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Expert Committee Report on Retrospective Amendments Relating to Indirect Transfer

The Finance Act, 2012 introduced certain amendments having retrospective application from 1 April 1962. One such retrospective amendment was introduction of Explanation 5 to section 9(1)(i) of the Act to tax indirect transfer of shares or interest in a foreign entity which derived its value from assets in India. This amendment, besides widening the incidence of Indian tax laws, with its retrospective implementation, also overruled the Supreme Court ruling on the issue of taxability in India of indirect transfers. For these reasons, this amendment in particular, caused apprehensions amongst the investor community and also raised questions regarding the certainty of tax positions in India. Accordingly, amidst pressure from the various forums and industry groups, the Prime Minister constituted an Expert Committee under the chairmanship of Dr. Parthasarathi Shome (hereinafter referred to as the 'Shome Committee') to analyse the

amendments introduced vide the Finance Act 2012 and provide its recommendations.

Key Recommendations of the Shome Committee

Following is the gist of key recommendations made by the Shome Committee vide its report¹ relating to indirect transfers:

- Amendment of tax law having effect retrospectively should be done in exceptional or rarest of rare cases and should only be to clarify the legislative intent. They should not have the effect of widening the tax base.

¹ Draft Report on Retrospective Amendments Relating to Indirect Transfer

- Amendments relating to taxation of indirect transfer of assets made in Finance Act, 2012 are not clarificatory in nature and instead would tend to widen the tax base; the Committee recommends that these provisions after introducing clear definitions, should apply prospectively.
- Where the Government decides to apply the provisions retrospectively, the following should also be provided for
 - No person should be treated as assessee in default under section 201 read with section 9(1)(i) of the Act or a representative assessee of a non resident;
 - The provisions to apply only to the taxpayer who has earned capital gains from indirect transfer;
 - Where tax demand is raised pursuant to provisions relating to indirect transfer, interest under sections 234A, 234B, 234C and 201(1A) of the Act should not be levied. Further, penalty under sections 271(1)(c) and 271C of the Act should not be levied.
- As regards the provisions of Explanation 5 to section 9(1)(i) of the Act, the Shome Committee recommends as follows:
 - The term 'asset or capital asset' be replaced by 'capital asset' as the intention of the section is to tax shares or interest in an entity held as capital asset only.
 - The Panel has recommended that the word 'substantially' be defined as a threshold of 50% of the total value derived from global assets of the Indian company or.
 - The phrase 'share or interest in a company or entity' should be defined to include only such share or interests which result in participation in ownership, capital, control or management. Accordingly, mere economic interest in shares should be excluded.
- The term 'directly or indirectly' should be clarified to represent the 'look through approach' which implies that all intermediaries between the foreign company and assets in India would be ignored.
- The term 'value' be clarified as 'fair market value' as may be prescribed and the value shall be ascertained based on net assets of the company. It may be further clarified that the value be determined at the time of the last balance sheet date of the foreign company with appropriate adjustments made for significant disposal/acquisition, if any, between the last balance sheet date and the date of transfer.
- The above recommendations also apply to private equity investors.
- Further, in order to avoid undue hardship to small shareholders, the Committee recommends that the transfer of share or interest of a company or entity outside India may be excluded from taxation in India if the shareholding of transferor and its associated enterprises in the Indian company or in the immediate holding company, is less than 26% of total voting power or share capital of the company or entity during the preceding 12 months.
- Foreign company listed on a recognised stock exchange, shares of which are frequently traded in, be exempted.
- Intra group restructuring (in the form of amalgamation or demerger as defined under the Act or any other form of group restructuring) be exempted from taxation subject to the following conditions:
 - Such transfers are not taxable in the jurisdiction where the company is resident
 - Minimum 75% ownership should continue in case of amalgamation or demerger and 100% in other form of restructuring within the group.

- Since direct and indirect investments by foreign institutional investors (FII) are subject to tax in India in the hands of FII, the same should be excluded from taxation in India.
- Where the provisions of section 9(1)(i) of the Act read with Explanation 5 apply, the general provisions of section 2(47) of the Act relating to transfer should not apply on a standalone basis.
- The capital gains proposed to be taxed under this section should be taxed proportionally to the extent the value of the share or interest is derived from assets in India.
- Dividends paid by a foreign company shall not be deemed to accrue or arise in India under section 9(1)(i) of the Act read with Explanation 5.
- In order to provide certainty to foreign investors, it is clarified that in double taxation avoidance agreement (tax treaty) situations the provisions of section 9(1)(i) of the Act should be applied only if right of taxation of capital gains is specifically provided to India based on its domestic laws in the applicable tax treaty or the tax treaty specifically provides right of taxation to India on transfer of shares or interest of a foreign company or entity.

The report states that the aforesaid recommendations may be carried out through amendment of the Income-tax Act, 1961 or Income-tax Rules, 1962 or by way of an explanatory circular, as appropriate in law.

Conclusion

The Shome Committee, in its report has made some welcome recommendations, which if considered/implemented by the Government are likely to bring in certainty in the taxation of indirect transfers in India and restore the much needed confidence of the foreign investors in the Indian tax regime.

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