# Taxation of Indirect Transfers - A Revisit & Introspection...

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**Piyush Baid**
Tax Practitioner

"*The art of taxation consists of so plucking the goose as to obtain the largest amount of feathers with the smallest amount of hissing*." [Jean Baptiste Colbert]

Indirect transfers are transfers of underlying assets in a third jurisdiction, by entities in different jurisdictions, possibly in order to avoid tax regimes of both the buyer and seller jurisdictions and thus might also be regarded as a form of tax arbitrage. How successful has it been having different dimensions to the stories is a different story. However, one common factor in all the cases has been availability of better knowledge of tax affairs of the jurisdiction in which the underlying assets are. Such indirect transfers, per se, also include transfers by ways of swaps,

The issue is that "indirect transfers" are per se not illegal. They are completely legal, but however, the taxability of such a transaction, particularly with reference, to the underlying asset, most likely to be in a source country with a higher incidence of taxation, is the bane of all. On one hand the source jurisdiction is within its rights to claim taxability on transfer of embedded capital as it is the sovereign right of the state to claim taxes on economic activity within its jurisdiction, on the other hand, "clever scheming" by High-Net-Worth persons, who generally have access to higher levels of knowledge resources, claim that they have legal rights to manage "their" affairs as they like. None of them per se is wrong. But, then more often than not the question is: Which is the lesser devil? The author attempts within this work to answer this very controversial question.

Tax is a sovereign right; this is a given. But the main issue in "offshore indirect transfers" (OIT) is not of the assets (which derive economic value), but of the entity owning the assets , which is most likely in a low or nil taxed jurisdiction, which creates an unfair tax arbitrage for the owners, as opposed to the "normal" businesses who have to pay legitimate taxes on their capital gains in their source jurisdictions.

India has had a long and unenviable history of tax matters particularly with reference to foreign jurisdictions. Part of it might also be due to the reason of its tax infancy in civil and common law, and part of it owing to the fact that as a source jurisdiction, India is simply too lucrative for MNE's to ignore. Perhaps the single most case that comes first to mind when speaking of indirect transfers taxation is the infamous Vodafone[1] case, but is it a single instance?

Indirect transfers scenario (born around tax arbitrage) around the globe has been very active, and despite the Indian attempt to bring under its sovereignty umbrella, via amendments to the Indian Direct Taxes code angle[2], there have been multiple attempts for the same which would be discussed later.

There is a widespread concern, particularly amongst developing nations, that usage of OIT are and would be used to avoid legitimate, appropriate taxes in source jurisdictions, where the underlying assets are located. In fact the United Nations in its report[3] notes that there is a concern in developing nations that MNE's using their financial and resources superiority might actually engage in practices detriment to the fiscal affairs of the jurisdictions they derive economic benefit from. Although the report is on extractives, the common issue of practices employed bring coherence to this instant. One such form of practice is that they might use the doctrine of separate legal personality and derive fiscal benefits from residence of companies to change the ownership of the underlying economic asset without triggering corresponding economic taxation resulting from such change of ownership. In disguise, what might have actually amounted to a sale of assets in a source economy, is as a result, changed to a transfer/sale of a company with an offshore holding, usually to an offshore buyer, with no tax triggers. This is usually backed up by a claim that such transfer is outside the "territorial jurisdiction" of the source country and the "event" of transfer as such is outside the limits of its tax residency criteria. Sometimes there is a further claim that treaty benefits between the source country and the transferor company override domestic tax law considerations and thus there is not taxable event and hence no incidence of taxation.

In order to counteract such scenarios, it is imperative that countries actually engage in incorporating indirect transfer legislations in their direct tax codes so as to enable the Domestic tax triggers, which could override treaty obligations (as they take significantly longer time to negotiate and bring to the fore), and also anti avoidance measures such as GAAR or SAAR. While it is observed that mostly such transactions are motivated by tax avoidance, it might be also that, there are in substance requirements of conducting such transactions offshore. While such factors should be taken into account, it should also be the prerogative of tax administrations, that such factors should not act as a wolf amongst sheep. Tax legislations should in those cases take that into account and wherever encountered the authorities must be within the law to allow for such desired relief. It might be pertinent to note that we are as of this exercise, using the term "taxes" to involve all kind of taxes, whether it be withholding taxes, or business profits, or capital gains. Invariably, there are going to be some sort of differences between common law and civil law and hybrid law jurisdictions on the terminology and manner of application of taxes, but, because a discussion on them would be outside the scope of this report hence the arrangement.

Interestingly, while creation of the such fiscal policies, require a detailed analysis of the framework required, similar effort should also go into how the implementation is supposed to happen. There is no use creating a legal framework wherein it cannot be enforced. With superior assets at disposal MNE's characterize their transactions, so that they escape the net of tax administrations. Enforcement in those cases becomes a very complex task, as such flow of information also becomes tedious. Pertinently, with the schemes of assessment all through the globe and with time barring limitations, flow of timely information and hence proper operations of information systems becomes very important. Unless information is timely received and compiled for assessment, it becomes useless and hence a good information technology systems backed up with strong legal framework is also of paramount importance in implementation of the same.

In more often cases, it is also seen that cross-border arrangements by individuals and/or companies more often than not involve complex holding structures which encompass multiple jurisdictions. Under such circumstances the entire assessment procedure becomes a matrix of tax laws and treaty laws of different jurisdictions and interactions thereof. This matrix as such might also have a material impact on the outcome of assessment and enforcement of taxing rights. Also, in such cases since there is no defined common path, the outcomes of such assessment, could be a combination, of no DTAA relief, DTAA relief and also possibly double non-taxation. Another possibly potential outcome of the entire exercise, is the identification of the ultimate beneficiary, who would be assailing of the economic benefit of the income being transferred. Whether that ultimate beneficiary could be brought to tax is another aspect that administrations need to consider.

While most jurisdictions have accorded the domestic tax approach[4] to indirect asset transfers a treaty-based look would be appropriate.

In case of any offshore asset transfers the Model Conventions would either

- Exclusive rights to tax in the residence state
- Primary rights to tax to the jurisdiction in which the underlying asset is located, with article for reliefs playing out their roles.
- Provide recourse to Domestic laws for OIT's under the renvoi clause 3(2).

(In absence of course the taxpayer might be subject to double taxation or maybe double-non taxation.)

Both the OECD and the UN model in article 13(1) say inter alia that gains out of disposal of immoveable property are to be taxed in the state in which the property is located.

Article 13(4) of both the Model conventions inter alia deal with indirect transfers, with regards to the immoveable property for which capital gains have accrued. This actually reflects on a common agenda in the two models. In cases of underlying assets consisting of immoveable property, both the models allocate taxing rights on the situs of the immoveable property, regardless of the situs of residence the person transferring the property in question. As to what can constitute immoveable property, the definition is afforded by both the models in Article 6, "*The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources*; ..." is similar in both the models, also reflecting a common intent.

However, further down is where the distinction arises, the UN model has an article 13(5) for the purpose of extending treaty definitions to offshore transfers. The said article 13(5) inter alia states "*Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least.......... per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.*" This essentially is an anti-abuse treaty shopping mechanism similar to the one found in Article 9(4) of the MLI. In case parties do not have this anti abuse article in their treaties incorporated, parties can opt for having this article 9(4) incorporated in their synthesized texts. By doing so the jurisdiction which is the situs of the immoveable property would be able to tax capital gains accruing in a CTA partner jurisdiction arising out of alienation of shares or holding rights of companies holding more than 50% embedded value of the embedded property. Also to be noted is that Article 33 of the MLI actually allows parties to a CTA to amend their position in the future, so as to incorporate more types of OIT.

At this juncture it is pertinent that we discuss regarding problematic issues with OIT

- Both the model treaties have a contractual threshold of 50% in order that their applicability comes into play. Does the renvoi 3(2) clause come to play in other scenarios? This is an unchartered territory till date, and application of the same would depend on a host of factors, like the investment climate and compulsion for the transferee, the stringency of the tax administration in the state where the embedded value is derived from, the structure of the tax legislation in the state where the embedded value is derived from etc.
- Even when the treaties are suitably poised, the transfer might take place in a offshore haven like the Caymans or Bermudas or other tax havens which might have no treaties with India and hence enforcement of such an decree or order would be significantly difficult.
- The fundamental characteristic is that it is a legal separate organization and that might have an impact. Courts in different jurisdictions might have different interpretations on the subject, and sovereignty of judicial process is generally held to be above sovereignty of a tax administration process.
- Although GAAR and SAAR might be applied in such cases, it is very difficult to enforce a sovereign tax enforcement in foreign jurisdictions.

Coming to the Indian scenario the scenario with indirect transfers have not been on their own bit of controversy, owing primarily to the following reasons

- Relentless pursuit by the Indian Administration
- Huge amounts of demands raised
- The Indian administration's strong headedness in all the cases

A brief note on the Indian tax scenario

- Indirect transfers are taxable under section 9 and retrospection amendments were made by Finance Bill 2012
- Most notable out of the impacted cases Vodafone and Cairn went for BIT Arbitration, Sanofi won at the AP high court

- Vodafone and Cairn won at the BIT arbitration in Sep 2020 and Dec 2020 respectively.
- The Indian Govt filed appeals at the Singapore Commercial courts in 2021.
- Cairn filed attachment proceedings against the Indian Govt.
- The Indian govt came out with Taxation Laws (Amendment) Bill 2021 and inserted insert three provisos (Fourth, Fifth, and Sixth Proviso) in Explanation 5 to Section 9(1)(i) to give relief to certain eligible entities impacted by the above retrospective amendment.

Some of the prominent Indian OIT cases are mentioned in brief below

| **Sr. No.** | **Case** | **Decision** | **Citation** |
|---|---|---|---|
| 1. | *Group Industrial Marcel Dassault and Merieux Alliance –* | The transaction is taxable in India | [TS-5007-AAR-2011-O] |
| 2 | *Cairn U K Holdings Ltd. v. Deputy Commissioner of Income-tax (International Taxation) Circle 1(2)(1), New Delhi* | The transaction is taxable in India | [TS-89-ITAT-2017(DEL)] |
| 3 | *Moody's Analytics Inc. USA, In re* | The transaction is not taxable in India | [TS-577-AAR-2012] |
| 4 | *Aditya Birla Nuvo v. Dy. CIT* | The transaction is taxable in India | [TS-346-HC-2011(BOM)] |
| 5 | *Vodafone International Holdings B.V. v. Union of India* | The transaction is not taxable in India | [TS-23-SC-2012] |
| 6 | *Sanofi Pasteur Holding SA v. Department of Revenue, Ministry of Finance* | The transaction is not taxable in India | [TS-57-HC-2013(AP)] |
| 7 | *Sofina S.A. v. Asstt. CIT (International Taxation)* | The transaction is not taxable in India | [TS-129-ITAT-2020(Mum)] |
| 8 | *GEA Refrigeration Technologies GmBH In re* | The transaction is not taxable in India | [TS-625-AAR-2017] |
| 9 | *Moody's Analytics Inc. USA In re* | The transaction is taxable in India | [TS-577-AAR-2012] |
| 10 | *E*Trade Mauritius Ltd., In re* | The transaction is not taxable in India | [TS-121-AAR-2010] |
| 11 | *In re : Dy. DIT v. Saraswati Holding Corpn. Inc.,* | The transaction is not taxable in India | [IT Appeal No. 2889 (Delhi) of 2008, dated 10-7-2009] |
| 12 | *Tiger Global International Holdings, In re* | The transaction is taxable in India | (AAR/04/05/07 of 2019) |

Interestingly the case of Tiger Global (divestment of Flipkart) was declined by the AAR citing the bar under clause (iii) to proviso to Section 245R(2) of the Act. The relevant extract is "*In view of the foregoing, we are of the considered opinion that the issue involved in the question raised in the present applications was designed prima facie for avoidance of tax. The applicants have contended that shares of the Singapore Company derived their value substantially from assets located in India and, therefore, it was eligible to take benefit of Article 13 (4) of India – Mauritius Treaty. Even if the Singapore Company derived its value from the assets located in India, the fact remains that what the applicants had transferred was shares of Singapore Company and not that of an Indian company. The objective of India-Mauritius DTAA was to allow exemption of capital gains on transfer of shares of Indian company only and any such exemption on transfer of shares of the company not resident in India, was never intended by the legislator. Further, as discussed earlier the actual control and management of the applicants was not in Mauritius but in USA with Mr. Charles P. Coleman, the beneficial owner of the entire group structure. Therefore, we have no hesitation to conclude that the entire arrangement made by the applicants was with an intention to claim benefit under India – Mauritius DTAA, which was not intended by the lawmakers, and such an arrangement was nothing but an arrangement for avoidance of tax in India. Therefore, the bar under clause (iii) to proviso to Section 245R(2) of the Act is found to be squarely* *applicable to the present cases. Accordingly, the applications are rejected*."

Although the finality of the controversy surrounding OIT is not over, hopefully, in the coming times, the government would come up with schemes like the Taxation (Amendment ) Bill 2021 to clear up the scenario and especially that of Section 245R(2) and GAAR, and also renew its commitment to anti abuse Measures like the MLI and also that the courts would take note of the same.

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[1] Vodafone International Holdings v. Union of India [TS-23-SC-2012]

[2] Amendment to section 9 by Finance Bill 2012.

[3] United Nations Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries 2017 https://www.un.org/esa/ffd/wp-content/uploads/2018/05/Extractives-Handbook_2017.pdf

[4] Bharti Zain case in Uganda for which the underlying assets were telecom in Uganda, Petrotech case for which the underlying assets were petroleum assets in Peru, and Vodafone Hutch case for which the underlying assets were Telecom in India.