronounces its ruling in the Vodafone case.

[4] Please refer to Ernst & Young Tax Alert dated 24 October 2011 'The 'Vodafone Case': The last chapter?'

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