Deloitte.

India | Tax & Regulatory | For private circulation only | 29 March 2017

Global Business Tax Alert
Sharp Insights

The Delhi Tribunal in the case of Cairn UK Holdings Limited (ITA No. 1669/Del/2016), rejecting the argument of the taxpayer that the transaction is a genuine case of group restructuring, held that transfer of shares of a foreign company deriving its value solely from the assets located in India, is deemed to be situated in India and therefore, capital gains arising on the same is taxable in India.

Issue no: GBTA/23/2017

In this issue:

Background

- Cairn Energy Plc ('CPLC') is a company incorporated outside India and has 9 wholly-owned subsidiaries, which have oil and gas assets located in India.
- Cairn UK Holdings Limited ('taxpayer') was incorporated in UK. Thereafter, it entered into a share exchange agreement with CPLC, wherein the entire issued share capital of the 9 subsidiaries of CPLC were transferred to the taxpayer in exchange for issuance of the share capital of the taxpayer.
- Thereafter, Cairn India Holdings Limited ('CIHL') was incorporated in Jersey and post incorporation, it entered into a share exchange agreement with the taxpayer. As per the said agreement, the taxpayer transferred all the shares of the 9 subsidiaries to CIHL in exchange for the issuance of shares of CIHL. The said agreement was entered into in financial year 2006-07.
- Further, vide a Debt Conversion Agreement, the debt owed by Cairn Energy Hydrocarbons Limited to CPLC, was assigned to the taxpayer for a consideration in the form of shares of the taxpayer. The said debt was further assigned by the taxpayer to CIHL for a consideration in the form of shares of CIHL.
- Finally, Cairn India Limited ('CIL') was incorporated in India as a wholly-owned subsidiary of the taxpayer. Vide a subscription and share purchase agreement and a share purchase deed, the entire share capital of CIHL was transferred by the taxpayer to CIL during the financial year 2006-07 for a consideration which was partly paid in cash and partly as shares of CIL.
- Subsequently, CIL floated an initial public offer ('IPO') in the Indian capital market and the shares of CIL were listed on various stock exchanges in India.
- Thereafter, a survey was conducted under section 133A of the Income-tax Act, 1961 ('the Act') at the office premises of CIL. Pursuant to the survey, the tax officer issued a notice under section 148 of the Act and the taxpayer filed a Nil return of income in compliance to the said notice.
- The tax officer alleged that the impugned transaction entered into by the taxpayer is governed by the provisions of section 9(1)(i) read with explanation 5 of the Act as there is a transfer of share or interest in a company which derives its value substantially from assets located in India. The tax officer therefore held that the gains from the sale of shares of CIHL by the taxpayer to CIL are short term capital gains chargeable to tax in India.
- The DRP upheld the draft order of the tax officer and thereafter the tax officer passed the final assessment order.
- The taxpayer filed an appeal before the Tribunal against the final assessment order.

Ruling of the Tribunal

Reassessment Proceedings

- Firstly, the taxpayer argued that the reassessment proceedings were not valid based on the following reasons:
  - Approval under section 151(2) of the Act had not been correctly provided;
  - No specific mention in the notice under section 148 of the Act that the notice is issued after obtaining the approval under section 151 of the Act;

- – Violation of Supreme Court guidelines with respect to disposal of the taxpayer's objections;
  – Information regarding share transfer of CIHL was available with the tax officer of CIL during the regular assessment proceedings of CIL;
  – No reference was made to explanation 5 of section 9(1)(i) of the Act in the reasons for reopening of the assessment;
  – Recorded reasons provided by the tax officer were not signed.
- The Tribunal rejected all the aforesaid contentions of the taxpayer and upheld the reassessment proceedings.

Taxability of Capital Gains

- The first contention taken by the taxpayer was that the retrospective amendment to section 9(1)(i) of the Act by the Finance Act, 2012, is bad in law and *ultra vires*. The Tribunal held that it is not the right forum to challenge the validity of the provisions of the Act and thus rejected the contention of the taxpayer.
- The Tribunal thereafter went on to decide the grounds challenging the chargeability of capital gains and computation of the same under the Act.
- On the argument of the taxpayer that the transaction of transfer of shares by the taxpayer to CIL is an internal reorganization of the group and there is no change in the controlling interest, the Tribunal held that part of the purchase price was paid by CIL from the proceeds of IPO and the balance consideration was paid through issue of shares of CIL to the taxpayer. Therefore, the said transaction is not merely a business reorganization process. Further, the Tribunal was not convinced with the argument of the taxpayer that there is no increase in the wealth of the taxpayer. The Tribunal held that the value of the holdings of the taxpayer in CIL has been unlocked due to the IPO and value is derived by the book building process.
- On the argument that no real income accrued to the taxpayer, the Tribunal looked into the financial statements of the taxpayer and held that the taxpayer has earned substantial gain on sale of shares and has also gained on account of taxes as the said gains were not chargeable to tax in UK and thereby, the taxpayer earned real income on account of sale of shares of CIHL to CIL.
- On the additional ground raised by the taxpayer that for the purpose of taxability of capital gains, the domestic law should be seen as it was in existence on the date on which the India-UK tax treaty was notified, the Tribunal held that provisions of the tax treaty cannot make the domestic law static with respect to taxability of a particular income when unequivocally, both states have left it to the domestic laws of the countries.

Computation of Capital Gains

- The Tribunal observed that since both the taxpayer and the tax officer had determined same amount of sale consideration, it did not get into the controversy of whether the transaction is of exchange or sale.
- The tax payer argued that the cost of acquisition should be stepped up to the fair value of the shares of CIHL on the date of acquisition. Further, when any asset is transferred in lieu of another asset and no specific amount for consideration is agreed between the parties, in such cases while computing capital gains fair market value of the asset received in consideration for the assets transferred, should be considered as full value of consideration. The Tribunal held that merely because the consideration is not stated in monetary terms in the agreement, it cannot be said that sale consideration and cost cannot be determined. In this case,

the price of shares in each agreement was identified and the amount of acquisition recorded in the books of account, also proves the amount paid for the acquisition of the shares.

- The taxpayer further argued that as per the tax officer's stand even the earlier transfers were taxable and the cost of acquisition for the transfer of shares by the taxpayer, will be the sale consideration determined in earlier transfers. Since there is no difference of time between the transfers, the cost of acquisition will be same as the sale consideration in the hands of the taxpayer and there will not be any capital gains.
- The Tribunal did not agree with the contention of the taxpayer. The Tribunal held that the provision of section 48, 49 and 55(2) of the Act does not allow such treatment as it does not fall under any of the clauses which provide for considering cost to previous owner as cost to the taxpayer.

Levy of Interest under section 234A and section 234B

- As regards the ground of the taxpayer challenging the levy of interest under section 234A and 234B of the Act, the Tribunal agreed with the contentions of the taxpayer and held that in case of retrospective amendments, the taxpayer could not visualize its liability for payment of advance tax in the year of transaction and therefore, there cannot be any interest payable under section 234A and 234B of the Act. Further, the payments made to the taxpayer were also subject to withholding tax under section 195 of the Act.

Conclusion

- The Tribunal upholds the taxability on capital gains arising due to indirect transfer and concludes that any income arising 'through or from' transfer of any property in India shall be chargeable to tax as income deemed to accrue or arise in India in terms of the provision of section 9(1)(i) of the Act.
- The Tribunal rejected the plea of the taxpayer that the transaction is an internal business reorganization and does not create any wealth for the taxpayer as there is no third party involved. It relies on the fact that part of the sale consideration is paid from the money received from the shares offered under an initial public offer.
- Cost in relation to securities acquired in exchange of an asset is a debatable issue. This decision will further add to the controversy as the Act does not specifically provide how to determine the cost of acquisition in such transactions.

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