

# Sharing insights

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## **AAR rejects application as the share arrangement flouted the SEBI guidelines and impaired public interest even though no tax avoidance motive existed**

### **In brief**

Recently, the Authority for Advance Rulings (AAR) rejected Mahindra–BT Investments<sup>1</sup> (applicant) application on the ground that the share arrangement entered into by the applicant was designed to circumvent the Securities and Exchange Board of India (Disclosure & Investor Protection) Guidelines 2000<sup>2</sup>

(SEBI guidelines) and thus impair public interest. The AAR held that it cannot shut its eyes to this illegality, even if no tax avoidance motive existed.

### **Facts**

- In 1986, Mahindra and Mahindra Ltd, India (M&M) and British Telecommunications Plc, UK (BT) formed a joint venture company (JV)-Tech Mahindra Ltd. (TML) in India.
- During 2004, TML and AT&T Ltd, USA entered into an agreement under which TML was to provide software and professional services to AT&T for an agreed price.

<sup>1</sup> Mahindra-BT Investment Co. (Mauritius) Ltd. , *In re* [2012] 24 taxmann.com 296 (AAR)

<sup>2</sup> As per clause 26(5) of the Securities And Exchange Board Of India (Issue of capital and disclosure requirements) Regulations, 2009, no issuer shall make an initial public offer if there are any outstanding convertible securities or any other right which would entitle any person any option to receive equity shares after the initial public offer.

- On 9 May 2005, the applicant company was incorporated in Mauritius as a JV between M&M and BT.
- On 10 May 2005, i.e., a day after the incorporation of the applicant, a multi-party option agreement was entered between the applicant, AT&T, M&M, BT and TML, providing that AT&T will be granted options representing 8% of the share capital of TML if certain specified milestones are achieved.
- TML wanted to have an Initial Public Offer (IPO) of shares. However, pursuant to clause 2.61 of the SEBI guidelines which prohibits the issuer to make an IPO, if there are any outstanding convertible securities or any other right which entitles the existing promoters or shareholders any option to receive equity shares after the IPO, it would not have been possible to bring out an IPO, if an obligation on the part of TML remained outstanding to allot shares to AT&T pursuant to the multi-party option agreement.
- On 23 June 2005, another agreement was entered into between the applicant and TML whereby TML agreed to issue 8% of its shares to the applicant. The applicant also entered into an agreement with AT&T to sell those shares to AT&T.
- TML came out with an IPO in 2006.
- In addition to the above, the applicant is now proposing selling the shares allotted by TML, giving rise to the question of chargeability to tax.

### Issue

- Can the AAR refuse an application on the ground that though an arrangement does not result in avoidance of tax but results in circumvention of any rule or regulation made in public interest?

### Applicant's contention

- TML wanted to have an IPO of shares which would not have been possible if it was obliged to AT&T to allot its shares as per the multi-party option agreement in line with the SEBI guidelines.
- The adopted process did not result in any tax avoidance. Even if TML had allotted the shares to AT&T in place of the applicant, this would not have attracted capital gains tax since allotment of shares is not a sale.
- The applicant had no intention to avoid tax and the aim of such allotment (to the applicant) was only to speed-up the public issue. If the current route had not been adopted, TML would not have come out with a public issue before 2010.
- It is not for the AAR to consider aspects relating to the SEBI guidelines as they were exclusively in the domain of the authorities concerned with the public issue of shares.
- The role of the AAR is only to take note of the transaction and give a ruling on questions raised, if otherwise, conditions for giving a ruling are satisfied.

### AAR ruling

The AAR denied giving a ruling on the above matter on the following grounds:

- The SEBI guidelines were avoided by entering into a circuitous arrangement whereby TML will allot its shares to the applicant and the latter will enter into a contract with AT&T to sell those shares for an agreed consideration. Thus, the obligation of TML pursuant to the multi-party option agreement was shifted to the applicant in order to facilitate an IPO.

- The SEBI guidelines are issued for the protection of public interest and thus the circumvention resulted in impairing public interest.
- Although the above arrangement of circumventing the SEBI guidelines may not directly concern the AAR, but when it is called upon to give a ruling on a transaction which it finds to be on the basis of circumventing a vital guideline issued in public interest, it cannot shut its eyes on such illegality.
- The AAR has a discretion to refuse a ruling in an appropriate case (even outside the proviso to section 245R(2)<sup>3</sup> of the Income-tax Act, 1961) as was held in the case of Microsoft Operations Pte. Ltd.<sup>4</sup>.

## Conclusion

The AAR held that the transaction was entered to circumvent a guideline which had been issued in public interest. This in itself was a sufficient ground for the authority to refuse a ruling even though no tax avoidance motive existed.

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<sup>3</sup> The AAR has the power to reject the application specifically in three cases viz. 1) where the case is already pending before any income tax authority, 2) if it involves determination of fair market value of the property and 3) it relates to a transaction which is designed *prima facie* for avoidance of income tax.

<sup>4</sup> Microsoft Operations Pte. Ltd., *In re* [2009] 310 ITR 408 (AAR)

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