Delhi High Court's landmark ruling on 'Indirect transfer' taxation

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In brief

Recently, in a landmark judgment, the Delhi High Court (HC) dismissed the writ petitions filed by the Indian Revenue Authorities against the ruling of the Authority for Advance Rulings (AAR). The AAR had held that the capital gains arising on sale of shares of an Indian company by a Mauritius company (Direct Transfer), and on the sale of shares of a US company (which in turn held shares of an Indian company) by another Mauritian company (Indirect Transfer), shall not be chargeable to tax in India on applicability of the beneficial provisions of Article 13(4) of the India Mauritius Double Taxation Avoidance Tax Treat (tax treaty).

The HC, while examining the taxability of 'indirect transfer', has adjudicated on the applicability of Explanation 5 to section 9(1)(i) of the Income-tax Act, 1961 (the Act), and also interpreted the term 'substantially' in the said explanation and held that it would cover transfer of shares of a company incorporated overseas, which derive more than 50% of their value from assets situated in India, and not otherwise.

In detail

Facts

- Copal Partners Limited, Jersey (Copal–Jersey)[1], held 100% of the shares in Copal Research Limited, Mauritius (CRL). CRL, held 100% of the shares in Copal Research India Private Limited, India (CRIL).
- Further, CRL also held 100 per cent of shares in Copal Market Research Limited, Mauritius (CMRL). CMRL Mauritius, in-turn, held 100% shares in Exevo Inc., USA, (Exevo Inc. US). Exevo Inc. US held 100% of the shares in Exevo India Private Limited, India (Exevo India).
- Three separate Share Purchase Agreements (SPA's) were signed between Copal Group (Sellers) and Moody's Group (Buyers) which had the following effects:
  - **<u>Transaction I</u>:** Sale of 100% shares of CRIL by CRL to Moody's Group Cyprus Limited (Moody's Cyprus) (SPA–I entered on November 3, 2011);
  - **<u>Transaction II:</u>** Sale of 100% shares of Exevo Inc. US by CMRL to Moody's Analytics Inc., USA (Moody's–USA), (SPA–II entered on November 3, 2011); and
  - **<u>Transaction III:</u>** Sale of 67% shares of Copal - Jersey to Moody's–UK, (SPA–III entered on November 4, 2011).
- On these facts, advance ruling was sought by the sellers and the buyers on the question of taxability in India of gains arising from Transaction 1 and 2, and consequently corresponding tax withholding obligations if any, on the respective buyer. The AAR passed a common order in favour of the applicants by holding that capital gains arising on sale of shares pursuant to Transaction 1 and 2 shall not be chargeable to tax in India, and consequently there shall not be any withholding obligation.
- Aggrieved by the AAR's ruling, the Revenue filed writ petitions before the Delhi HC.

[1] DIT(International Tax) *v.* Copal Research Limited [TS-509-HC-2014(DEL)]

Proceedings before the HC

Allegations of the Revenue:

- The transactions were structured prima facie for avoidance of tax, and therefore advance ruling was not maintainable by virtue of section 245R (2)(iii) of the Act;
- Transaction 1, Transaction 2 and Transaction 3 were an integral part of a single transaction, and these must not be viewed in isolation;
- The transactions were structured to transfer the entire businesses and interests of the Copal group to the Moody Group;
- All three transactions were structured in order to avoid the incidence of tax arising out of Transactions 1 and 2 by taking benefit of India-Mauritius tax treaty;
- Capital gains arising from sale of shares of Copal–Jersey would be subject to tax, if shares of Exevo–US and CRIL had not been sold by CRL and CMRL;
- The entire structure of investment to hold the companies in India had been evolved only with the object of avoiding tax and that the intermediary companies in Mauritius had been incorporated only with a view to avoid tax; and
- CRL and CMRL are shell companies.

Rebuttals of the respondents (sellers and buyers):

- The entire structure had evolved over a period of time since 2004, and none of the entities were created or inserted for the purpose of transactions with Moody's group;
- The three transactions were separate and distinct from each other. In Transaction 1, Moody's Cyprus acquired 100% shares in CRIL. In transaction 2, Moody's USA acquired 100% shares in Exevo Inc. (indirectly 100% interest in Exevo India). In the third transaction, Moody's acquired 67% shares in Copal Jersey and consequently interest in rest of the Copal Group (excluding CRL and CMRL and the companies held by them);
- There is a commercial rationale for the sale of shares in CRIL and Exevo–US as Moody's had interest on acquiring the entire 100% capital of those companies;
- Therefore, commercially transactions could be effected only in the manner in which these were done, as otherwise, by acquiring 67% stake in Copal Jersey, Moody's could not have acquired 100% stake in CRIL & Exevo–US;
- The structure of transfer as suggested by the Revenue would not give the same/ similar result as commercially agreed between the parties as, in that case, the buyer could not have acquired 100% control over Indian Companies;
- Mauritius companies were managed by the respective Boards of Directors and held category-I Global Business Licences. Further, they also received substantial revenues from provision of services. Therefore, the companies were in fact operational companies and not shell companies;
- In absence of LOB clause in India Mauritius tax treaty, it is not open to the Revenue to challenge the Treaty benefits;
- Available judicial precedents support that Mauritius sellers are entitled to India Mauritius tax treaty benefits; and
- It is apparent that only a fraction of the value of shares of Copal–Jersey was derived indirectly from the value of the shares of CRIL and Exevo–India. Therefore, section 9(1)(i) read with Explanation 5[2] had no application as the said value was not 'derived substantially' as mandated by Section 9(1)(i) read with Explanation 5 thereto.

Decision of the HC:

- The contention of the Revenue that the entire structure had been evolved only with the object of avoiding tax is devoid of any merits as the organisation structure was in existence over a period of time.
- The transaction structure as suggested by the Revenue, i.e., sale of shares at Copal–Jersey level alone, would not give same commercial results vis-à-vis actual transaction, and therefore the allegation that the transaction at Mauritius level was made to avoid an incidence of tax in India needs to be ruled out;
- The funds flow involved payment of dividends (by virtue of consideration received by CRL and CMRL as a result of Transaction 1 and Transaction 2) to Copal Group shareholders as well as to banks and financial institutions who were also shareholders in Copal Jersey. This would not have been possible without Transaction 1 and Transaction 2;
- Even if transactions are to be examined at Jersey level (ignoring SPA1 sand SPA2), no taxability could arise in India, as:
  - Only a fraction of the value of shares of Copal–Jersey derived

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[2] Explanation 5 (along with Explanation 4) was inserted in Section 9 of the Act to neutralize the judgment of the Supreme Court in the case of Vodafone International Holdings BV *v.* UOI [(2012) 204 Taxman 408], so as to cover cases of indirect transfer of shares within the Indian tax net.

Explanation 5 (which places thrust on the term 'substantially') reads as - "*For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value **substantially** from the assets located in India;*"

  - its value indirectly from Companies in India (i.e. CRIL and Exevo-India);
  - There could be no recourse to Explanation 5 to enlarge the scope of section 9(1) of the Act so as to cast the net of tax on gains or income that may arise from transfer of an asset situated outside India, which derived bulk of its value from assets outside India;
  - The expression "substantially" occurring in Explanation 5 to section 9(1)(i) introduced by the Finance Act, 2012 with retrospective effect from April 01, 1962 would necessarily have to be read as synonymous to "principally", "mainly" or at least "majority". Thus, this should represent more than 50% threshold[3];
  - Gains arising from sale of shares of a company incorporated overseas, which derives less than 50% of its value from assets situated in India, would not be taxable under section 9(1)(i) of the Act read with Explanation 5 thereto;
- The Revenue was unable to show that the effective management of the companies was not where the Board of Directors of the company was situated;
- The fact that the companies were rendering services to related parties, would not render the companies to be non-existent or give reasons for lifting the corporate veil; and
- CRL and CMRL were Mauritian resident companies, as these were managed by their respective Boards of Directors.

The takeaway

While the Revenue may decide to file an appeal against the decision, the Delhi HC upheld the AAR's ruling on non-taxability of gains arising from sale of shares by Mauritian Companies (that held the shares in Indian companies, either directly or indirectly).

While upholding the decision of AAR, the Delhi HC, in a landmark decision, interpreted the 'Indirect transfer provisions' in light of section 9(1)(i) of the Act, and the term 'substantially' by relating the term to the context and intent of that section, while also relying on OECD/ UN Model commentaries, etc.. The commercial rationale behind the transaction, including the adverse effect it would have if it were done as suggested by the Revenue, was amply considered by the HC in rejecting the writ petition of the Revenue.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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[3] For this purpose, the HC referred to the draft report of Shome Committee on retrospective amendment, Direct Taxes Code Bill (2010), UN and OECD Model Conventions in connection with Articles relevant to Capital Gains

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