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TAX FLASH NEWS

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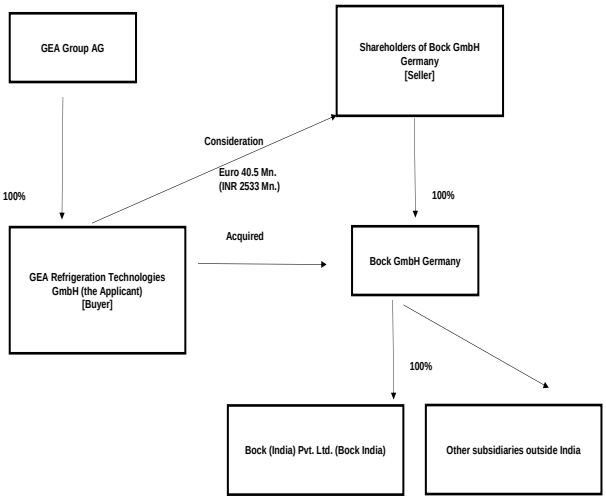
Capital gains arising from indirect transfer of shares of an Indian company on sale of shares of German company are not taxable in India

Background

Recently, the Authority for Advance Rulings (AAR) in the case of GEA Refrigeration Technologies GmbH[1] (the applicant) held that capital gains arising from indirect transfer of shares of an Indian company on sale of shares of German company shall not be taxable in India under the provisions of Section 9(1)(i) of the Income-tax Act, 1961 (the Act). German company has derived its value substantially from its other companies[2] whereas its value of assets in Indian company is a mere 5.40 per cent, far lower than the requirement of 50 per cent. Hence, it fails the test of deriving value substantially from the Indian company. The AAR also held that since the transfer is effected in Germany, and the payments have also been made in Germany, the gains arising from the alienation of shares by the shareholders of Bock GmbH can be brought to tax only in Germany.

Facts of the case

- The applicant is a German company engaged in the business of industrial refrigeration. The applicant has extensive experience in the fields of the food and beverage industry, petroleum and gas, etc. The GEA group is one of the largest system providers for food and energy processes, and is a market and technology leader in its business areas.
- In order to gain access to wider range of cooling applications and to enhance the know-how with regard to environment friendly solutions, on 31 March 2011, the applicant entered into a Share Purchase Agreement (SPA) to acquire an unrelated German company, Bock Kaltemaschinen GmbH (Bock GmbH) at a purchase price of Euro 40.50 million.
- Bock GmbH is a family owned company. The consideration of Euro40.50 million was paid to the shareholders of Bock GmbH (9 nos.), all of whom are residents of Germany. Bock GmbH holds 100 per cent shares in Bock India, and also holds, directly or indirectly, shares in the companies located in various countries[3]. Bock GmbH also holds, directly or indirectly, majority of the voting rights in a Thailand company, and a minority stake in an Australian company.
- Bock India is an operating company with its own manufacturing facilities in India and as a result of the aforementioned transaction, there was an indirect change in the ownership of Bock India due to the acquisition of Bock GmbH by the applicant. A diagrammatic representation of the said transaction is as under



[1] GEA Refrigeration Technologies GmbH (AAR No. 1232 of 2012) – Taxsutra.com

[2] Situated in Germany, China, England, Czech Republic, Singapore, Malaysia, Thailand, Australia, etc.

[3] Germany, China, England, Czech Republic, Singapore, Malaysia, Thailand, Australia, etc.

Issues before the AAR

- Whether income derived from the indirect transfer of Bock (India) on sale of shares of Bock GmbH, Germany is chargeable to tax in India under Act read with the provisions of the tax treaty?
- Whether the applicant is liable to deduct tax at source under Section 195 of the Act on the payments made by it to the shareholders of Bock GmbH, Germany on account of purchase of shares?

AAR ruling

Taxability under the Act

- The applicant has filed the detailed valuation report as per the formula prescribed in the Rules[4]. On perusal of the valuations, the AAR observed that the report from the independent valuer is a detailed one and can be relied upon. The AAR observed that the value of the assets of Bock India against the total assets of Bock GmbH ranges between 5.23 per cent to 5.57 per cent of the value of Bock GmbH, which is miniscule, as against the requirement of 50 per cent mentioned in Explanation 6 to Section 9(1)(i) of the Act.
- Even some variation in the valuation, as apprehended by the tax department, is unlikely to enhance this ratio to the extent that it can be classified as substantially derived. In fact the same may only go down when the liabilities of Bock GmbH are taken into account.
- The AAR observed that the present ruling is based on the facts and figures available on record and if subsequently the same are found to be at variance such as to exceed 50 per cent, the ruling would not apply to the new set of facts and figures that may come before the tax department, and it would not be bound by this ruling.
- The AAR observed that in the facts and circumstances of the case the applicant's income cannot be brought to tax in India under the provisions of the Act, as Bock GmbH derives its value substantially from its other companies situated in Germany, China, England, Czech Republic, Singapore, Malaysia, Thailand and Australia, etc., whereas its value of assets in Bock India is a mere 5.40 per cent, far lower than the requirement of 50 per cent. Hence, it fails the test of deriving value substantially from the Indian company.

Taxability under the tax treaty

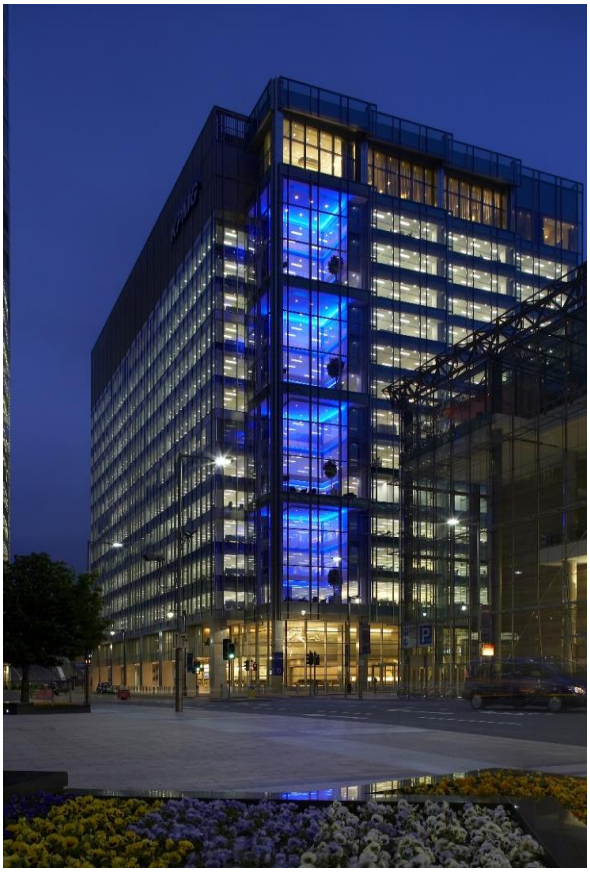
- Since the AAR ruled that the gains arising from the indirect transfer of shares of Bock GmbH are not chargeable to tax in India in view of the provisions of the Act. Hence, in view of Section 90(2) of the Act, the applicant would be entitled to take advantage of the provision that was more beneficial to it.
- The nine sellers, being the shareholders of Bock GmbH, and the applicant, as per the SPA of 16 December 2010, are all tax residents of Germany. The transfer is effected in Germany, and the payments have also been made in Germany, the gains arising from the alienation of shares by the shareholders of Bock GmbH can be brought to tax only in Germany.
- Even if a view was taken that some other rights were transferred, other than shares, in light of the decision in the case of Vodafone[5], then Article 13(5) of the tax treaty would come into operation, and then again tax could be charged only in the country of the alienator, i.e. the shareholders of Bock GmbH, that is in Germany.
- A view could be possible that since the shares of Bock GmbH were sitting in Bock India, that is in India, and got indirectly transferred to the applicant in Germany when it acquired Bock GmbH, gains arising from the same could be taxed in India. However, it is seen that a similar matter under similar provisions of the tax treaty, was decided in the case of Sanofi Pasteur Holding SA[6], wherein shares of a French company which held 80 per cent shares in an Indian company were transferred to another French company. It was held that the gain arising from such transfer was taxable in France and not in India. Hence, in spite of a possible contrarian argument, in cases of indirect transfer, the decision in the case Sanofi Pasteur stands as of date and has to be respectfully followed.
- Accordingly, the AAR ruled that the gains arising from the alienation of shares of Bock GmbH, on account of its acquisition by the applicant, shall not be taxable in India.

[4] Rule 11UB(6) of the Income-tax Rules, 1962 (the Rules)

[5] Vodafone International Holdings BV [2012] 341 ITR 1 (SC)
[6] Sanofi Pasteur Holding SA v. Dept of Revenue [2013] 354 ITR 316 (AP)

Withholding of tax

- The liability to deduct tax arises only if the sum so paid was chargeable to tax in view of the decision of the Supreme Court in the case of GE Technology Centre P. Ltd.[7]. Respectfully following that decision, it has been held that there is no obligation on an applicant to withhold tax.



Our comments

The issue with respect to taxability of indirect transfer of shares of an Indian company has been a subject matter of litigation before the courts. The Delhi High Court in the case of Copal Research Limited, Mauritius & Ors[8] explained the meaning of the term 'substantially' used in the context of indirect transfers. It was held that gains arising from the sale of a share of a company incorporated overseas which derives less than 50 per cent of its value from assets in India would not be taxable under Section 9(1)(i) of the Act.

The Finance Act, 2015 introduced Explanation 6 to Section 9(1)(i) of the Act to provide that a share/interest will be deemed to derive its value substantially from assets located in India if the value of Indian assets exceeds INR100 million and the value represents at least 50 per cent of the value of all assets owned by the foreign company/entity. CBDT has issued rules[9] with respect to indirect transfer of shares providing some degree of certainty on computation of income chargeable to tax in India.

The AAR in the present case held that gains arising from indirect transfer of shares of an Indian company on sale of shares of German company shall not be taxable in India under the provisions of Section 9(1)(i) of the Act as German company derives its value substantially from its other companies whereas its value of assets in Indian company is a mere 5.40 per cent, far lower than the requirement of 50 per cent. Hence, it fails the test of deriving value substantially from the Indian company. The AAR ruling supports the applicability of 50 per cent threshold and valuation rules for past transactions even if such objective threshold is introduced under the Act with effect from Financial Year 2015-16.

This is a welcome decision on the taxability of indirect transfers because it will help reinforcing the confidence of foreign investors in India. Another positive indication is that the courts are not willing to indiscriminately pierce the corporate veil, and the onus would lie on the Indian tax authorities to successfully prove that piercing the corporate veil is warranted.

Even though the decision of the AAR is binding only on the parties involved in a particular case, the decision would have a persuasive value in similar matters before the income-tax authorities and courts of law.

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[7] GE Technology Centre P. Ltd. v. CIT [2010] 327 ITR 456 (SC)
[8] DIT v. Copal Research Limited [2014] 371 ITR 114 (Del)
[9] CBDT Notification No. 2226(E), dated 28 June 2016

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