

TAX TIMES

Summary of draft report on retrospective amendments relating to indirect transfer



The Finance Act, 2012 has inserted certain retrospective amendments in the Income Tax Act, 1961. One of them is insertion of explanation 4 and 5 to section 9 (1) (i) with an intent to tax transfer between nonresidents of shares of foreign company deriving value from assets located in India. The retrospective amendment in particular obviating an earlier Supreme Court decision on the matter of indirect transfer was perceived in negative lights and it led to concerns about certainty, predictability and stability of tax laws in India. The expert committee was established to examine amendment on taxation of non –resident transfer of assets where underlying asset is in India, in the context of all non – resident taxpayers. The committee concluded that retrospective application of Tax should occur in exceptional or rarest of rare cases. Also, it states that retrospective amendment should occur only after exhaustive and transparent consultations with stakeholders who would be affected. Recommendations of committee are summarized in this report.

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Summary of Draft Report on retrospective amendments relating to Indirect Transfer

- ❖ Committee has recommended that amendments are applied **prospectively**. Countries such as Brazil, Greece, Mexico, Mozambique, Paraguay, Peru, Venezuela, Romania, Russia, Slovenia and Sweden have prohibited retrospective taxation. After considering the article 20 of the constitution of India committee recommended that in case, the same is applied retrospectively, **no person shall be treated neither as an assessee in default under section 201 nor as a representative assessee of a non-resident as this would amount to imposition of a burden of impossibility of performance.** It means that only the person who has earned the income can be made liable to tax. Further, **no interest u/s 234A, 234B, 234C and 201 (1A) for late filing of return, for late deposit of advance tax, for late/non deposit of TDS shall be levied. Also, no penalty u/s 271 (1) (c) and for concealment of income and for failure to deduct tax shall apply.**(Point No. 1)
- ❖ **Clarification of certain terms used in Explanation 5:** Income deemed to accrue or arise in India as provided in Section 9 (1) (i) of the act includes, inter alia, income accruing or arising, directly or indirectly through the transfer of a capital asset situate in India. *Explanation 5* has been inserted to clarify that **an asset or a capital asset** being **shares or interest** in a company incorporated outside India shall be deemed to have been situated in India if it derives, directly or **indirectly**, its **value substantially** from the assets located in India.
 1. The Phrase "**Share or Interest in a company**" shall mean and include only such share or interest which results in participation in ownership, control or management.
 2. The word "**substantially**" should be defined to as a threshold of 50% as proposed in DTC bill, 2010. It has been suggested that if Indian Company has invested outside India, then whole of assets of Indian company will be considered as assets located in India to test whether shares of foreign company derives its value from assets located in India being more than 50 % of global assets of such company.
 3. The phrase "**directly or indirectly**" may be clarified to mean "look through" approach which means all intermediaries to be ignored.
 4. The **Value** shall refer to fair market value (DCF method for service sector and NAV method for non-service sector) to be ascertained on net basis including both tangible and intangible assets to be determined at the time of last balance sheet with appropriate adjustments for significant acquisition/ disposal between the last balance sheet date and the date of transfer.
 5. The Phrase "**asset or**" put next to the phrase "capital assets" shall be omitted otherwise it will lead to unintended consequences.

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6. As provisions of section 9 (1) (i) is specific to indirect transfer of capital asset, the general provisions of section 2 (47) relating to transfer should not be applied on a standalone basis.
 7. The taxation shall be restricted only to capital gains attributed to assets located in India as proposed in DTC bill 2010. A **basis of proportionality** to be followed.
- ◆ **Safeguard for Small Investors:** Committee recommended that where foreign company whose shares are transferred is an immediate holding company of the assets situated in India and transferor along with its associate enterprise holds voting power or share capital less than 26% of foreign company during preceding 12 months, then it would not be subject to Tax in India u/s 9 (1) (i) of the Act. In case, such foreign company is not an immediate holding company of assets located in India, then if the transferor along with its associate enterprise during preceding 12 months holds less than 26% of total voting power of the immediate holding company of the assets situated in India. (Point No. 3)
 - ◆ **Safeguard to Listed company :** Exemption may be provided to a company listed in a Recognized stock exchange whose shares are frequently traded as defined in SEBI guidelines and RBI regulation. (Point No. 4)
 - ◆ **Safeguard for intra group structuring:** Section 47 (via) and (vic) of the Act provides that transfer of shares of an Indian company is not taxable subject to certain conditions. There is no reason that this exemption shall not be extended to transfer of shares of foreign company. Committee recommended for exemption of transfer of shares or interest in a foreign company under intra group structuring if it is not taxable in the country in which company is resident. Intra group structuring may include amalgamation/demerger as defined in the Act subject to 75% continuity in ownership or any other restructuring with associated enterprise subject to continuity of 100% ownership. (Point No. 5)
 - ◆ **Safeguard for investors in FII:** Income of FII is taxable in India. Therefore, non - resident investors who have invested in FII directly or indirectly should not be again taxed under section 9 (1) (i) of the Act otherwise it would result in multiple taxation. (Point No. 6)
 - ◆ **Safeguard for investors in Private equity fund:** Committee recommended that non - resident private equity investor would be out of the coverage of taxation of indirect transfer. Investment by non - resident investor in a PE fund would be outside the scope of section 9 (1) (i) of the Act if-
 1. Investment is in the form of unit which does not result in participation in control and management of the fund.
 2. Investor along with associates does not hold more than 26% share in voting/ capital of PE fund.

The way to gain a good reputation is to endeavor to be what you desire to appear.

3. Company in which investment is made must not be holding 50% assets in India as compared to its shares its global assets
4. Investment is made in a company listed in a recognized stock exchange and whose shares are frequently traded.
5. The transfer of share or interest in a foreign entity results due to reorganization within a group.(Point No. 7)

❖ Deeming provision not to apply to dividend income: As per explanation 5, if shares of a foreign company derive its value substantially from asset located in India, then shares of a foreign company is deemed to be situated in India. It will result in taxing NOT ONLY capital gain from indirect transfer but also dividend paid by foreign company as the same will also be deemed to be accrued in India as the shares are the source of dividend and it has been deemed to be situated in India. Committee recommended that dividend paid by foreign company shall not be deemed to accrue or arise in India u/s 9 (1) (i) of the Act. (Point No. 8)

❖ Retrospective amendment not to override DTAA provisions: If there is a DTAA with country of non - resident, then it shall be taxed only in accordance with provisions of DTAA. So, it shall not override Treaty. Therefore, it can be taxed only when DTAA specifically grants right of Taxation or leaves the right to tax as per domestic law. (Point No. 9)

❖ Retrospective amendment to the term "transfer ": section 2 (47) of the Act has been amended retrospectively to include following within the ambit of definition of transfer.

1. disposing or parting with an asset
2. disposing or parting with an interest in an asset
3. creating any interest in an asset

The above activity may be carried out in any manner including

1. Directly or indirectly
2. Absolutely or unconditionally
3. voluntarily or involuntarily
4. by way of an agreement (whether entered into in India or outside India) or otherwise

Further it is irrelevant whether such transfer of rights has been characterized as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India

It will result in following ambiguity.

- If a new partner is included in partnership firm, then it may be considered as parting with an interest in an asset.
- If a pledge is created, it may result in creation of interest in an asset.

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- If shares of holding company are transferred, it may be contended that shares of subsidiary company is transferred indirectly. It is not clear whether transfer of 100% shares of holding company or transfer of controlling interest in holding company, or a single share transfer of holding company, would amount to transfer of shares of subsidiary company or not.

This widened definition of transfer would result in taxing transfer of shares of foreign company even though it does not derive its value substantially from assets located in India. Committee therefore recommended that definition of transfer need not to be looked at on standalone basis for indirect transfer.

- ◆ Definition of the term "property": Section 2 (14) of the act has been amended to clarify the meaning of the term "property" used in the definition of "capital Asset ". It provides for property includes rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever. This amendment is to cover an arrangement where management or controlling rights are transferred separately from share transfer. E.g., if the right to further acquire the share is transferred and which results in transferee acquiring the control and management of the company, then such transfer of control and management is now covered within the definition of capital asset. In 2002-03 Suzuki motor company Ltd, Japan took over the control in Maruti Udyog Ltd. by paying control premium of Rs. 1000 crores to Govt of India. Another example is Essar enjoyed first right of refusal in the Hutchison - Vodafone deal.
- ◆ Conclusion: Dr. Parthsarathi Shome committee has analyzed the provisions and its impact on sentiments of foreign investor. If suggestions of the committee are implemented, it will result in confidence in legal system of India.