India | Tax & Regulatory | For private circulation only | 31 August 2016

Global Business Tax Alert

Sharp Insights

The Authority for Advance Rulings (AAR) in the case of Banca Sella (AAR No. 1130 of 2011) has, inter alia, held that the Indian branch office of a foreign company is a capital asset for tax purposes. However, the transfer of such branch office in a scheme of amalgamation between two foreign companies would not be chargeable to tax as capital gains, in the absence of any consideration (in which case the computation mechanism fails). The AAR further upheld the applicability of non-discrimination clause (Article 25) of India-Italy tax treaty, pursuant to which a non-resident transferor can invoke exemption from capital gains under section 47(vi) of the Income-tax Act, 1961 in a scheme of amalgamation.

Issue no: GBTA/45/2016

In this issue:

Background

- The applicant, Banca Sella S.p.A., is a banking company established in Italy and is part of the Banca Sella group of companies. Apart from conduct of banking activities in Italy and abroad, the applicant also provides outsourcing services, banking and financial services, and other ancillary/ incidental services.
- Sella Servizi Bancari S.C.P.A. (SSBS) is a group company of the Banca Sella group, engaged in rendering support services to other group companies. Such services include group direction, business and commercial support services, administrative services etc. the applicant holds 15% equity stake in SSBS.
- The Banca Sella group also has a subsidiary company in India, engaged in rendering information technology (IT) support services to group entities.
- SSBS established a branch office (BO) in India on 15 January 2010. The BO acquired the IT support business of the Indian subsidiary on slump sale basis on 15 February 2010. The capital gains arising on the transfer of business was discharged by the Indian subsidiary.
- The Banca Sella group underwent global restructuring pursuant to which SSBS merged with the applicant company. Consequent to the amalgamation, the shareholders of SSBS were allotted shares in the applicant company. The effective date of amalgamation was 30 May 2011.

Questions before the AAR

Inter alia, the applicant sought ruling on the following questions:

- Whether the amalgamation of SSBS with the applicant constitutes a 'transfer' of capital asset, being the Indian BO, u/s 2(47) of the Income-tax Act, 1961 (the Act)?
- In case answer to the above question is in the affirmative, whether exemption from capital gains u/s 47(vi) of the Act is available to SSBS by virtue of Article 25 of the India-Italy tax treaty?
- Whether the applicant is liable to capital gains tax in view of extinguishment of shareholding in SSBS?
- Whether other shareholders of SBSS are liable to capital gains tax in view of extinguishment of shareholding in SSBS?
- Whether the amalgamation of SSBS with the applicant subject to Indian transfer pricing provisions?

With regard to the above questions, the contentions of the applicant and revenue were as follows:

Question on whether the amalgamation of SSBS with the applicant constitutes a 'transfer'

Arguments by the applicant

- 'Transfer' postulates a change in ownership of property from one person to another, with both of them as well as the property in existence. In the instant case, SSBS would stand dissolved, and therefore, there is no transfer.
- There is no independent transfer of right, title and interest in, or transfer of, BO as it was only as a consequence of amalgamation that all assets of SSBS stood vested in the applicant, which does not tantamount to a transfer.
- Even assuming there is a transfer, there is no consideration which accrues to SSBS. Therefore, there can be no question of levy of capital gains as the computation provisions would break down.
- Computation method under section 45 of the Act postulates reduction of cost of acquisition and cost of improvement from the sale consideration. Thus, there should be a positive inflow of consideration before the charge can be triggered. Market value of the asset which is parted cannot be the basis to determine capital gains.

Arguments by the revenue

- The amalgamation involved extinguishment of rights in shares of SSBS held by all shareholders, including the applicant, which squarely falls within the ambit of section 2(47) of the Act.
- The capital asset, being the BO situated in India, has been parted with or interest therein has been parted with SSBS indirectly by way of amalgamation, which attracts capital gains tax.
- On the effective date of amalgamation, both the transferor and the transferee were in existence. Thus, the applicant's argument regarding the scope of 'transfer' is misplaced. The case of the applicant is not covered under section 47 of the Act, therefore, the transfer is chargeable to capital gains tax in India.
- The price at which the BO acquired the business of the Indian subsidiary is the cost of acquisition of the BO. Capital gains shall be computed as the market value of SSBS as reduced by the net asset value.

The AAR held as under

- In a merger/ amalgamation, tax liabilities are attracted in the case of both the amalgamating company and the shareholders.
- However, even if such cases are treated as transfer under section 2(47) of the Act, the important question is whether in the absence of consideration flowing to the amalgamating company can such transfer be taxed for capital gains.
- The notional market value cannot be treated as cost of consideration for the purpose of capital gains in the hands of SSBS, which could not receive any consideration before it merged and lost its identity.
- The AAR referred to apex court ruling in the case of B C Srinivas Reddy, and held that in the absence of consideration, capital gains cannot be computed.

Question on whether exemption from capital gains u/s 47(vi) of the Act is available to SSBS by virtue of Article 25 of the India-Italy tax treaty

Arguments by the applicant

- The charge to capital gains, if any, would fail having regard to the non-discrimination clause provided under Article 25(1) of the tax treaty.

- Article 25(3), which provides for non-applicability of Article 25(1), only deals with personal allowances, reliefs and reductions for taxation purposes and does not deal with the exclusion from the ambit of section 45, which is provided for in section 47.
- The personal allowances are those that are available to certain individuals only. Reliefs are provided for in Chapter-VIII(B) of the Act and reduction for tax purposes refers to various amounts allowed as deduction in computing income chargeable to tax. Thus, Article 25(3) has no applicability in the instant case.

Arguments by the revenue

- Article 25(1) would not apply to the applicant in view of the specific provisions of Article 25(3).
- Non-discrimination clause under Article 25(1) only triggers when an Indian company is exempted from taxation in India under the same circumstances and under the same conditions in which a non-resident is held to be taxable.
- Where a State grants any personal allowances, reliefs and reduction for taxation purposes to its residents, then it would not become encumbering on that State to grant such benefits to non-resident tax payers.

The AAR held as under

- Article 25 basically means that there is no discrimination between locals and foreigners in the matter of taxation and no preferential treatment be given to local taxpayers.
- The exception is only in case of personal allowances, relief, reduction etc. and these are in the context of individuals and not in case of companies as the stating word 'personal' denotes.
- If a case of amalgamation results in some special benefits to a local company and its shareholders, there is no reason to deny the same to a foreign company and its shareholders in similar case of amalgamation.
- Non-discrimination clause seeks to ensure that both countries do not decline any allowance or exemption only to the ground of nationality of taxpayers. Therefore, exemption u/s 47(vi) of the Act would be available to SSBS.

Question on whether applicant is liable to capital gains tax in view of extinguishment of shareholding in SSBS

Arguments by the applicant

- What is covered in 'transfer' u/s 2(47) is an extinguishment of any right in an asset and not the extinguishment of the asset itself. However, the applicant also admitted that this aspect is concluded against the applicant by virtue of the Supreme Court ruling in the case of Grace Collis (248 ITR 223).
- Even if there is a transfer, the applicant did not receive any consideration as a consequence of the extinguishment of shares. Further, the shares do not constitute an asset situated in India. Thus, there ought to be no tax liability.
- As per Explanation 5 to section 9(1)(i), shares of SBSS should derive their value substantially from assets located in India and the assets located in India. In this regard, the word 'substantial' must be given to mean 'which is close to the whole'.
- Further, even under the tax treaty, Article 14(5) provides that capital gains from alienation of shares would be taxable in Italy and not in India.

Arguments by the revenue

- The valuation carried out for the purpose of amalgamation would find its suitable place in the Balance Sheet of the applicant post amalgamation. The applicant would also be required to pay out or show as liability an amount equal to 85% of the valuation. What comes into the Balance Sheet post amalgamation is the 15% of valuation of SBSS, which is the sale consideration for capital gains purposes.

- ‘Substantially’ cannot mean ‘wholly’ or ‘entirely’, not even ‘almost wholly’. The Delhi High Court in the case of Copal Research (371 ITR 114) has already held that sale of shares deriving less than 50% value would not be taxable in India. Further, Explanation 6 to section 9(1)(i) has defined ‘substantially’ on similar lines.
- The BO in India was the capital asset, and also a PE, of SBSS in India. The movable properties held by the BO form part of business properties of the PE in India.
- The amalgamation involved alienation of the PE together with SBSS, which are chargeable to tax in India by virtue of Article 14(2) of the tax treaty, which is more specific in applicability to the instant case.

The AAR held as under

- ‘Substantial’ will always mean at least 50%. The AAR also agrees with the Delhi High Court ruling in the case of Copal Research in this regard.
- The most important issue is whether the applicant received any consideration. The answer is in the negative. The revenue has given a strange method of working out capital gains which is completely on notional basis and based on presumptions. Capital gains have to be calculated on real gains. Thus, the applicant is not chargeable to capital gains.

Question on whether other shareholders of SBSS are liable to capital gains tax in view of extinguishment of shareholding in SSBS

- On this question, the AAR held that there is a consideration received by the shareholders. It is thus important to see what has been parted with by the shareholders.
- Shareholders have parted with their shares in SSBS and not the movable property of the BO. Therefore, Article 14(2) of the tax treaty would not apply and the capital gains accruing to the other shareholders will not be chargeable to tax in India by virtue of Article 14(5).

Question on applicability of Indian transfer pricing provisions on amalgamation

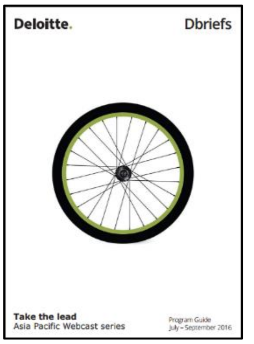
- The AAR relied on its own ruling in the case of Amiantit International Holding Limited (322 ITR 678) to hold that the transfer pricing provisions would not apply in the absence of charge to tax.

Conclusion

In principle, the AAR concluded that the transfer of branch office of a foreign company to another foreign company in a scheme of amalgamation is taxable event in India. However, in the absence of any consideration accruing to the transferee, the capital gains computation mechanism would fail which would ultimately result in non-taxability. Separately, the ruling provides welcome clarification regarding the disputed scope of non-discrimination clause of the India-Italy tax treaty.

Upcoming Dbriefs – Register

Tax impact of Indian Accounting Standards (IndAS)



1 September, 2:00 – 3:00 PM HKT (GMT +8)

Many Indian companies are required to adopt the new Indian Accounting Standards (IndAS) in a phased manner. IndAS brings in the concept of fair valuation and much more rigour in accounting for a transaction in accordance with its substance, rather than form. This raises the potential for notional income or expenses to be recognised for accounting purposes. But how will IndAS impact the calculation of taxable income for Indian tax purposes?

Register

Contacts

Ahmedabad
19th Floor, Shapath - V
SG Highway,
Ahmedabad – 380 015.
Tel: + 91 (079) 6682 7300
Fax: + 91 (079) 6682 7400

Bangalore
Deloitte Centre, Anchorage II,
100/2, Richmond Road,
Bangalore 560 025.
Tel: +91 (080) 6627 6000
Fax: +91 (080) 6627 6010

Chennai
No.52, Venkatanarayana Road,
7th Floor, ASV N Ramana Tower,
T-Nagar,
Chennai 600 017.
Tel: +91 (044) 6688 5000
Fax: +91 (044) 6688 5050

Coimbatore
Shanmugha Manram
41, Race Course,
Coimbatore
Tamil Nadu - 641018
Tel: + 91 (0422) 439 2801
Fax: +91 (0422) 222 3615

Delhi/Gurgaon
Building 10,
Tower B, 7th Floor,
DLF Cyber City,
Gurgaon 122 002
Tel : +91 (0124) 679 2000
Fax : + 91 (0124) 679 2012

Hyderabad
1-8-384 and 385, 3rd Floor,
Gowra Grand S.P.Road,
Begumpet,
Secunderabad – 500 003.
Tel: +91 (040) 6603 2600
Fax:+91 (040) 6603 2714

Kolkata
Bengal Intelligent Park Building
Alpha, 1st floor, Block EP and GP
Sector V, Salt Lake Electronics
Complex,
Kolkata - 700 091.
Tel : + 91 (033) 6612 1000
Fax : + 91 (033) 6612 1001

Mumbai
Indiabulls Finance Centre,
Tower 3, 28th Floor,
Elphinstone Mill Compound,
Senapati Bapat Marg, Elphinstone
(W),
Mumbai – 400013
Tel: + 91 (022) 6185 4000
Fax: + 91 (022) 6185 4101

Pune
106, B-Wing, 7th Floor,
ICC Trade Tower,
Senapati Bapat Road,
Pune – 411 016.
Tel: + 91 (020) 6624 4600
Fax: +91 (020) 6624 4605

Deloitte makes an impact that matters