Snapshot of 'Indirect Transfers' Taxation under Tax Treaties...

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Rahul Jalan

Chartered Accountant

The recent rejection of application by the AAR in the case of Walmart's acquisition of Flipkart has brought the focus back on the taxability of gains from indirect transfer of shares which derives its value substantially from India. Traditionally, transfer of shares of a foreign company deriving its value substantially from India was not considered taxable under the Income tax Act. However, in the backdrop of apex court ruling in case of Vodafone International Holdings BV, an explanation 5 to section 9(1)(i) was inserted in year 2012 with retrospective effect which deems the shares of foreign company to be situated in India if it derives the value substantially from the assets located in India and therefore, after this amendment, gains arising out of indirect transfer of shares are held taxable under Income tax Act if it fulfils the certain conditions in respect to threshold limits.

Interplay between tax treaties and income tax act provisions

If we look at bilateral tax treaties, there has been no introduction of similar provisions (under the Income tax Act) in any of the tax treaties. In almost all the tax treaties with India, Article 13 or 14 deals with the taxability of capital gains which overrides the domestic law (subject to GAAR, PPT and LOB provisions) if it is more beneficial to an assessee. However, the capital gains arising out of indirect transfer of shares outside India is not covered under any specific clause of such articles in any of the tax treaties. In certain treaties, there is a specific clause to give taxing rights to India only in case the shares of an Indian resident company are transferred. Further, a residual clause under the Article on capital gains gives taxing rights to the country of transferor which has transferred the capital assets in most of the treaties.

Here, it is very pertinent to note that Explanation 5 to section 9(1)(i) of Income tax Act deems only shares of a foreign company to be situated in India. It does not deem that the said foreign company itself becomes a resident in India to be covered under specific clause of Articles on capital gains. Mumbai bench of Tribunal in case of Sofina S.A. vs ACIT upheld this view while determining the taxability of indirect transfers under India- Belgium treaty. Therefore, the indirect transfer of shares should not be covered under the specific clause as it only deals with the shares of the companies which are resident in India. Also, there are various judicial ruling which have a taken a view that provisions of domestic law cannot be imported into the treaty unless it is expressly provided by the treaty. In view of the above, the gains arising out of indirect transfer of shares should be covered under residual clause of tax treaties wherein the taxing rights have been allocated to the country in which transferor is a resident.

Indirect Transfers under India- Mauritius Treaty

Under India- Mauritius treaty too, gains arising out of transfer of shares of a third country is not covered under any specific clause. Andhra Pradesh High Court in the case of Sanofi Pasteur Holding SA held that if indirect transfer of shares is not covered by a specific clause, the residual clause would apply. Under Article 13(3A), taxing rights on the transfer of shares of an Indian resident company has been specifically allocated to India for the investments made after 1 April 2017. However, there is no specific clause under Article 13 to deal with taxability of indirect transfer of Indian companies. Given that the tax treaties do not have a 'see through' approach to determine the residency of a company in a third country unlike Income tax Act, the residual clause of 13(4) should apply in the case of transfer of shares of a company resident in a third country deriving its value substantially from an Indian company. It is also worthwhile to note that prior to amendment in India- Mauritius Treaty, there was no specific clause for allocation of taxing rights in case of transfer of shares of an Indian resident company and the same also used to be covered under erstwhile residual clause of 13(4).

Separately, Article 27A on limitation of treaty benefits ('LOB') under India-Mauritius Treaty does not provide for denial or limitation of treaty benefits under Article 13(4). Further, Mauritius has not included India in its covered tax agreements as signatory to Multi-lateral Instruments ('MLI'). Therefore, the Principal Purpose Test ('PPT') as envisaged in Article 7 of MLI would not apply to India- Mauritius Treaty. Also, under General Anti- Avoidance Rules (GAAR), investments made prior to 1 April 2017 have been grandfathered for the purpose of capital gains on transfer under Rule 10U(1)(d) of Income Tax Rules, 1962. Hence, GAAR would also not apply on indirect transfer of shares by a Mauritius Company which was acquired prior to 1 April 2017.

Therefore, even if it is established in a case that certain transactions are structured in a specific way with a primary purpose of tax avoidance or treaty shopping, taxing gains out of such indirect transfers in India seems onerous if such shares of foreign company were acquired prior to 1 April 2017 (i.e. prior to applicability of GAAR).

One would need to wait to see how tax department approaches this issue going forward and to the extent, it would use this AAR ruling for denial of tax treaty benefits even under other treaties. In this regard, we have analysed relevant capital gains provisions that would be applicable under tax treaties in case of indirect transfer.

<u>Analysis of tax treaties for taxability of indirect transfers</u>

Currently, India has tax treaties with 94 countries (excluding Hongkong), which can be categorized in below 4 categories: -

1. Covered under MLI and domestic tax laws applies for indirect transfers as per the treaty: -

There are 29 tax treaties that are covered tax agreements under MLI w.e.f. 1 April 2020 as both India and other countries have ratified MLI and have included each other in the covered tax agreements. Accordingly, PPT would be applicable in case of these treaties without any grandfathering provisions. Out of these 29 covered tax agreements, in case of treaties with Australia, Canada and United Kingdom, domestic tax law would anyway apply on indirect transfer of shares under the residual clause of capital gains article.

2. Covered under MLI and taxing rights for indirect transfers lies with country of transferor under residual clause: -

In case of other countries covered under MLI, gains should be taxable in other country (i.e. not in India) where the transferor is a resident under the residual clause of relevant article on capital gains. However, under these treaties if Revenue establishes that one of the principal purposes of the underlying transactions is to avail the treaty benefits, the treaty benefits can still be denied, and gains would be taxable in India under domestic tax law. It is to be noted that PPT does not have any grandfathering provisions unlike in GAAR and therefore would apply technically in all cases of transfer of indirect investments. The countries covered in this category are as under: -

1	Austria	7	Georgia	12	Latvia	17	Ukraine	22	Singapore
2	Belgium	8	Iceland	13	Lithuania	18	Norway	23	Slovakia
3	Denmark	9	Ireland	14	Luxembourg	19	Poland	24	Slovenia
4	Finland	10	Israel	15	Malta	20	Russia	25	Sweden
5	France	11	Japan	16	Netherlands	21	Serbia	26	UAE
6	New Zealand								

3. Treaties not covered under MLI and domestic tax laws applies for indirect transfers as per the treaty: -

Further, there are certain countries and regions like Bangladesh, Brazil, China, Hongkong and USA which do not have covered tax agreement with India and hence PPT is not applicable. However, even under these treaties, Indian domestic tax law would apply in case of Indirect transfer of shares as per residual clause of relevant article on capital gains. So, there is no treaty benefits as such on taxability of capital gains in India under these tax treaties.

4. Treaties not covered under MLI and taxing rights for indirect transfers lies with country of transferor under residual clause: -

There are other 57 countries (refer table below) which have tax treaties with India and are not covered for PPT under MLI. Under these treaties, gains on indirect transfer of shares would be taxable in other country (i.e. not in India) where the transferor is a resident under the residual clause. However, GAAR would still be applicable if the underlying shares were acquired on or after 1 April 2017. In such cases, the treaty benefits may be denied, and gains would be taxable under Indian domestic law. Further, in case of a LOB clause in a treaty, the same would also need to be considered to evaluate the possibility of denial of treaty benefits on capital gains.

1	Albania	13	Fiji	25	Mauritius	37	Qatar	49	Thailand
2	Armenia	14	Germany	26	Mongolia	38	Romania	50	Trinidad & Tobago
3	Belarus	15	Jordan	27	Montenegro	39	Saudi Arabia	51	Turkey
4	Bhutan	16	Hungary	28	Morocco	40	South Africa	52	Turkmenistan
5	Botswana	17	Indonesia	29	Mozambique	41	Spain	53	Uganda
6	Bulgaria	18	Italy	30	Myanmar	42	Srilanka	54	Mexico
7	Columbia	19	Kazakhstan	31	Namibia	43	Sudan	55	Uzbekistan
8	Croatia	20	Kenya	32	Nepal	44	Switzerland	56	Vietnam
9	Cyprus	21	South Korea	33	Oman	45	Syria	57	Zambia
10	Czech Republic	22	Kuwait	34	Uruguay	46	Taiwan		
11	Estonia	23	Kyrgyz Republic	35	Philippines	47	Tajikistan		
12	Ethiopia	24	Malaysia	36	Portugal	48	Tanzania		

Way forward

Going forward, assessees may face increased scrutiny by tax authorities as this AAR ruling seems to have given fresh ammunitions. Given the wide ambit of GAAR provisions in the domestic law and application of PPT (wherever applicable), it is imperative that taxpayers revisit its existing holding structures, critically analyse tax position under respective treaties and maintains robust documentation to substantiate business rationale behind underlying transactions.