

Recent tax developments in India highlight the need for focused legal advice on India-related cross border transactions.

Background

On 20 January 2012, the Supreme Court of India delivered a landmark ruling in *Vodafone International Holdings BV v. Union of India*¹, where it recognized a well-accepted principle of taxation: the transfer of shares of a company incorporated outside India from a non-resident seller to a non-resident buyer is not taxable by the Indian tax authorities, even if such transfer indirectly transfers an asset in India.

Vodafone closed a fairly contentious matter in which the India's income tax department spent five years trying to recover approximately US\$2.2 billion in capital gains tax it claimed was due following Vodafone's US\$11.08 billion² acquisition of Hutchison Essar Limited, from The Hutchison Group, a Hong Kong company. It was a landmark decision for the foreign investment community, particularly given that numerous other transactions that it would have affected, and was of even wider significance given what the judges said about tax avoidance. Key principles set out in the decision were:

- It was not possible to read the tax legislation dealing with transfers of capital assets situated in India as extending to indirect transfers: that would amount to reading words into the provision under Section 9(1) of the Income Tax Act 1961 (**IT Act**) which were not there.
- There was nothing objectionable about multinationals using special purpose vehicles (**SPVs**) and holding companies in cross-border structures for tax planning, commercial and regulatory reasons. However, if a SPV or a holding company was created without any commercial or business substance only to avoid tax, then the tax authorities may ignore such entity. Structuring transactions to achieve tax efficiency is permissible provided that the structure used is not a sham or a colorable tax avoidance device.
- The corporate veil could not be pierced except in exceptional circumstances where companies were used as tax avoidance devices or to perpetrate tax evasion such as round tripping of funds back into India.

- While looking at such structures, the courts and the tax department should look at transactions as a whole and not dissect them at the outset in search of an unacceptable tax motive. The factors that the tax authorities and courts should consider include: (i) duration of time for which such structure has been in existence, (ii) the period of business operations in India, (iii) the timing of the exit, and (iv) the continuity of business on such exit.
- The burden is on the tax authorities to determine the dominant purpose of a transaction and to establish that a given transaction is a sham or a colorable device designed to avoid tax.
- Whether a structure represents a genuine tax planning on the one hand or a sham or a colorable device to avoid tax on the other has to be determined at the threshold, by looking at the transaction as a whole in the context to which it properly belongs and not by dissecting the individual parts and looking at them in isolation. According to the Supreme Court, examples of colorable devices include structures that are "used for circular trading or round tripping or to pay bribes." On the other hand, structures designed to avoid the lengthy approval and registration processes in India may be permissible.

Following its holistic approach, the Supreme Court found that the transaction between Vodafone and the Hutchison Group was exactly as the parties contemplated: an offshore sale between offshore parties of an offshore asset and was not subject to tax in India. The Supreme Court denied the Indian government's review petition for the decision in *Vodafone*, leaving legislation as the government's only option to overturn the ruling.

Reversal of *Vodafone* Decision

Following the landmark ruling, on 16 March 2012, India's finance minister proposed, and the Indian Parliament approved, amendments to the IT Act to override the Supreme Court's ruling in the *Vodafone* Case. The amendment includes provisions requiring the taxation of indirect foreign investment in India, and which would be applied retroactively from 1 April 1962, defying international norms. The amendments reverse virtually all the other principles established in the *Vodafone* Case.³ Summarized below are the amendments:

(1) *Vodafone International Holding B.V. v. Union of India & Anr.*, Civil Appeal No. 733 of 2012, Supreme Court of India, Jan. 20, 2012

(2) Paragraph 78 of *Vodafone* Case

(3) Faced with the prospect of retrospective taxation, Vodafone sought to exercise its rights under the India-Netherlands Bilateral Investment Treaty, having attempted conciliation with the government. It served the Indian government with a notice under the treaty, threatening international arbitration if the amendment was not "abandon[ed] or suitably amend[ed]". For more information, see Vodafone's [press release](#). Vodafone has currently moved the International Court of Justice in Hague for the resolution of this dispute.

• Indirect Transfer (IDT) Provisions

The IDT provisions cover taxation of gains arising from the transfer of share or interest in a foreign company or foreign entity whose value is “substantially derived”, directly or indirectly, from assets located in India. This modification allows the Indian tax department to require the buyer to withhold taxes on indirect foreign investment in India. The government has chosen to classify these changes as explanatory amendments, even though these changes are in direct conflict with the Supreme Court’s ruling in the Vodafone Case.

• Definition of “Substantial Value”

The share or interest is deemed to derive its value substantially from assets situated in India if on the “specified date”, the value of such assets:

- Exceed INR 100 million
- Represent at least 50% of value of all the assets owned by that entity

• Definition of “Specified Date”

The “specified date” is defined as either:

- The last date of the accounting period of the entity prior to the date of transfer
- The date of transfer, if the book value of the assets has increased by 15% from the last day of the accounting period

The second part of the definition prevents the altering of asset percentages in preparation for an upcoming high-value transaction.

• Retroactive Amendments

The IDT provisions are implemented retroactively, “notwithstanding anything contained in any judgment, decree or order of any Court or Tribunal or any authority.”

• Withholding Requirement

The IDT provisions require any person or entity resident outside India (irrespective of whether they have a residence, place of business, business connection or any other presence in India) to withhold Indian income tax when making payments to other persons or entities resident outside India, to the extent Indian income tax applies to such transaction.

• Exemptions

The IDT provisions are not attracted in the following cases:

- Where the transferor is a “small shareholder” who does not hold the right of management or control of such company or entity and holds less than 5% of the total voting power, share capital or interest of the company that directly or indirectly owns the assets situated in India.
- Transfer of shares of a foreign company, which derives substantial value from assets situated in India, as a result of amalgamation/demerger of the foreign company, subject to fulfilment of certain conditions.

• Reporting Obligation

The reporting obligation for IDT transactions is cast on the Indian entity whose shares are substantially held directly or indirectly by a company or entity registered or incorporated outside India. Failure to report any such transactions could bring upon them a penalty of up to 2% of the transaction value of such unreported transaction.

• Introduction of General Anti-Avoidance Rules

The Indian government additionally introduced the General Anti-Avoidance Rule (**GAAR**) in the IT Act, which gives the tax department the power to scrutinize transactions structured to deliberately avoid paying tax in India, declare these as “impermissible avoidance arrangement” and readjusted and potentially taxed in India. “Impermissible avoidance arrangements” are transaction structures whose main purpose (or any element of which) is designed to reduce, avoid or defer tax and which satisfy any one of the following tests: (i) are not for bona fide business purposes; (ii) create rights or obligations not ordinarily created between persons dealing at arm’s length; (iii) result directly or indirectly in misuse or abuse of tax laws; or (iv) lack commercial substance.

If an arrangement is held to be an impermissible avoidance arrangement, Indian tax authorities can deny tax treaty benefits and look through such arrangement by disregarding any corporate structures in determining tax liability. In all possibility, after all delays and debates, GAAR will be finally implemented with effect from 1 April 2017.

Although India is not new to retroactive legislation, labelling these significant changes as clarifications and imposing them retroactively, regardless of court orders, has led many commentators to suggest that the government has weakened the rule of law by destroying the separation of powers and reducing foreign investors’ faith in India’s institutional safeguards through eroding the clarity and certainty of taxation laws within India.

New Rules and Clarifications

Given the wide-ranging implications of the IDT provisions, investors and industry associations have raised queries on their scope and applicability. On 23 May 2016, the Central Board of Direct Taxes (**CBDT**), the apex administrative body for direct taxes in India, issued draft rules and forms in relation with the IDT provisions. The draft rules provide for valuation mechanism, determination of proportionate income, forms for reporting compliance and details of documents to be maintained by Indian concern in respect of indirect tax provisions. The final rules are keenly awaited to provide the much required clarity and certainty in taxation laws in India. In addition, on 21 December 2016, the CBDT issued a circular (**21 December Circular**) to clarify the following:

- If a foreign portfolio investor’s (FPI) investments in Indian securities constitute more than 50% of its assets and amount to a value or more than INR 100 million, transfer of shares in the FPI will be liable to tax under the indirect transfer provisions.

- If an investor or nominee holder does not hold the right of management/control, or hold total voting power, share capital or interest exceeding 5%, the indirect transfer provisions will not apply to them under “small shareholder” exemption.
- The exemption from IDT provisions for amalgamations/ merger of foreign entities with substantial assets in India does not extend to the shareholders/ investors of the amalgamating foreign company. Furthermore, the exemption is only available to corporate entities and not to funds.

Various stakeholders presented their concerns that the 21 December Circular does not address the issue of possible multiple taxation of the same income. On 17 January 2017, CBDT issued another circular stating that the 21 December Circular was put on hold pending further deliberations.

Conclusion

Presently, there is considerable uncertainty regarding IDT provisions while we await further clarifications from CBDT and the Indian government on the final scope of the IDT provisions. Meanwhile, parties should examine their existing transaction structures and their past and current transactions that could be vulnerable to challenge by the Indian tax authorities and should consider what steps can be taken now to mitigate any adverse consequences. In addition, there are a number of other material amendments proposed to the IT Act and parties should consult their advisors to fully understand these changes and their implications. We can help you to protect your position and mitigate the tax risks by:

- Obtaining advance clearances and rulings for transactions
- Structuring transactions appropriately with regard to relevant bilateral investment treaties and double taxation treaties
- Drafting the relevant legal documentation to ensure that the risks are managed appropriately

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