



Transfer Pricing Alert Insight with information

'International transaction' has a wider connotation than an actual transaction – Concept of 'acting in concert' analysed

Issue no: TP/1/2018

In this issue:

[Brief facts of the case](#)
[Observations and judgements of the Tribunal](#)

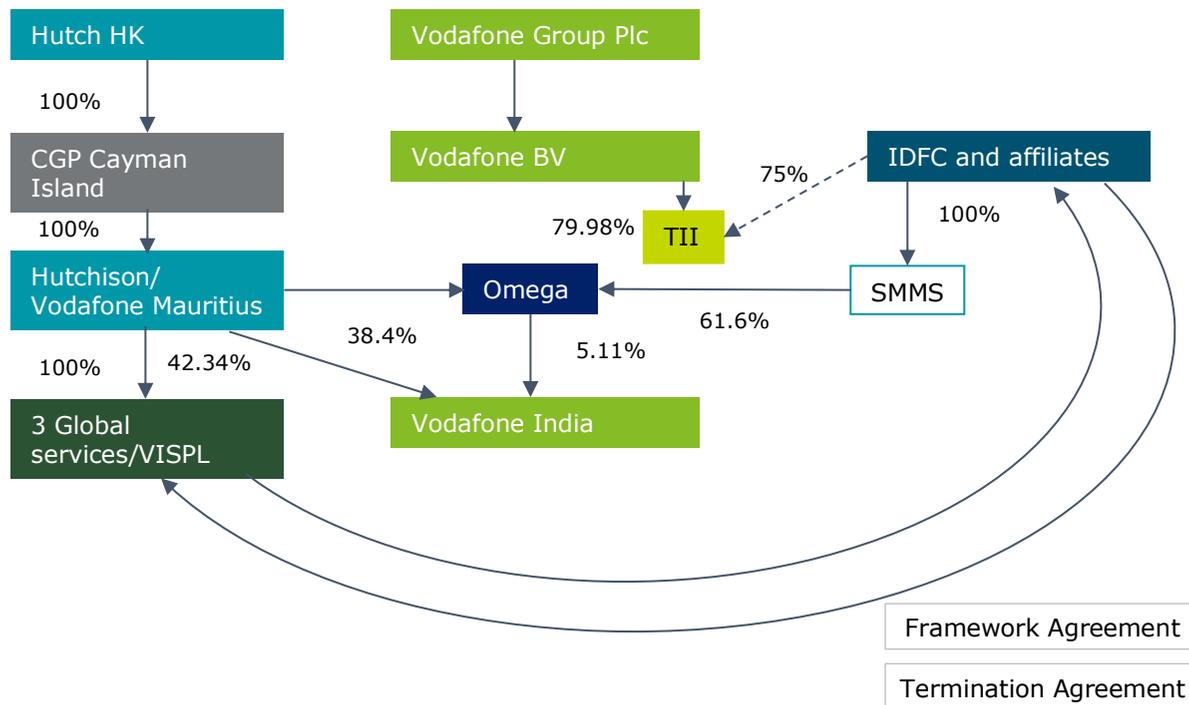
[Conclusion](#)

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Brief Facts of the case

Schematic diagram below explains the ownership structure of the case, including the underlying transactions.



Historical Background

Historical background of the acquisition of the Hutchison group by the Vodafone group, relating back to the controversy has a germane and wide linkage to the case at hand. It will thus be useful to recall facts of the earlier case. It may be recalled that Hutchison Hong Kong was the ultimate owner of the Hutchison group with Hutchison Cayman being its wholly-owned subsidiary. CGP Cayman, held Hutchison Mauritius which, in turn, held 3 Global services Private Limited, the assessee in the present case, and also part stake in Hutchison Essar Limited (HEL).

Hutchison HK sold the entire shareholding of CGP Cayman to Vodafone International Holdings BV (Vodafone BV) which resulted in the acquisition of Hutch group by Vodafone in 2007, and controlling stake in HEL, its Indian operating company. This acquisition was regarded as "indirect transfer", taxable in India, which was finally settled by the Supreme Court in favor of the taxpayer. The government, as it may be recalled, made retrospective amendments in the Indian tax laws in 2012 to bring this indirect transfer to taxation by amending Section 9 of the I-T Act.

Present Dispute

HEL post-acquisition named as Vodafone India Limited (Vodafone India is the Indian company in telecom operation). The shareholding of this company is held by a number of subsidiaries and associates as well as network through framework agreements and associated financial arrangements.

One of the shareholders of Vodafone India is Omega Telecom Holding Private Limited (Omega), which was holding 5.11% stake in Vodafone India. The dispute in the present case relates to the transfer of the shareholding of Omega in Vodafone India.

Facts of the case in the above respect are that in 2006, SMMS Investment Private Limited (SMMS), an Indian company, acquired 61.6% stake in Omega, which held 5.11% stake in Vodafone India. SMMS indirectly held 3.15% stake in Vodafone India.

The assessee, 3 Global services (post-acquisition named as Vodafone India Services Private Limited, or VISPL) entered into a framework agreement with SMMS and its investors (IDFC and affiliates) in June, 2007, which provided to VISPL a call option i.e., right to buy entire shareholding of SMMS for just Rs. 2 crore, plus 17.5% annually compounded interest or Rs. 78 lacs, whichever is higher. In effect, VISPL had the right to buy 3.15% stake in Vodafone India for just Rs. 2.78 crores. Similarly, the shareholders of SMMS had the put option i.e., requiring VISPL to purchase the entire shareholding of SMMS.

During Financial year (FY) 2011-12 however, the assessee entered into a termination deed dated November 24, 2011 and paid Rs. 21.25 crores as termination fees.

Subsequently, TII which was held by Vodafone BV (to an extent of 79.98%) acquired 75% stake in SMMS. Further SMMS bought back the balance shares from the investors. Accordingly, Vodafone BV's equity interest in Vodafone India increased by 2.52% through TII which became the 100% owner of SMMS, which indirectly held 3.15% stake in Vodafone India.

The Transfer Pricing officer disputed the termination fee of Rs. 21.25 crore paid by VISPL to IDFC.

The assessee explained that in November, 2011, the investors of SMMS exercised the put option as they wanted to sell the entire shareholding of SMMS. However, the assessee was not in a position to honour its obligation and hence the investors decided to terminate the agreement. Further, since the termination of the framework agreement was delayed due to the assessee, the assessee had to pay termination fee of Rs. 21.25 crore to IDFC.

The TPO observed that the assessee was unable to acquire 3.15% stake in Vodafone India for a petty amount of Rs. 2.78 crores but agreed to pay Rs. 21.25 crore for the termination fees. The TPO analysed the framework agreement in detail and held that the holding company of the assessee was not only a party to the agreement but had also agreed to provide financing to IDFC and affiliates for the acquisition of stake in SMMS. The framework agreement constituted a prior agreement based on which the termination agreement was entered into by the assessee resulting in deliberate substantial loss to the assessee. Therefore, even though the termination agreement was entered into between the Indian entities, it was in essence decided by its AEs and hence the termination agreement was an international transaction.

The TPO further held that the option right was a capital asset and the extinguishment of such right is transfer of capital asset which is subject to capital gain and subject to transfer pricing provisions. The TPO thereafter computed arm's length value of the transfer of capital asset at Rs. 1588.85 crores by adopting internal CUP taking the base of termination fee for extinguishment of 0.1234% shares in an earlier independent transaction for Rs. 62.23 crores and accordingly made TP adjustment.

Observations and judgement of the Tribunal

After analyzing the various agreements and arrangements under the historical structuring of the Hutchison group as well as its acquisition by the Vodafone group, the Tribunal took a holistic view and summarized the entire group structuring leading to the present transaction in dispute.

Holistic view of the arrangement

Pursuant to the relaxation in FDI norms in 2005 in the telecom sector, the Hutchison group concentrated on increasing its stake in HEL from 42.23%.

Omega was holding 5.11% stake in Vodafone India. In order to acquire this stake, Hutchison group (post-acquisition Vodafone group) made an arrangement to buy stake in Omega.

Hutch Mauritius contracted with the Hinduja TMT and Indusind Network to buy a total stake of 54.21% in Omega. It identified independent investors, IDFC and affiliates which subscribed to the equity and preference shares of SMMS. SMMS was nominated to buy 54.21% shares in Omega. Hutchison group also arranges finances to enable SMMS to buy shares from Hinduja TMT and Indusind Network. Hutchison group arranges for finances and provided guarantee for this entire arrangement.

The Tribunal observed that while the shares of Omega was purchased from outside investors, instead of directly holding the shares, the shares were parked in an entity (SMMS), which was apparently owned by independent investors (IDFC and affiliates). But in order to ensure that SMMS investors remains in the control of the group entities, the assessee, a group entity, enters into an agreement with IDFC investors under which assessee had a right to buy entire equity of SMMS Investments from IDFC Investors for a consideration of the same Rs 2 crores plus interest @ 17.5% p.a.

This arrangement however was terminated in the relevant assessment year 2011-12 and the shareholding in SMMS Investments is transferred to TII, group entity of Vodafone.

International transaction

The Tribunal held that the entire arrangement involves several parties acting in concert including non-resident associated enterprises. Section 92F (v) of the Act provides that irrespective of whether an arrangement, understanding, or action in concert is legally enforceable or not, it falls within the ambit of "transaction" for the purpose of TP provisions. Further, as the non-resident associated enterprises were parties to such action in concert, it becomes an "international transaction".

The Tribunal rejected the assessee's reliance on the Supreme Court decision in Vodafone International Holdings BV wherein the Supreme Court held that the arrangement was not an international transaction, on the ground that the Supreme Court only dealt with the legal ownership of the entities and not the factual rights.

With respect to the contention of the assessee that the termination agreement had no bearing on the profit and loss of the assessee as the assessee did not claim the deduction of the termination fee in its return of income, the Tribunal held that just because an income/ expense is not taken into account in computation of taxable income, an international transaction cannot be said to be regarded as outside the ambit of "international transaction". What is material is whether the transaction in question is capable of producing an income chargeable to tax or not.

Deemed International transaction

The Tribunal further analysed the applicability of deemed international transaction provision under section 92B(2) of the Act. The Tribunal observed that the foreign AE and parent entity of the assessee but also decided the terms & conditions of the agreement. Hence, the transaction falls under section 92B(2).

Capital Asset

The Tribunal analysed the definition of capital asset as defined under section 2(14) of the Act and held that post amendment of the section in 2012 the scope of the section has been enlarged to cover the right to nominate the option rights, which was

exercised by the assessee in present case. The Tribunal distinguished the High Court judgement in assessee's own case in previous year where the High Court ruled that options rights were not capital asset.

Further, the Tribunal held that the transfer of such rights is extinguishment of right which is covered under the definition of "transfer" of capital asset for the purpose of capital gain.

Computation of Capital Gain

The Tribunal observed that the assessee paid Rs. 62.24 crores towards assignment of rights of 0.1234% shares in Vodafone India which was never actually exercised by the assessee. Further, as part of the same arrangement, the assessee got the right to buy entire shareholding of SMMS which was later assigned to TII for Rs. 21.25 crores. Accordingly, the total payment of Rs. 83.49 crores was considered cost of acquisition.

Considering the value of Rs. 62.23 crores as value for 0.1234%, the Tribunal upheld the arm's length value of these capital assets as proportionate value of 5.11% shares of Vodafone India.

Conclusion

The ITAT judgement is significant and lays down guiding principles for structuring deals. It emphatically makes it clear that Indian TP regulations are very wide and covers all the action with the involvement of non-resident associated enterprise. Factual rights preside over legal rights for the application of TP provisions.

Vodafone India Services Private Limited vs DCIT [ITA No. 565/Ahd/17, AY 2012-13]

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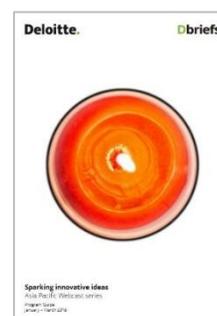
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