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News Alert
12 March 2013

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Capital gains arising out of transfer of shares of a non resident company between two non-residents not taxable in India and lifting of corporate veil is not warranted

In brief

In a path-breaking judgement, in the long-awaited case of Sanofi Pasteur Holding SA, France[1] (the assessee, or Sanofi), the Andhra Pradesh High Court has recently overruled the earlier order passed by the Authority for Advance Rulings (AAR) in November, 2011 and held that capital gains arising out of transfer of French company's shares by French corporate shareholders to the assessee, will not be taxable in India, under the beneficial provisions of the Double Taxation Avoidance Agreement (tax treaty) between India and France. Further, it was held that the retrospective amendments to provisions of the Income-tax Act, 1961 (the Act) do not have any impact on the interpretation of the tax treaty provisions; consequentially, the Revenue's order under section 201 holding Sanofi as 'an assessee-in-default', is not sustainable.

Facts of the case

- Shanta Biotechnics Ltd, (SBL), an Indian company engaged in the business of research and development of technologies for pharmaceutical products, is a subsidiary of ShanH SAS, France (ShanH).

[1]Sanofi Pasteur Holding SA *v.* The Department of Revenue [TS-57-HC-2013 (AP)]

- ShanH is a joint venture of Merieux Alliance (MA) and Groupe Industriel Marcel Dassault (GIMD). Both MA and GIMD were French entities engaged in different lines of businesses.

- A share purchase agreement (SPA) was entered into between MA/GIMD (the sellers) and Sanofi (the buyer) of ShanH shares on 10 July, 2009. Pursuant to the SPA, Sanofi had purchased 80.37% shares of ShanH from MA and balance 19.63% of ShanH shares from ShanH.

- MA and GIMD sought advance ruling on the taxability of sale of shares of ShanH to Sanofi in India. The AAR[2] ruled that the transactions are part of a scheme for avoidance of tax and is accordingly taxable in India as per the Act and also in terms of Article 14(5) of the tax treaty.

- Aggrieved by the ruling of the AAR, the buyer as well as sellers filed a writ petition before the Andhra Pradesh High Court.

Issues before the High Court

The following key issues were *inter alia* raised before the High Court:

Issue 1: Whether ShanH is a colourable device incorporated and pursued for the purpose of avoiding capital gains liability in India and if yes, whether the same is liable to tax in India based on the interpretations of provisions under the Act and tax treaty.

Issue 2: Whether retrospective amendments to provisions of the Act alter the impact of provisions of tax treaty.

[2] Groupe Industrial Marcel Dassault, *In re* [2011] 16 taxmann.com 21 (AAR) and Merieux Alliance, *In re* [2011] 340 ITR 353 (AAR)

Revenue's contentions

Issue 1: Avoidance of capital gains tax liability in India

- The transaction under consideration is one of transfer of control, management and business interests in SBL by MA and GIMD.

- In SPA, MA is defined to include its successors and permitted assignees, whereas there is no assignment by MA in favour of ShanH. In the amended Articles of Association of SBL, MA is defined to mean itself and does not include its successor and assignee.

- MA and GIMD are legal and beneficial owners of SBL shares.

- MA and GIMD participated in capital, control and management of SBL. As such, ShanH had neither control over management nor enjoyed any shareholder's rights over SBL.

- ShanH has no commercial substance. This is supported by the fact that ShanH does not operate any business, has no fixed assets (except investment in SBL) or employees. Also, due diligence with respect to SBL was carried out on the mandate of MA.

- ShanH did not make payments for acquisition of SBL shares. The subsequent accounting by ShanH of the purchase consideration paid directly by MA to SBL, as a loan from MA, will not change reality.

- As such, lifting of corporate veil of ShanH is justified. This is supported by various judicial precedents[3].

[3] McDowell and Company Ltd. *v.* CTO [1985] 154 ITR 148 (SC), National Cement Mines Industries Ltd. *v.* CIT [1961] 42 ITR 69 (SC), Juggilal Kamalapat *v.* CIT [1969] 73 ITR 702 (SC) and

- On lifting the corporate veil, it is evident that MA and GIMD realised the gain on alienation of shares representing participation of more than 10% in the capital, control and management of SBL. Thus, the gains are chargeable to tax in India, in view of Article 14(5) of tax treaty.

- The long-term capital gains arising on transfer of controlling rights and underlying assets of SBL, is capable of computation. The gains will be computed by reducing the cost of acquisition of SBL shares by ShanH from the value of sales of ShanH shares by MA/GIMD to Sanofi.

- Once the right to tax the gains stand allocated to the source country, domestic law provisions of the source country will have to be read into the tax treaty in terms of Article 3(2) of the tax treaty, where any expression has not been defined in a tax treaty. Since 'alienation' is not defined in the tax treaty, its meaning has to be imported from the domestic law (refer section 2(47) of the Act which includes disposal of an asset whether directly or indirectly). This exercise amounts to giving effect to Article 3(2) of the tax treaty and does not amount to overriding the tax treaty.

Issue 2- Retrospective amendments

- The retrospective amendments should not be understood by resorting to the speech of the Finance Minister while introducing the Finance Bill.

Assessee's contentions

Issue 1- Avoidance of capital gains tax liability in India

- GIMD, a major business conglomerate would not have committed to invest 20% in ShanH, if MA and not ShanH was the legal and beneficial owner of SBL shares. Further, the Revenue cannot ignore that the FIPB before the transaction recognised it as a valid transaction.

- There is no necessity of any deed of assignment since ShanH owns the shares since inception.

- The copy of general ledger of ShanH substantiates remittances from ShanH to SBL towards acquisition of shares.

- ShanH is an investment company with a commercial substance of investment in an Indian company, SBL. Setting up of a subsidiary company for making fresh acquisitions was a legal, permissible and known method of doing business. ShanH is a joint venture (JV) and genuineness of JV's had never been disputed in any jurisdiction, either in India or France.

- Article 14(5) of the tax treaty does not provide for 'see through' and accordingly lifting of corporate veil is impermissible.

- The right to tax capital gain arising on the share transfer transaction was allocated to France as per the tax treaty. Further, the capital gains tax payable in France was more than the tax payable in India. Thus, ShanH was not conceived, pursued and persisted to serve as an Indian tax-avoidant scheme.

- Alternatively, it is not possible to determine the consideration and the cost of acquisition apportionable to the controlling rights and underlying assets. Where the computation provisions are linked with the charging provisions, failure of one component will also make the other inapplicable. Hence based on the provisions of the Act and tax treaty the sale of shares of ShanH was not liable to tax in India.

Aditya Birla Nuvo Ltd. *v.* DDIT [2011] 342 ITR 308 (Bom)

Issue 2- Retrospective amendments

- The retrospective amendments are not applicable where tax treaties operate along with the domestic law provisions. Reliance is placed on the Finance Minister's speech in 2012 wherein it was clarified that retrospective amendments cannot override the provisions of specific tax treaty.

High Court Ruling

Issue 1- Avoidance of capital gains tax liability in India

- ShanH was incorporated as an investment vehicle, to facilitate foreign direct investment and to cushion potential investment risks of MA/GIMD directly investing into SBL.
- ShanH purchased and owned SBL shares since inception and is the legal and beneficial owner of SBL shares, being the registered shareholder. ShanH continues to receive dividends on its SBL shareholding which are assessable to tax under provisions of the Act.
- ShanH as a French resident corporate entity is a distinct entity from MA and has commercial substance, otherwise GIMD would not have committed to invest 20% of stake in ShanH.
- Subsequently, ShanH became a JV company in which MA and GIMD were the joint venture partners.
- ShanH exists as a corporate entity and continues to hold shares of SBL after the share transfer between MA/GIMD and Sanofi.
- In the absence of any evidence to prove that ShanH was set up only as tax-avoidant device, piercing or lifting the corporate veil of ShanH is not permitted. Further, this is supported by the fact that higher rate of capital gains tax has been paid in France.
- As such, as observed in Vodafone International Holdings BV[4], further enquiry as to *de facto* control versus legal control and legal right versus practical rights by ShanH over SBL was unwarranted.
- Even on piercing the corporate veil of ShanH, the transaction was that of transfer by MA/GIMD of their ShanH shareholding as opposed to transfer of SBL shares in favour of Sanofi.
- The transaction under consideration was for alienation of 100% shares of ShanH in favour of Sanofi and did not constitute transfer or deemed transfer of shares, control, management, or underlying assets of SBL.
- The right to tax capital gain arising to MA/GIMD has been allocated to France under the provisions of Article 14(5) of tax treaty.
- The value of controlling interest or rights of ShanH over the affairs, assets and management of SBL cannot be computed separately as these rights are incidental to its shareholding and are not separate assets.

Issue 2- Retrospective amendments

- The retrospective amendments to provisions of the Act do not have bearing on the provisions of the tax treaty. There is no ambiguity in the terms 'alienation or participation' used in Article 14(5) of the tax treaty. Further, since these terms are not defined in the Act, provisions of Article 3(2) of tax treaty should not be invoked.

[4] Vodafone International Holdings BV *v.* UOI [2012] 341 ITR 1 (SC)

Conclusion

This is a landmark ruling from the High Court which would be welcoming news from the perspective of foreign strategic investors who have made investments in India through a layered structure.

Further, the High Court has commented that in cases involving tax treaty implication on domestic laws, Azadi Bachao Andolan[5] and Vodafone International Holdings BV (above) could be relevant cases that may be referred for guidance.

Besides, the High Court has laid down an important principle that retrospective amendments in the Finance Act, 2012 does not have impact on the protection and taxing rights under the tax treaty.

[5] UOI *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

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