## INDIAN TAX BENEFITS ON AMALGAMATIONS APPLIED TO FOREIGN COMPANIES – AN IMPORTANT DEVELOPMENT

In a recent ruling in the case of Banca Sella SpA (AAR No. 1130 of 2011 dated August 17, 2016), India's Authority for Advance Rulings ("**AAR**") has held that, although the Indian branch office ("**IBO**") of a foreign company is a capital asset for tax purposes, the transfer of a branch office in a scheme of amalgamation between two foreign companies will not be chargeable to capital gains tax in India in the absence of any consideration flowing to the amalgamating company. The AAR has also upheld the applicability of the non-discrimination clause under the double taxation avoidance agreement between India and Italy (the "**Italy DTAA**"). Pursuant to this, a non-resident transferor can seek an exemption from capital gains tax, which is available to domestic taxpayers in a scheme of amalgamation under the Income-tax Act, 1961 (the "**IT Act**").

### *Facts in brief*

Banca Sella SpA ("**BSS**") is an Italian tax resident and engaged in banking services. BSS is a part of the Banca Sella group of companies. BSS also provides outsourcing, financial, and other incidental services. Sella Servizi Bancari SCPA ("**SSBS**") is a group company engaged in rendering support services to other Banca Sella group companies. BSS holds a 15% equity stake in SSBS.

An entity of the Banca Sella group had a subsidiary private limited company in India engaged in rendering information technology support services to group entities. SSBS established the IBO in January 2010. The IBO acquired the IT support business of the Banca Sella group's Indian subsidiary on a slump sale basis in February 2010. The capital gains tax arising from the slump sale transaction was paid by the Indian subsidiary to the Indian tax authorities (the "**ITA**").

The Banca Sella group underwent a global restructuring pursuant to which SSBS merged with BSS. Consequent to the foreign amalgamation, the shareholders of SSBS were allotted shares in BSS.

### *Questions before the AAR*

The following four questions were raised by BSS before the AAR.

- Whether the amalgamation of SSBS with BSS would constitute a "transfer" of the IBO as a capital asset under the provisions of the IT Act and be subject to capital gains tax in India? If so, whether the price paid by the IBO to the Indian subsidiary could be considered as the cost of acquisition?

- Whether the capital gains tax exemption would be available under the non-discrimination article of the Italy DTAA?

- Whether the other shareholders in SSBS would be liable to capital gains tax in India because of the extinguishment of their rights in the 15% shareholding in SSBS?

- Whether the amalgamation of SSBS with BSS would be subject to the Indian transfer pricing provisions under the IT Act?



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***BSS's arguments***

The term "transfer" postulated a change in the ownership of property from one person to another, with both persons and the property continuing to be in existence. Because SSBS would stand dissolved, there was no transfer of any right, title or interest in, or transfer of, IBO. It was only as a consequence of the amalgamation that all assets of SSBS stood vested in BSS, and this did not tantamount to a transfer. Even assuming that there was a transfer, no consideration accrued to SSBS, and only if there was a positive inflow of consideration could the charge be triggered. Therefore, as the computation provisions would not be operational, there could be no question of levy of capital gains (the computation method under the provisions of the IT Act provides for reduction of the cost of acquisition from the sale consideration).

***ITA's arguments***

The amalgamation involved the extinguishment of rights in the shares of SSBS held by all the shareholders, including BSS. The capital asset, being the IBO, had been parted with and the interest therein had been given away to BSS indirectly, by way of amalgamation, which would attract capital gains tax. On the effective date of the amalgamation, both the transferor and the transferee were in existence. The price at which the IBO acquired the business of the Indian subsidiary would be the cost of acquisition of the IBO, and capital gains tax should be computed as the market value of SSBS as reduced by the net asset value.

***AAR's ruling***

The AAR held that in an amalgamation a "transfer" took place, and both, the amalgamating company as well as to the shareholders, would be subject to tax. However, relying on India's Supreme Court's ruling in the case of *BC Srinivas Shetty*, the AAR held that in the absence of any consideration flowing to the amalgamating company such transfers would not attract capital gains tax. The AAR held that the notional market value could not be treated as the cost of consideration for calculating capital gains in the hands of SSBS because SSBS did not receive any consideration before it merged and lost its identity.

Separately, the AAR also held that Article 25 of the Italy DTAA provided for non-discrimination between locals and foreigners with no preferential treatment in the matter of taxation. The exceptions applied to individuals and not to companies. If an amalgamation resulted in some special benefits to a local company and its shareholders under the IT Act, there was no reason to deny these benefits to a foreign company and its shareholders in a similar situation. Therefore, the tax exemption should be available to SSBS.

For the other Italian shareholders of SSBS, even though they received a consideration (in the form of shares of the amalgamated company), the capital gains arising to them would be taxable only in Italy by virtue of the provisions of the Italy DTAA. Also, the indirect transfer provisions of the IT Act did not get triggered because BSS derived only a small value from the assets (IBO) located in India.

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Lastly, the AAR relied on its own ruling in the case of *Amiantit International Holding Limited* (322 ITR 678) to hold that the transfer pricing provisions would not apply in the absence of any income being chargeable to tax in India.

***Our comments***

Under the IT Act, the capital gains arising from the "transfer" of a capital asset situated in India are taxable in India. The term "transfer" is broadly defined to include, *inter alia*, disposing of or parting with an asset or any interest therein, or extinguishment of any rights. However, an exemption has been provided to the transfer of a capital asset in a scheme of amalgamation, provided the amalgamated company is an Indian company. Moreover, under the Italy DTAA, the non-discrimination clause provides that neither country can decline any allowance or exemption only on the grounds of the nationality of the taxpayer.

Based on the foregoing, the AAR has concluded that the transfer of an Indian branch office of a foreign company to another foreign company in a scheme of amalgamation will be a taxable event in India. However, in the absence of any consideration accruing to the transferee, the capital gains computation mechanism will fail and will ultimately result in non-taxability.

Separately, the AAR ruling provides a welcome clarification on the scope of a non-discrimination clause of a tax treaty while analyzing the Italy DTAA.

In our view, this is a favorable ruling, and an overseas group restructuring may be able to take advantage of the principles prescribed in this ruling by the AAR.

It may, however, be noted that an advance ruling is binding only on the applicant and only in respect of the particular transaction in relation to which the ruling is sought. Notwithstanding, AAR rulings do have a persuasive value, but it is likely that the ITA may prefer a special leave petition before India's Supreme Court, in which case one will have to wait for the Supreme Court's final verdict.

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