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Taxation of Indirect Share Transfers: Recent Developments in India And Related Policy Considerations

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INTRODUCTION

Source country taxation of indirect share transfers made by nonresidents[1] has, for some time now, been a subject of focus for both tax authorities and multinational groups. A handful of countries, including India and China, have enacted legislation (or interpreted older legislation) to allow the taxation of such transfers, primarily as an anti-avoidance measure intended to protect the taxation of direct share transfers by nonresidents. These countries now are seeking to enforce their tax laws and collect this tax.

Moreover, interest in this type of tax is growing among developing countries. A recent paper presented at a United Nations workshop on protecting the tax base of developing countries advocates taxing the capital gains of nonresidents and discusses how to improve taxing indirect share transfers.[2] The future, therefore, probably will see more countries asserting jurisdiction to tax such transfers.

Taxes on indirect share transfers raise a variety of fundamental questions, including the scope of included transactions, determination of the correct taxable amount, collection and payment of the tax, consistency with income tax treaty obligations, whether the tax is creditable, and, perhaps most significantly, whether source country taxation of such share gains is good tax policy. We review the history of the Vodafone transaction and recent developments in India, discuss some of the issues raised by such taxes in the context of the Indian and U.S. tax systems, and consider briefly the broader policy issues.

BACKGROUND

Indian Income Tax Law

Under the Indian Income-Tax Act, 1961 (the ''ITA''), §5(2), nonresidents of India are subject to tax on all income from whatever source derived that either is received or is deemed to be received in India or accrues or is deemed to accrue in India during the year. Section 9 of the ITA defines when income is deemed to accrue or arise in India very broadly: ''all income accruing or arising, whether directly or indi-

[1] *See* the discussion of *Vodafone* below for an example of such a transaction.

[2] Cui, *Taxation of Capital Gains* (2014). Available at http://www.un.org/esa/ffd/tax/2014TBP2/Paper_TaxationCapitalGains.pdf/.

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rectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.''

India also has a broadly written withholding tax that requires withholding of Indian tax on payments made to a nonresident in connection with a transaction that is subject to tax in India. Any person that purchases a capital asset from a nonresident seller is generally required to withhold tax under §195 of the ITA to the extent that income realized by the seller on the transfer of the capital asset is taxable in India. Further, this obligation exists irrespective of whether the nonresident has a place of business or business connection in India, or any other presence in whatsoever manner in India.[3]

Vodafone 2007–2012

Vodafone[4] is the seminal case on the taxation of indirect share transfers. Not only does the case have a fascinating history, but the surrounding litigation and governmental responses are worth study for anyone interested in the issues that such taxation presents.

Facts

In 1992, a Hong Kong multinational, the Hutchison Group (''Hutch''), formed a joint venture to operate a telecommunications business in India with an Indian multinational. Hutch owned approximately two-thirds of the joint venture directly and indirectly through a chain of holding companies. In 2006, Hutch entered into an agreement with Vodafone to sell its interest in the joint venture. This was accomplished by the sale of a single share of a Cayman Islands holding company to Vodafone.[5]

The transaction was publicized in India and, in 2007, Indian Revenue issued a show-cause notice to Vodafone to explain why it did not withhold tax on payments made to Hutch when it purchased the single holding company share.

Litigation

Initially, there was litigation in the Indian courts as to whether the courts had jurisdiction to hear the case. This was resolved in favor of Indian Revenue by the Indian High Court. The High Court also decided that the sale was taxable by India and that Vodafone was required to withhold tax on the sale.

Vodafone appealed the High Court judgment to the Supreme Court of India, which held in Vodafone's favor in January 2012. In so doing, the Supreme Court rejected three arguments as to why Vodafone was subject to tax. The first was a substance-over-form argument, i.e., that the holding company was a sham and should be ignored. The second was a statutory construction argument, i.e., that the ITA could be read broadly enough to extend Indian taxing jurisdiction to indirect share transfers. The final argument, which found support in the opinion of the High Court, was that Vodafone did not acquire a single share, but rather a bundle of property rights that were located in India.

DEVELOPMENTS IN INDIA 2012–2014

Legislative Developments

Following the *Vodafone* ruling, the Indian legislature did a complete U-turn by making retroactive ''clarificatory'' amendments to the ITA to overrule the Supreme Court verdict and fortify its intention to tax gains arising out of indirect transfers of assets located in India. The clarificatory law provides that in the event there is a transfer of a share or interest in a company or entity registered or incorporated outside India, and the value of such share or interest is derived substantially from assets located in India, such a transfer is taxable in India.

Given the huge public outcry over the retroactive change, the government expanded the terms of reference for an Expert Committee, constituted under the chairmanship of Dr. Parthasarthi Shome to examine India's General Anti-Abuse Rule (''GAAR''), to include within its ambit the applicability of the amendments on taxation of a nonresident's transfer of assets where the underlying asset is situated in India. The Committee's draft report on retrospective amendments relating to indirect transfers of assets situated in India was released for public comments in October 2012. The draft report contained a number of recommendations, including providing an exemption for small shareholders, foreign institutional investors, and private equity investors, explaining the meaning of ''substantial,'' and so on and so forth. The Committee suggested that these recommendations be carried out through an amendment to the ITA or the Income Tax Rules, 1962, or by way of an explanatory Circular. The objective was to allay apprehensions of taxpayers and yet protect India's tax base from ''erosion'' on account of indirect transfers of assets lying in India.

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[3] This was a retroactive provision which was introduced by the Finance Act 2012 to counter the Indian Supreme Court's *Vodafone* ruling, which held that a nonresident should not be made liable to withhold taxes in the event that such a person does not have any presence or place of business or business connection in India.

[4] *Vodafone Int'l Holdings B.V. vs Union of India*, [2012] 341 ITR 1 (SC).

[5] In fact, the transaction was considerably more complicated. However, for purposes of this discussion, these are the salient facts.

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However, while the Committee provided its recommendations in late 2012, these recommendations have not yet been incorporated in law, and taxpayers are still grappling with a lot of issues and unanswered questions when it comes to taxability of indirect transfers of assets. One probable reason for not incorporating these suggestions is that they would mean the retrospective amendments were not actually ''clarificatory'' in nature, and could be liable to be struck down by a court.

In August 2014, the Central Board of Direct Taxation (CBDT) constituted a high-powered committee to look into and scrutinize all fresh cases arising out of the retrospective amendments of 2012 in respect of indirect transfers. Thus, there can be no automatic tax assessment of such transfers which took place before April 1, 2012.

Finally, the *Vodafone* case continues to be unresolved. Post amendment, Vodafone invoked the dispute settlement process under India-Netherlands Bilateral Investment Treaty (''BIT'') and initiated conciliation with Government of India under BIT, which follows the United Nations Commission on International Trade Law (''UNCITRAL'') rules. The Indian government made a counter-offer for conciliation under the Indian laws which has been rejected by Vodafone. While both parties have appointed their respective arbitrators, the two arbitrators have yet to decide the third arbitrator. The arbitration in Vodafone's tax dispute has been delayed; however, the Indian government and Vodafone have mutually agreed to extend the deadline for appointment of the third arbitrator to resolve the tax dispute.

Recent Cases

On the judicial front, there have been two rulings on the issue of taxation of indirect transfers. The first is by the Andhra Pradesh High Court in the case of *Sanofi Pasteur Holding SA*[6] on the taxability of gains arising from an offshore transfer of shares of a French company holding substantial shares in an Indian company. The revenue authorities asserted that the gains arising on account of the transaction of sale of shares by the French shareholders of a French holding company were taxable in India because the asset which actually got transferred was shares of the Indian company. The matter was put before the Authority for Advance Rulings (AAR) which ruled in favor of the Revenue by asserting that the French holding company was a sham entity and the real purpose of the transaction was to transfer the shares of the Indian company.

On an appeal to the High Court, the latter decided in favor of the shareholders of the French holding company by ruling that the French holding company was not a sham, and creation of wholly owned subsidiaries or joint ventures for investments is a well-established business protocol and a legitimate, established, and globally well-recognized practice. The High Court further looked at the tax treaty between India and France and held that since the article providing for taxation of capital gain income did not envisage a ''look-through'' approach for transfers of underlying assets, the French shareholders were not liable to pay tax on the gains arising on account of the transfer of shares of the French holding company which in turn held shares of an Indian company, due to the supremacy of the treaty provisions over the domestic tax law.

While there have been a number of cases wherein the judiciary has upheld the applicability of a treaty over the provisions of domestic tax law (even though the ITA specifically provides so), this was the first case where provisions of a tax treaty were applied in a matter involving an indirect transfer of assets situated in India.

The second case, which was decided by the Delhi High Court, involved the interpretation of the term ''substantial'' in the context of the provisions of the ITA.[7] As stated earlier, under the retroactive law India has a right to tax income arising from the transfer of shares of a foreign company, provided the shares' value is derived ''substantially'' from assets located in India. The High Court delved into a transaction involving the sale of shares of two Indian companies by two Mauritius companies that were part of the same group and the subsequent indirect transfer of the Mauritius companies by shareholders of a Jersey company holding the Mauritius company (and its subsidiary). The Revenue argued that the transaction was structured in a manner to avoid paying tax on the indirect transfer of shares of the Indian companies under §9(1)(i) of the ITA and also that all three transactions were part of a single transaction with an intent to transfer the entire business and interest of the group to the purchaser.

The High Court delved deep into the matter to arrive at the conclusion that the three transactions were not done in a manner to avoid payment of tax under §9(1)(i) of the ITA; rather, there was a commercial rationale for the transfer of the business in a structured manner. Thus, none of the transactions was subject to tax (sale by Mauritius companies being exempt under the India-Mauritius Income Tax Treaty and sale of

[6] *Sanofi Pasteur Holding SA vs Dep't of Revenue, Ministry of Finance* (2013) (257 CTR 401) (AP HC).

[7] *DIT vs Copal Research Ltd. and Ors.* (2014) (270 CTR 223) (Del HC).

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shares of the Jersey company not being a taxable event since it did not hold any Indian assets directly or indirectly).

Having held the above, the High Court actually went a step further to determine whether the shareholders of the Jersey company would nevertheless have been liable to pay tax had all the transactions taken place as a single transaction. The High Court relied on the U.N. Model Double Taxation Convention and the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital to hold foreign shares would derive value ''substantially'' from assets located in India only if more than 50% of the value of such shares was derived from such assets. In the current situation, the total value of assets situated in India represented only 23% of the combined value of shares and therefore in any case the transaction would not have been subject to tax under the retroactive law in India.

THE U.S. PERSPECTIVE

U.S. Tax Policy

U.S. tax policy concerning the taxation of share gains is reflected in the U.S. source-of-income rules contained in the Internal Revenue Code (''Code''). Such gains are generally sourced based on the residence of the taxpayer.[8] Thus, the United States asserts primary taxing jurisdiction over such gains when earned by U.S. residents.[9] Conversely, share gains of nonresidents generally are sourced outside the United States and are not subject to U.S. tax no matter the type of gain.[10] The U.S. Congress has considered and rejected at least one proposal to tax foreign persons on gains realized on the disposition of shares in U.S. companies when the seller has at least a 10% interest.[11]

The one exception to this general rule is that the United States does tax foreign persons on gains realized upon the disposition of shares in a U.S. real property holding company.[12] The United States does not tax indirect transfers of shares in a U.S. real property holding company, however. Thus, a foreign person generally may employ a foreign company to own a U.S. real estate investment and trade those shares without incurring U.S. tax.[13] The United States leaves taxation of gains on those shares to the residence country. Given the U.S. experience with the complexity of enforcing a regime of withholding on transactions in shares of a U.S. real property holding company, the U.S. position on taxing transfers of shares in foreign companies owning U.S. real estate appears both realistic and prudent.

Consistent with the U.S. policy of taxing share gains based on residence, the Internal Revenue Code includes provisions intended to tax such share gains currently (or with an interest charge under the PFIC rules) when realized by foreign corporations in which U.S. persons have an interest.[14] Thus, U.S. persons may not avoid U.S. tax on their share gains by owning investments through foreign corporations.

U.S. treaty policy on share gains is congruent with the Internal Revenue Code's policy. U.S. treaties allocate taxing jurisdiction of share gains to the residence state, except in the case of U.S. real property holding companies.[15] Thus, the United States does not assert jurisdiction to tax gain realized by a treaty country resident on the disposition of shares of a U.S. company, unless it is a U.S. real property holding company.

The 1989 U.S.-India Income Tax Treaty

The 1989 U.S.-India Income Tax (''Treaty'') is one exception to the general rule. Article 13 of the Treaty permits India to tax gains realized by U.S. residents from the disposition of shares in Indian companies.[16] By treaty, the United States agrees to treat those gains as foreign-source income so as to provide a credit against U.S. tax for the Indian tax.[17]

Under the Treaty, India may tax gains ''in accordance with its domestic law.'' During the years in which the United States and India negotiated their income tax treaty, India did not assert jurisdiction to tax indirect share transfers, such as the Vodafone transaction. Presumably, the U.S. position is that neither

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[8] Code §865(a). Gains from the disposition of shares in a foreign affiliate may be sourced outside the United States in limited circumstances. Code §865(f). *See also* Code §865(e)(1).

[9] However, *see* Code §865(h).

[10] Code §864(c)(4). Gains of nonresidents may be sourced in the United States and subject to U.S. tax if the nonresident maintains an office or fixed place of business in the United States. Code §865(e)(2) and §864(c)(2).

[11] In 1995, a conference committee of the U.S. Senate and House of Representatives rejected a proposal to add a new §899 (and a companion withholding provision) to the Code that would have treated gain realized by nonresident aliens and foreign corporations upon the disposition of a 10%-or-greater interest in a U.S. company as income effectively connected with a U.S. trade or business and therefore subject to U.S. tax. *See* H.R. 2491, The Balanced Budget Act of 1995, §1228. This provision was first advanced in 1992.

[12] *See* Code §897(a), §871(b), and §882.

[13] The exception is a foreign corporation that has made an election under Code §897(i).

[14] *See* Code §954(c)(1) and §1291–§1298.

[15] Model U.S. Income Tax Convention of November 15, 2006, Art. 13, ¶6 (Gains).

[16] 1989 U.S.-India Income Tax Treaty, Art. 13.

[17] 1989 U.S.-India Income Tax Treaty, Art. 25(3).

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party intended such transactions to be covered by Article 13 and so, in accordance with the Treaty, India may not tax those gains when earned by a U.S. company.[18] For that reason, the United States probably also would argue that the resourcing rule in Article 25 would not apply to make such taxes creditable in the United States.[19]

India takes the position that since Article 13 allows each country to tax capital gains income in accordance with its own laws, India would have the right to tax such gains earned by a U.S. company. This is especially because the Indian law is retrospective, which, according to India, means that India intended to tax such transfers. Moreover, to the extent that the seller is not a U.S. tax resident (e.g., a controlled foreign corporation of a U.S. parent), India may argue that the provisions of the Treaty are not relevant or limiting.

ISSUES RAISED BY A TAX ON INDIRECT SHARE TRANSFERS

We discuss below some of the knotty issues raised by source country taxation of indirect share transfers.

Practical Issues

Collection

Base ''erosion'' resulting from the indirect transfer of assets can be addressed by means of suitable legislation or through a general anti-avoidance rule. However, the biggest challenge lies in implementing such legislation, especially given the fact that the source country may not have recourse to the assets owned by the exiting foreign shareholders. Enforcement would result in exercising jurisdiction over the territory of another country, which may or may not be permissible under the laws of the latter. While taxing indirect share gains may be no different in principle than imposing taxes on a nonresident for income sourced in a country (other than by way of indirect transfers), the problem gets especially complicated in a situation where multiple countries are involved.

Some countries, such as India, obligate the payor of the income to withhold taxes on payments made to the seller. In fact, as discussed earlier, the *Vodafone* case is about the failure of Vodafone to withhold taxes at the time of making payment for the purchase of shares to Hutch.

Other approaches to enforcement include reporting requirements by either (or both) the transferee and the transferor. While reporting, combined with exchange of information, may ensure that the source country is aware of the change in shareholding at the offshore level, nonetheless practically enforcing payment of taxes and subjecting a nonresident to foreign jurisdiction would remain a challenge. In such a situation, the source country may have to rely on the nonresident's country of residence for assistance in collection of taxes (to the extent there exists a treaty between the two countries and there exists an agreement to effect the same). It would also not be out of place to mention that ensuring compliance with a country's reporting mechanism along with ensuring collection of taxes could entail a high tax administration cost.

Measurement of Gain

A number of unanswered questions also arise when one starts looking into the micro details of how to calculate taxes. For example, should the entire capital gain be subject to tax, or only the amount that is proportionate to the value of the assets located in the source country? How should the gains be calculated — should the basis of the underlying assets be included for computational purposes? What will happen when there is a subsequent direct sale of the underlying assets? — a situation of double taxation could arise if credit for taxes paid on the prior indirect transfer is not provided. Moreover, complications could arise if multiple jurisdictions are involved, e.g., in the typical structure of multi-tier operating companies where more than one jurisdiction exercises its right to tax indirect transfers of assets.

In the view of the authors, if a source state insists on taxing indirect share transfers, its tax should be limited to the proportion of gains attributable to the assets located in the source country. Further, the source country should provide a credit for taxes paid in the event of a direct transfer to avoid taxation of the same income twice. Having said this, establishing standard principles for measurement of gains may not be a task that is easy to achieve, and different jurisdictions could follow different methodologies for taxation, which may complicate matters further.

Consistency with International Law

Most jurisdictions would need to enact extraterritorial laws to enforce applicability of such taxes. Under Indian law, the Parliament of India has the right to legislate laws for the territory of India, and no law

[18] *See* the discussion of static-versus-dynamic interpretation of internal law in American Law Institute, *Federal Income Tax Project, International Aspects of United States Income Taxation II, Proposals on United States Income Tax Treaties*, 41–43 (1991).

[19] Informal comments by the Internal Revenue Service have suggested that the United States would not provide a credit for the tax. The IRS either may interpret the Treaty so as not to give a credit for such a tax or it may simply view the tax, at least under current law, as a ''voluntary payment,'' which is not creditable under U.S. domestic law.

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is deemed invalid merely because it has extra-territorial applicability. As per judicial precedents, such extra-territorial applicability of law needs to be based on a sufficient nexus which the transaction that is sought to be taxed has with India. In the global context, the authors feel that such extra-territorial applicability of law would nonetheless need to be consistent with customary international law for it to be enforceable.

Creditability

The issue of creditability of taxes also poses certain challenges. Most income tax treaties are not geared up to address issues arising from taxation of indirect transfers of assets. Similarly, many jurisdictions may be hesitant to provide a credit for taxes paid in the source country since the taxation may not have been ''in accordance with the provisions of the tax treaty.'' Even otherwise, multi-tier structures present some complex credit issues. Consider, for instance, a situation common in multinational structures: Company A is holding shares of Company B, which is holding shares of Company C, which in turn is holding shares of Company D, and all companies are located and operating in different jurisdictions. A sale of shares of Company C by Company B could be subject to tax in the jurisdiction of Company D (by virtue of the indirect transfer of shares of Company D), in the jurisdiction of Company C (by virtue of the direct transfer of shares of Company C), and also in the jurisdiction of Company B (by virtue of residency). In such a situation, the jurisdiction of Company B should as such be obligated to give credit for taxes paid in the jurisdictions of both Company C and Company D, but practical challenges could arise in claiming such credits. Moreover, as discussed above, even should a credit be allowed, there may be some double taxation if countries measure gain inconsistently.

CONCLUSION

In the authors' view, the current efforts to tax indirect share transfers are simply a manifestation of the larger BEPS problem. Source countries perceive their tax base eroding and are acting unilaterally to address the revenue loss. While perfectly rational, this approach is fraught with practical difficulties as described above.

One theme of the OECD's Base Erosion and Profit Shifting (BEPS) initiative is multilateral, rather than unilateral, action to address BEPS. A coordinated adoption of stronger residence-based tax systems is one approach to the BEPS problem. In this context, U.S. Treasury officials recently have advocated stronger controlled foreign corporation (CFC) rules consistent with BEPS Action 3.[20]

The authors suggest that more effective CFC rules should be considered as an answer to avoidance of the tax on shares that some countries seek to impose. If a multinational group will pay tax on shares sold by holding companies located in low-tax or no-tax jurisdictions because of its home country CFC regime, it usually will have little or no tax incentive to use such companies. In such a world, a multinational group would be indifferent (or perhaps nearly so) between selling those shares directly and selling the shares of an offshore holding company. Moreover, for their part, multinationals should prefer to pay one tax on share gain as opposed to the current system which, in some countries, offers potential double taxation resulting from nonfunctional treaty networks or the uncertain results offered by a lengthy and expensive process under a treaty Mutual Agreement Procedure article.

It remains to be seen whether countries will choose unilateral or multilateral action. The current dialogue between developing and developed countries over BEPS is a hopeful sign that future actions will be coordinated. Multinational groups also should do their part to support a coordinated approach as it would appear to be for their benefit.

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[20] *See, e.g., New CFC Rule May Be 'Dominant' in BEPS Effort for Developing Countries*, 190 DTR G-7 (Sept. 30, 2014).

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