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TAX FLASH NEWS

13 December 2020

Gifting of shares to a group company pursuant to restructuring is not valid due to absence of voluntariness and thus it is taxable as capital gains

Recently, the Madras High Court in the case of Redington (India) Limited[1] (the taxpayer) dealt with the issue of taxability of gift of shares by a company to its step-down subsidiary. The High Court held that the transaction was not covered within the capital gains tax exemption provisions[2] as it was a transfer of a capital asset. The share transfer was not voluntary and would not qualify as a valid gift. Further it was executed for a consideration and therefore, it fails to satisfy the test laid down under the provisions[3] of the Transfer of Property Act, 1882 (TOPA) to qualify as a valid gift. The High Court has not proceeded solely on the basis of the title of the document but it was guided by the form, the substance and the intention behind the transaction. Accordingly, it was held that the manner in which the transfer was effected and ultimately the investment landing in a tax haven clearly show that it was a sham transaction devised to avoid tax in India.

Facts of the case

The taxpayer is an Indian company registered on stock exchanges in India. The overseas operation of the taxpayer in Middle East and Africa is carried on through the taxpayer's wholly owned subsidiary (RG), a Dubai based entity which has sixteen subsidiaries located in several countries in the Middle East and Africa. RG was acquired with effect from 1 April 2004 and the total investment in RG equity amounts to INR 214 Crores.

During 2008, a private equity fund, Investcorp GO FRG (IVC), evinced interest in investing in the Middle East and Africa operations of the taxpayer. RG is established as a Free Zone Enterprise (FTZ) and the Free Zone Authority does not permit more than one shareholder in an FTZ. Thus, it was not possible for IVC to directly invest in RG due to single shareholder restriction. Therefore, the taxpayer incorporated entity in Mauritius (RM) and Cayman Islands (RC) and the entire share capital of RC is held by RM. On 13 November 2008 (Assessment Year 2009-10), the taxpayer transferred its entire shareholding in RG to RC without consideration. Subsequently, within a very short period[4], IVC corporation invested USD 65 million in the RC for 27.17 per cent stake. The taxpayer claimed the above transaction as a gift and claimed exemption under Section 47(iii) of the Income-tax Act, 1961. The entire transaction was in the form of restructuring.

The Assessing Officer (AO) observed that the voluntary transfer of shares of RG by the taxpayer without consideration to RC was held to be not a valid gift and not covered under Section 47(iii) and accordingly, determined the long-term capital gain tax under Section 45. Subsequently, the Dispute Resolution Panel (DRP) upheld the order of the AO.

The Tribunal held that the transfer of shares made by the taxpayer to its step-down subsidiary located in Cayman Island is a gift eligible for exemption under Section 47(iii) and no capital gain tax is imputable to the said transfer of shares.

High Court's decision

Referring to the provisions[5] of TOPA, the High Court observed that a company would be entitled to execute a gift in terms of the TOPA. The Tribunal accepted the contention of the taxpayer that it was entitled to gift

[1] PCIT v. Redington (India) Limited (T.C.A.Nos.590 & 591 of 2019) - Taxsutra.com
Note: The High Court has dealt with several issues. However, this flash news deals with only one issue i.e. the taxability of transfer of shares by way of gift.
[2] Under Section 47 of the Income-tax Act
[3] Section 122 of the TOPA
[4] Less than a week
[5] Section 5 of the TOPA

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its shares in RG to RC. However, the Tribunal failed to examine as to whether the ingredients of the provisions of the TPOA have been fulfilled to qualify as a valid gift.

Further, the provisions of the TOPA define '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 are (i) absence of consideration; (ii) the donor; (iii) the donee; (iv) to be voluntary; (v) the subject matter; (vi) transfer; and (vii) the acceptance. The concept of gift is diametrically opposed to any person of consideration or compensation. It cannot be disputed that there can be transactions which may not amount to gift within the provisions[6] of the TOPA but would qualify as gift for the purpose of levy of tax under the Gift Tax Act owing to the definition contained in the Gift Tax Act. Black's dictionary states that 'gift' is always gratuitous, grants or upon some consideration or equivalent. Further, various decisions have held that for proving a document of gift was executed with free and voluntary consent of the donor, it must be proved that the physical act of signing the deed coincide with the mental act viz., the intention to execute the gift. The principles laid down in the Indian Contract Act relating to free consent would apply in determining whether gift is voluntary.

Referring to the decision of Tulsidas Kilachand[7], the High Court observed that neither in the board resolution, nor in the deed of share transfer, there was any mention of the word 'gift' or any like term to indicate 'gift'. The board resolution states that the transfer of shares was towards restructuring the concern for which the board accords its approval. In view of this factual position, 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 is the intention to execute the gift.

The board resolution does not state that the transfer was by way of a gift, as the words used in the resolution was with or without consideration. Therefore, at the time when the board of the taxpayer took a decision to transfer its entire holdings in RG to RC, it did not consider it to be a gratuitous transfer. 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. Therefore, the Court has to look into the background facts to ascertain as to what had driven the taxpayer to effect the share transfer. If there were factors, which were working behind the scene which led to the approval of the proposal to transfer the shares, then obviously, it would mean that the transfer of share was not voluntary and it would not qualify as a valid gift. This aspect of the matter has been brought out not only by the TPO in the draft assessment order, but also by the DRP in the assessment order.

The decisions[8] relied on by the taxpayer was distinguishable on facts of the present case. In McDowell & Co. Ltd.[9], it was held that the tax planning may be legitimate provided it is within the framework of law. The tax authorities as well as the Tribunal and Courts are required to examine as to whether the taxpayer had adopted any ingenious method to avoid taxation. Therefore, the tax authorities as well as the Tribunal and Courts are entitled to go behind the veil to examine the real intention of the parties in effecting transactions to come to a conclusion whether the 'gifts' were genuine.

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. The sole intention of the taxpayer was for corporate re-structuring, which was stated to have identified a third-party investor who holds the investment in Cayman Island.

If the chain of events is considered, it is clear that the incorporation of the company in Mauritius and Cayman Island just before the transfer of shares is undoubtedly a means to avoid taxation in India and the said two companies have been used as conduits to avoid income tax. The manner in which the transfer was effected and ultimately the investment landing in a tax haven will clearly show that it was a sham transaction devised to avoid tax in India. Further, RC had no commercial substance on its own and the third party investor acquired about 27 per cent stake in RC because, it had acquired the shares of RG held by the taxpayer, which were transferred and this acquisition took place within a week after the RG's share was transferred to RC. Thus, the asset owned by the taxpayer which were hither to within the network of the Indian tax laws, stood shifted to Cayman Island which is a tax haven. Therefore, the entire transaction was so structured to accommodate the third-party investor, who has put certain conditions even prior to effecting the transfer. This was spelt out by the CFO of the taxpayer in his sworn statement wherein, he had

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[6] Section 122 of the TOPA

[7] Tulsidas Kilachand v. CIT [AIR 1961 SC 1023]

[8] Sonia Bhatia v. State of U.P. (1981) 2 SCC 585, Goodyear Tire & Rubber Co. [2011] 334 ITR 69 (AAR), Cadell Weaving Co. P. Ltd. [2001] 249 ITR 265 (Bom), Dheer & Co., In re [2011] 337 ITR 277 (AAR), Dana Corporation v. DIT [2010] 321 ITR 178 (AAR)

[9] McDowell & Co. Ltd. v. CTO AIR 1986 SC 649

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admitted that as per the request of the third-party investor, they had incorporated RC and, RG's shares were transferred to RC.

Thus, the factual matrix demolishes the case of the taxpayer, as there is absolutely no voluntary element. It was executed for consideration and therefore, it fails to satisfy the test laid down under the provisions[10] of the TOPA to qualify as a valid gift.

The High Court has not proceeded solely on the basis of the title of the document, but are guided by the form, the substance and the intention behind the transaction bearing in mind the words of caution expressed by the Supreme Court as regards the duty of the Courts and Tribunal while examining a transaction to consider it as to whether it is legitimate tax planning or a device adopted for tax evasion.

The High Court held that the transaction was not covered under Section 47(iii), as it was not a transfer of capital asset under a gift and the lower authorities rightly classified the transaction under Clause (iv) of Section 47. The argument of the taxpayer was that clause (iv) of Section 47 would not be attracted, as it would apply only to a wholly owned subsidiary. It should not be forgotten that the Court have been called upon to decide as to whether the subsidiary company and the step-down subsidiary were incorporated as a device to act as a conduit to avoid tax in India. Incorporation of the step-down subsidiary and transfer of shares in favour of a third party investor within a short span of less than a week for a stake of more than 27 per cent and surrounding circumstances clearly bring the transaction as transfer of the capital asset by a company to its subsidiary company and therefore, to be classified as a transaction under Section 47(iv). The subsidiary company is a non-resident and therefore, the taxpayer had violated the conditions stipulated under Section 47(iv), consequently, the taxpayer is liable for capital gain tax under Section 45, as the transaction would fall within the definition 'transfer' as defined under Section 2(47).

The decision of Kalindi Investment P. Ltd.[11] relied on by the taxpayer, is distinguishable on the facts of the case. Further the High Court distinguished the decisions in the case of Prakriya Pharmachem[12] and Asian Satellite Broadcast Pvt. Ltd.[13] as both the decisions were rendered in writ petitions quashing the reopening of the assessment and incidentally, the factual issue has been touched upon and in one of the cases, the AO himself did not dispute the theory of gift which was missing in the case on hand.

Accordingly, the High Court held that capital gains tax exemption provisions will not apply to the taxpayer's case, as it was not a valid gift.

Our comments

The issue of taxability of transfer of shares by way of gifts (without consideration) by a company has been a subject matter of debate before the Courts and Tribunal.

The Karnataka High Court in the case of Nadatur Holdings and Investment Pvt Ltd[14] held that there was no bar for gifting of shares to a company. The definition of gift means transfers by one person to another of an existing property made voluntarily and without consideration and includes deemed transfer or conversion of any property.

However, the AAR in the case of Orient Green Power Pte Ltd[15] held that inter-corporate gift is 'strange transactions' and that such transactions may not be eligible for exemption under Section 47(iii), as it covers only gifts made by an individual, Hindu Undivided Family, etc.

Recently, the Bombay High Court in the case of Asian Satellite Broadcast Pvt. Ltd.[16] while quashing reassessment proceedings observed that the transfer of shares without consideration by a company was a gift transaction which was valid, permissible and genuine. Such transfer of shares by a company by way of gift are exempt from the provisions of capital gains.

However, the Madras High Court in the present case has held that the transaction of inter-corporate gift is not covered within the capital gains tax exemption provisions, as the transfer of share was not voluntary and would not qualify as a valid gift. The manner in which the transfer was effected and ultimately the investment landing in a tax haven clearly show that it was a sham transaction devised to avoid tax in India.

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[10] Section 122 of the TOPA
[11] Kalindi Investment P. Ltd. v. CIT [2002] 256 ITR 713 (Guj)
[12] Prakriya Pharmachem vs. ITO [(2016) 66 taxmann.com 149 (Guj), Asian Satellite Broadcast Pvt. Ltd. v. ITO (Writ Petition No.2749 of 2019)
[13] Asian Satellite Broadcast Pvt. Ltd. v. ITO (Writ Petition No.2749 of 2019)
[14] CIT v. Nadatur Holdings and Investments (P.) Ltd. [2012] 210 Taxman 597 (Kar)
[15] Orient Green Power Pte Ltd. [2012] 346 ITR 557 (AAR)
[16] Asian Satellite Broadcast Pvt. Ltd. v. ITO (Writ Petition No.2749 of 2019)

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KPMG in India addresses:

Ahmedabad
Commerce House V, 9th Floor,
902, Near Vodafone House, Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051.
Tel: +91 79 4040 2200

Bengaluru
Embassy Golf Links Business Park,
Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road, Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh
SCO 22-23 (1st Floor),
Sector 8C, Madhya Marg,
Chandigarh – 160 009.
Tel: +91 172 664 4000

Chennai
KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road,
Chetpet, Chennai – 600 031.
Tel: +91 44 3914 5000

Gurugram
Building No.10, 8th Floor,
DLF Cyber City, Phase II,
Gurugram, Haryana – 122 002.
Tel: +91 124 307 4000

Hyderabad
Salarpuria Knowledge City,
6th Floor, Unit 3, Phase III,
Sy No. 83/1, Plot No 2, Serilingampally Mandal,
Ranga Reddy District,
Hyderabad – 500 081.
Tel: +91 40 6111 6000

Jaipur
Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 By pass Tonk Road,
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi
Syama Business Centre,
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019.
Tel: +91 484 302 5600

Kolkata
Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091.
Tel: +91 33 4403 4000

Mumbai
1st Floor, Lodha Excelus,
Apollo Mills,
N. M. Joshi Marg,
Mahalaxmi,
Mumbai – 400 011.
Tel: +91 22 3989 6000

Noida
Unit No. 501, 5th Floor,
Advant Navis Business Park,
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305.
Tel: +91 0120 386 8000

Pune
9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex,
Mundhwa Road, Ghorpadi,
Pune – 411 001.
Tel: +91 20 6747 7000

Vadodara
Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023.
Tel: +91 265 619 4200

Vijayawada
Door No. 54-15-18E,
Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District,
Andhra Pradesh – 520 008.
Tel: +91 0866 669 1000

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KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011
Phone: +91 22 3989 6000, Fax: +91 22 3983 6000

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