RECENT UPDATES ON GAAR, ANGEL TAX AND TAX EXEMPT CONVERSIONS

Recent developments

The Indian tax authorities have started invoking the general anti-avoidance rules ("**GAAR**") under India's Income-tax Act, 1961 (the "**IT Act**"). In the last twelve (12) months, tax notices have been issued to many Indian subsidiaries of foreign companies to question transactions such as mergers, demergers, hive-offs, stock purchase transactions in Indian subsidiaries where shares have been issued at a premium or on a deferred payment basis, or in the manner in which the capital assets have been sold. There are apprehensions that given the sweeping powers under GAAR, many genuine transactions may get impacted, especially if they have resulted in a tax benefit for the parties.

As per press reports, India's Central Board of Direct Taxes ("**CBDT**") has stated that no coercive action will be taken against start-ups to recover "angel tax" (under Section 56(2)(vii)(b) of the IT Act), which is a term used to describe tax payable on capital contributions made into private unlisted companies by Indian resident persons where the share price is in excess of the fair market value of the shares. The excess money is considered as income in the hands of the private unlisted companies and taxed at the rate of approximately 30% (excluding surcharge and education cess). This provision was introduced in 2012 to address the issue of money laundering, and press reports suggest that at least eighty (80) start-ups have received demand notices from the Indian tax authorities to pay the angel tax in the past one year. Further, angel investors of these companies have also been asked to furnish details on their source of income, their bank account statements and other financial data. Hopefully, the CBDT's directive will come to the aid of such companies and their angel investors.

After the angel tax controversy on start-ups, the tax authorities have turned their attention to foreign direct investment ("**FDI**") transactions in Indian subsidiaries of foreign companies where a premium has been paid over and above the fair market value of shares to non-residents. The income tax department has started issuing notices to several companies that have received FDI claiming that the "premiums" they received on such transactions are unexplained credits under Section 68 of the IT Act and can be held as income subject to tax in India.

From a transfer pricing country by country reporting perspective, the Indian tax authorities have issued notices to US companies with subsidiaries in India to submit details of their global revenue, profits and sales to them by December 31, 2018, under Section 92 of the IT Act read with the OECD BEPs guidelines. The short timeframe within which to submit all this information has put various companies (including the likes of Google, Facebook, Dell, IBM, etc.) in a difficult position.

Conversion of preference shares into equity shares is not a transfer subject to capital gains tax

In a recent ruling in the case of *Periar Trading Company Private Limited*, the Mumbai bench of the Income-tax Appellate Tribunal (the "**Mumbai Tribunal**") has held that the conversion of compulsory convertible preference shares ("**CCPS**") into equity shares will not amount to a "transfer" under the provisions of the IT Act and will, therefore, not be subject to capital gains tax. Relying on a CBDT circular, the Mumbai Tribunal held that such a conversion did not result in an exchange, barter or swap of a share into another form of share. The only result was that one type of share got converted into another type and the former share ceased to exist. Therefore, this was not a "transfer" of a capital asset giving rise to capital gains tax implications under the IT Act. Note that the IT Act was amended in 2017 to provide for a capital gains tax exemption on the conversion of a company's preference shares into equity shares; however, this case related to a prior assessment year, and the Mumbai Tribunal's ruling is welcome as it interprets accurately the legal position prior to the amendment.

Conversion of a company into an LLP is taxable

In a recent ruling in the case of *Celerity Power LLP*, the Mumbai Tribunal held that the conversion of a private limited company (the "**Pvt Co**") into a limited liability partnership ("**LLP**") results in a "transfer" of a capital asset and, therefore, will be subject to capital gains tax in India in the hands of the Pvt Co. The Mumbai Tribunal held that the Pvt Co ceases to exist and thus the gains will be taxable in the hands of the converted LLP unless covered by the specific exemption under the IT Act. For readers, this point may appear similar to the one in *Periar Trading* case *(supra)* where CCPS' ceased to exist, but it is not so. Note that in the *Periar Trading* case, there was a conversion/redemption of CCPS into shares in the assessee's own hands, whereas in the *Celerity Power* case, there was a transfer of shares on the conversion of one entity (i.e., the Pvt Co) to another entity (i.e., the LLP).

As regards the cost of acquisition of the undertaking, the Mumbai Tribunal observed that when the capital assets became the property of the LLP by succession or devolution, the cost of acquisition of the assets should be deemed to be the cost at which the previous owner of the property (i.e., the Pvt Co) had acquired them. On this basis, the Tribunal held that although there was a transfer of a capital asset from the Pvt Co to the LLP, but given that the difference between the transfer value and the cost of acquisition was nil, the IT Act provisions were rendered unworkable and no capital gains tax could be levied. Notwithstanding the foregoing, taxpayers will need to consider this ruling in light of subsequent provisions introduced in the IT Act that require the determination of fair market value of a capital asset in respect of a transfer if the consideration is unascertainable.

Deductions available under a tax treaty cannot be disallowed under the IT Act

In a recent decision in the case of *Unocol Bharat Ltd*, the Delhi bench of the Income-tax Appellate Tribunal (the "**Delhi Tribunal**") ruled that the phraseology used in Article 7(3) of the India-Mauritius Double Taxation Avoidance Agreement (the "**Mauritius DTAA**") provides for deduction of expenses incurred by a permanent establishment ("**PE**") without applying any limitation in the IT Act to this effect, and in the absence of such a restriction, the limitation under the IT Act cannot be imported into Article 7(3) of the Mauritius DTAA. The taxpayer, a Mauritius tax resident, was engaged in business development and promotion in the energy sector in India for its parent company. The taxpayer constituted a PE in terms of Article 5 of the Mauritius DTAA and offered its income to tax in India on a net income basis. During the assessment year 1998-99, the taxpayer had incurred certain expenses relating to operating contracts, employee salaries, and travel and entertainment. The tax officer noted that appropriate documentary evidence (i.e., vouchers and bills of expenditure for the travel costs, details of tax withheld on salaries paid to employees, etc.) was not produced for these expenses, and that the taxpayer had not withheld any taxes under section 195 of the IT Act. Accordingly, the tax officer disallowed the expenses.

The Delhi Tribunal held that Article 7(3) of the Mauritius DTAA provides for the determination of profits of a PE by allowing the deduction of expenses incurred for the PE's business, including executive and general administrative expenses incurred in the jurisdiction in which the PE is located. Accordingly, all the expenses incurred for the PE's business must be allowed, as there is no restriction in the Mauritius DTAA on the allowability of such expenses subject to any limitation of the IT ACT.

Note that the phraseology used in Article 7(3) of the Mauritius DTAA is different from that in other treaties. For instance, Article 7(3) of the India-US tax treaty provides that the deduction of expenses incurred for the purpose of the PE's business is to be allowed subject to any limitations in the domestic tax law of the State in which the PE exists. Similar verbiage is also used in the India-UAE tax treaty after the protocol. However, as no such restriction exists in the Mauritius DTAA, the limitations under the IT Act cannot be imported into the Mauritius DTAA.

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