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Non-voluntary gift of shares is liable to capital gains tax

The Madras High Court gave its decision that non-voluntary share transfer to a subsidiary company without consideration is not a valid gift and is liable to capital gains tax.

Background:

- The taxpayer[1] is a company incorporated in India and has several overseas investments.
- The overseas operation of the taxpayer in the Middle East and Africa (MEA) were carried on through its wholly owned subsidiary (WOS) in Jabel Ali Free Zone Authority (JAFZA), Dubai and the further step-down subsidiaries.
  - The taxpayer had acquired shares of WOS with effect from 1 April 2004.
- After about four years of acquiring the WOS's shares, in 2008, a private equity (PE fund) fund evinced interest in the MEA operations of the taxpayer.
  - As per the taxpayer, the regulations governing establishment and operations of the companies within JAFZA did not permit more than one shareholder in a free zone enterprise. Thus, it was not possible for the PE fund to directly invest in WOS due to single shareholder restriction.
- The taxpayer, in July 2008, set up a wholly owned subsidiary company in Mauritius (M Co). M Co in turn set-up a wholly owned subsidiary in Cayman Island (C Co) which started its operation from 14 July 2008. Consequently, C Co became a step-down subsidiary of the taxpayer.
  - In a sworn statement, the Chief Financial Officer (CFO) of the taxpayer accepted that at the time of incorporation, C Co had share capital of only US$ 10,400 and did not have any assets or income except the investment in the WOS.
- On 13 November 2008, the taxpayer gifted its holding in WOS (i.e. transferred its shares without consideration) to C Co [i.e. during the Financial Year (FY) 2008-09, corresponding to Assessment Year (AY) 2009-10].

  Within about a week of transfer of WOS shares to C Co, the PE fund (on 18 November 2008) invested in C Co for a 27.17% equity stake.
- During the audit proceedings for FY 2008-09, corresponding to AY 2009-10, the Assessing Officer (AO) / transfer pricing officer (TPO), held that the transfer of WOS shares by the taxpayer without consideration was liable to capital gains tax in India, on the following key basis:

[1] PCIT v. M/s. Redington (India) Limited T.C.A Nos. 590 & 591 of 2019

- The C Co did not have any commercial substance on its own and could be viewed for the purpose of tax avoidance as, if the shares of WOS were transferred directly to the PE fund, the taxpayer would have paid capital gains tax.
- There was no written gift deed / memorandum submitted by the taxpayer. The Board resolution also did not mention about any clauses in the Articles of Association authorising such transfer.
- As per statement given by the CFO of the taxpayer, the PE fund was headquartered in Cayman Island and the investment vehicle was also in Cayman Island and therefore, the PE fund requested that the C Co be based out of Cayman Island (and WOS's shares were transferred to C Co).
- The taxpayer transferred the shares of WOS to C Co which in turn, stood diluted by accommodating the PE fund which had acquired a stake of more than 27% in C Co for a consideration. The transactions were thus, closely interrelated and interlinked and a dissective approach could not be taken. The transaction was intended to commercially benefit, both the taxpayer and the third-party investor and there was no voluntary element attached to the transaction.
- To qualify as a gift under section 122 of the Transfer of Property Act (TP Act), it had to be voluntary, which was absent in the transaction as it had been devised to accommodate the PE fund on account of compulsion placed upon the taxpayer.
- As per the JAFZA guidelines of Dubai, a company could be incorporated either as branches or as free zone establishment (FZE) or as free trade zone company (FZCO). If there was only one shareholder in the company incorporated as FZE, its multiple shareholder could be incorporated as FZCO and there was no marked difference between FZE and FZCO, as both type of companies enjoyed tax and other benefits and they were at par and nothing prevented the taxpayer to form their company as FZCO.

- In appeal proceedings, the matter reached the Madras High Court (HC).

Certain relevant provisions of the ITA:

- Section 47(iii): any transfer of a capital asset under a gift or will or an irrevocable trust is not regarded as transfer.
- Section 47(iv): any transfer of a capital asset by a company to its subsidiary company is not regarded as a transfer, if –
  - the parent company or its nominees hold the whole of the share capital of the subsidiary company, and
  - the subsidiary company is an Indian company;
- Section 47(v): any transfer of a capital asset by a subsidiary company to the holding company is not regarded as a transfer, if –
  - the whole of the share capital of the subsidiary company is held by the holding company, and

  - the holding company is an Indian company;

Decision of the HC:

Whether a company, a corporate entity, is entitled to execute a gift

- The HC noted that, as per section 5 of the TP Act, living person included a company or association or body, individuals whether incorporated or not. Accordingly, the HC held that a company would be entitled to execute a gift in terms of section 5 of the TP Act.

  Thus, the HC proceeded to consider, as to whether in the current case it was a valid gift in terms of section 122 of the TP Act.

Whether in the current case it was valid gift

- The HC noted the following:
  - Section 122 of the TP Act defined 'gift' to be transfer of certain existing movable or immovable property made voluntarily and without consideration by one person called the donor to another called the donee and accepted by or on behalf of the donee. The essential elements of gift were (i) absence of consideration; (ii) the donor; (iii) the donee; (iv) to be voluntary; (v) the subject matter; (vi) transfer; and (vii) the acceptance.
  - In several decisions, it had been held that for proving a document of gift was executed with free and voluntary consent of the donor, it was to be proved that the physical act of signing the deed coincide with the mental act viz., the intention to execute the gift.

    For the purpose of making the gift of movable property, the transfer may be effected either by registered instrument signed (by or on behalf of the donor and attested by at least two witnesses) or by delivery.
  - The Board resolution of the taxpayer stated that the transfer of shares was towards re-structuring the concern for which the Board accorded its approval to such transfer with or without consideration.
  - The HC also took note of various other facts / chain of events.
- In light of the above and various other facts / chain of events, the HC observed that:
  - The Board resolution did not state that the transfer was by way of gift, as the words used in the resolution were "with or without consideration". Hence, at the time when the taxpayer's Board took a decision to transfer its entire holdings in WOS to C Co, it did not consider it to be a gratuitous transfer.

    The voluntary consent of the donor viz. the taxpayer was missing because the physical act in proving the transfer of shares and executing the deed of share transfer should coincide with the mental act that was the intention to execute the gift.

    If the intention of the donor / taxpayer was to effect transfer without consideration, the resolution would have spelt out the same in no uncertain terms. The deed of share transfer also did not spell out that it was for consideration. Therefore, the Court had to look into the background facts to ascertain as to what had driven the taxpayer to effect the share transfer.

- The decision of the Board of the taxpayer in resolving to approve the transfer of shares with or without consideration was a clear indicator to show that the transaction was not voluntary. This was so because, within less than a week after effecting transfer, the PE fund came into the picture, investing in C Co for 27.17%. Further, the C Co had only a share capital of US$ 10,400 on incorporation (i.e. July 2008) and as on 18 November 2008 when the transfer took place, C Co had no other assets or income except the value of shares in WOS.

  Thus, the facts clearly demonstrated that much prior to effecting transfer, there were other transactions, which were in the pipeline. The sole intention of the taxpayer was corporate restructuring. Therefore, the voluntariness in the transfer of shares stood excluded.

- With respect to the contention of the taxpayer that the WOS could have only one shareholder as per the regulations of JAFZA, was verified by the TPO and was found that there were other methods by which the taxpayer could have formed the company in Dubai. This factual aspect was not dislodged by the taxpayer.

  Thus, based on the chain of events, it was evidently clear that the incorporation of company in Mauritius and Cayman Island just before the transfer of shares was undoubtedly a means to avoid taxation in India and the said two companies were used as conduits to avoid income-tax.

  The asset owned by the taxpayer viz. the shares in WOS, which were hitherto within the network of the Indian tax laws, stood shifted to Cayman Island which was a tax haven. Therefore, it was evidently clear that the entire transaction was so structured to accommodate the third-party investor, who had put certain conditions even prior to effecting the transfer.

- The HC distinguished various case laws relied upon by the taxpayer.

Accordingly, the HC held that the transfer of WOS shares by the taxpayer would attract section 45 of the ITA and would be chargeable to income-tax under the head 'capital gains'.

- The HC distinguished the alternate contention of the taxpayer based on earlier cases[2] that assuming there was transfer, nevertheless there was no gain that was chargeable to tax in terms of section 45 of the ITA, as there was no consideration that accrued or arose or was received by the taxpayer. The HC held that the said cases were rendered on idealistic factual position with no allegation of dubious transactions against the taxpayer and therefore, these decisions were not applicable to the case of the taxpayer.

In view of the above, the HC held that there was absolutely no voluntary element in the share transfer; it was executed for consideration and therefore, it failed to satisfy the test laid down in section 122 of

[2] Sunil Siddharthbhai vs. CIT [1985] 156 ITR 509 (SC); CIT vs. B.C.Srinivasa Shetty [1981] 128 ITR 294 (SC); Dheer & Co., In re [2011] 337 ITR 277 (AAR); Dana Corporation vs. DIT [2010] 321 ITR 178 (AAR); Amiantit International Holding Ltd., In re [2010] 322 ITR 678 (AAR); DIT vs. Goodyear Tyre and Rubber Co. Ltd. [2014] 360 ITR 159 (Delhi HC)

the TP Act to qualify as a valid gift. In such factual position, the transfer attracted section 45 of the ITA and was chargeable to income-tax under the head capital gains.

Comment:

This ruling upholds the following principles:

- A company would be entitled to execute a gift in terms of section 5 of the TP Act.
- The essential elements of a gift are absence of consideration; the donor; the donee; to be voluntary; the subject matter; transfer; and the acceptance.
- Non-voluntary share transfer to subsidiary company without consideration is not a valid gift and is liable to capital gains tax.

Taxpayers having corporate gift transactions, may want to evaluate the impact of this ruling to the facts of their specific cases.