DELHI TRIBUNAL AFFIRMS TAX ON INDIRECT SHARE TRANSFERS DERIVING VALUE FROM ASSETS IN INDIA

Background

Under the provisions of the Income-tax Act, 1961 (the "**IT Act**"), the income of a non-resident is deemed to accrue or arise in India, *inter alia*, if it arises, directly or indirectly, through the transfer of a capital asset situated in India. The Finance Act, 2012, introduced an explanation to section 9(1)(i) of the IT Act, under which an indirect transfer of shares or an interest in a company or entity registered or incorporated outside India substantially deriving its value from assets located in India was subjected to capital gains tax in India on the theory that the offshore capital asset would be regarded as situated in India if it substantially derived its value (directly or indirectly) from assets located in India. As there was a lack of clarity on what "substantially" meant, the IT Act was amended with effect from April 1, 2016 to clarify that the indirect transfer tax provisions would apply only if the value of the assets located in India exceeded INR100 million (approx. US$1.5 million) and the assets in India represented at least 50% of the value of all the assets owned by the offshore transferor company.

In a recent case, the Delhi Bench of the Income Tax Appellate Tribunal (the " **Delhi ITAT**") upheld the order of the Indian tax authorities levying INR10,247 crores (approx. US$1.5 billion) of capital gains tax on Cairn UK Holdings Ltd. ("**CUHL**"). The tax demand was in respect of CUHL transferring shares of Cairn India Holdings Ltd. ("**CIHL**") to Cairn India Limited (" **CIL**") as a part of an internal group reorganization in 2006-07 preceding an initial public offering ("**IPO**") of CIL's shares.

Note that the Cairn group undertook an internal reorganization mainly to simplify the group structure for both, operational and strategic reasons, including to access the Indian capital markets, and to allow equity participation by Indian and foreign investors in their Indian business. Although the reorganization chart is very complex, we have briefly outlined the facts below.

In 1995, Cairn Energy Plc ("**CEP**"), a Scottish company, acquired a participating interest in various oil and gas assets in India through its direct or indirect foreign subsidiaries. CUHL was incorporated on June 26, 2006 in the UK as a 100% subsidiary of CEP. On June 30, 2006, CUHL issued about 22,14,44,034 ordinary shares of the face value of £1 each to CEP in exchange for the entire issued share capital of the subsidiaries of CEP. In August 2006, CUHL incorporated another 100% subsidiary Cairn India Holdings Ltd. ("**CIHL**"), which was registered in Jersey, Channel Islands, and transferred its entire shareholding in about twenty six (26) direct and indirect subsidiaries to CIHL in exchange for 22,14,44,034 ordinary shares of £1 each of CIHL. On September 15, 2006, CUHL entered into a subscription and share purchase agreement with Cairn India Limited ("**CIL**") and CIHL (both subsidiaries of CUHL) with CEP as the guarantor. The agreement provided for CIL to acquire about 22% of the share capital of CIHL in two tranches. Subsequently, on October 12, 2006, a new share purchase agreement was executed under which the entire shareholding of CIHL was acquired by CIL from CUHL. By virtue of the purchase of 100% shares of CIHL from CUHL, CIL acquired the entire Indian business of the group.

Issue before the Delhi ITAT and its Ruling

In this case, the critical issue before the Delhi ITAT was whether any capital gains accrued to CUHL in the financial year 2006-07 by virtue of acquiring and selling CIHL shares and whether the capital gains was taxable in India?

The Delhi ITAT ruled that through a series of transactions, CEP transferred its Indian assets, first to CUHL and then to CIHL, both offshore entities. Eventually, the Indian assets were transferred to CIL, an Indian company, for a consideration of INR26,681 crore (approx.US$3.92 billion). The final transaction of sale of the Indian assets to an Indian company was done after the market value of the Indian assets was ascertained by an independent valuation and established through the IPO. Further, by selling the Indian assets to an Indian company, the Cairn group had made stupendous gains, but had paid no tax anywhere. Therefore, the Delhi ITAT upheld the order of the Indian tax authorities levying INR10,247 crores (approx. US$1.5 billion) of capital gains tax in India.

Our Comments

The Delhi ITAT's order has set the stage for a prolonged legal battle that promises to be a grim reminder of the Vodafone saga. Press reports suggest that the Delhi ITAT order comes at a time when the Cairn group and the Indian government are in an arbitration in Singapore for breach of the provisions of the India-UK bilateral investment treaty. Although the Modi government created a special panel to review all new indirect transfer tax cases initiated under the explanation to section 9(1)(i) of the IT Act, the CEP case was never brought to the panel on the grounds that it was not a "new" case. What is perturbing is that CEP has filed a "statement of claim" before the international arbitration panel stating that the Indian government had cleared its deal back in 2006, and in this process, it never raised the issue of taxation. Press reports suggest that in September 2006, six months prior to its IPO, CEP went to the Foreign Investment Promotion Board (the "**FIPB**"), which has representatives of the finance ministry on it, and submitted all the details about the internal corporate restructuring. It appears that the FIPB cleared this, but never mentioned the possibility, leave alone certainty, of the internal corporate restructuring attracting any taxes. The matter will now go to the High Court and eventually to the Supreme Court.

The Indian tax impact on any offshore transfer of shares or assets that derive substantial value from assets located in India should be thoroughly assessed, and if necessary, an advance ruling should be obtained from the Indian tax authorities.