Vodafone’s ghost returns to haunt Cairn as Indian Tax Tribunal confirms USD 1.5 billion tax demand in indirect transfer case

News item offered by Taxsutra, 10 March 2017

A Delhi bench of the Indian Income Tax Appellate Tribunal (ITAT) recently confirmed INR 100 billion capital gains tax (USD 1.5 billion) on Cairn UK Holdings over the sale of its shareholding in Cairn India Holdings, to Cairn India Ltd Tribunal. In an extensive 166-page order, the ITAT upheld the order of the tax officer that calculated capital gains income to the tune of INR 245.03 billion on this transaction. The Tribunal accepted the tax officer's key finding and the Indian Revenue's arguments that shares of Cairn India Holdings derive their value solely from the assets located in India and, therefore, in accordance with the provisions of section 9(1)(i) of the Income Tax Act, it shall be deemed to have been situated in India.

**Brief Facts**

On 30 June 2006, the taxpayer, Cairn UK Holdings Ltd, a UK company, entered into the share exchange agreement with Cairn Energy Plc where the entire issued share capital of nine wholly owned subsidiaries of Cairn Energy Plc were exchanged by issue of 221,444,034 shares of taxpayer at the face value of GBP 1 each. Thereafter, the taxpayer entered into a share exchange agreement dated 7 August 2016 with another company, Cairn India Holdings Ltd, which was incorporated on 2 August 2006 in Jersey and the taxpayer exchanged all the shares of those nine subsidiaries with that company for issue to the taxpayer of 221,444,034 shares of GBP 1 each at par of that company, further for a debt of GBP 29,780,710 of Cairn Energy Hydrocarbons Ltd to Cairn Energy Plc was assigned to the taxpayer for a consideration of 29,780,710 ordinary shares of GBP 1 each by taxpayer to Cairn Energy Plc.

Thereby, in a nutshell, 29,780,710 shares of Cairn India Holdings Ltd were acquired by the taxpayer on account of the sale/transfer/assignment of debt. Therefore, by this stage, the taxpayer had acquired 221,444,034 + 29,780,710 (i.e. 251,224,744) of Cairn India Holdings Ltd. Subsequently, the taxpayer sold all the shares to a newly formed company in India, Cairn India Ltd, through a subscription and share purchase agreement dated 15 September 2006, and share purchase deed dated 12 October 2006. Cairn India Holdings Ltd is the holding company of nine subsidiary companies in India that are engaged in the oil and gas sector in India. As per submission of the taxpayer, consideration for this transfer was settled partly in cash and partly by shares issued in Cairn India Ltd in favour of the taxpayer.

The Indian Revenue reopened the audit proceedings and passed an order determining capital gains to the tune of INR 245.03 billion in the hands of the taxpayer on transfer of shares.

During the appeal before the Tribunal, the taxpayer had sought for an adjournment on the ground that it along with its holding company Cairn Energy Plc had invoked arbitration under article 9 of the India-UK bilateral investment treaty. However, the Tribunal opined that “keeping the issue unnecessarily pending for a very long time where there is no timeline available about the disposal of the application of the
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assessee for arbitration proceedings, which is pending since 11/03/2014, is not proper”. Considering the huge total amount involved, the Tribunal proceeded to hear the matter.

The precise issue before the Delhi Tribunal was whether the transaction entered into by the taxpayer of transferring 251,224,744 shares of Cairn India Holdings Ltd to Cairn India Ltd on 12 October 2006, is liable to tax in India?

Key takeaways from Delhi Tribunal ruling, rendered in favour of Indian Revenue

(1) The Tribunal upheld the validity of reassessment proceedings (reopening of completed audits).

(2) On merits, the Tribunal rejected the taxpayer’s stand that retrospective amendment to section 9(1)(i) of the Indian Income Tax Act 1961 by the Finance Act 2012 (bringing indirect transfer to tax in India) is bad in law and ultra vires, hence capital gains on sales of shares of Cairn India Holdings Ltd to Cairn India Ltd cannot be deemed to accrue or arise in India u/s 9(1) (i). The Tribunal clarified that in view of the Indian Supreme Court ruling in L. Chandra Kumar v. Union of India that “this is not the right forum to challenge validity of provisions of the Income Tax Act.”

(3) Further, the Tribunal rejected the taxpayer's stand that it was a mere internal group reorganization exercise, as there was no change in management or controlling interest on account of the transaction. The taxpayer had explained that the reason for the internal reorganization was with a view to bringing the entire Indian business operations of the Cairn group under one Indian company. As there was no third party involved in the whole transaction except the group itself, Cairn contended that there can be no tax levied on the internal reorganization when there is no increase in the wealth of the assessee. However, the Tribunal rejected such arguments by the taxpayer.

(4) The Tribunal referred to the Explanation to section 2(14) of the Indian Income Tax Act added by Finance Act 2012 (which has been given retrospective effect) as follows:

“Explanation For the removal of doubts, it is hereby clarified that — ‘property’ includes and shall be deemed to have always included any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever”.

Accordingly, the Tribunal held that all rights of management and control is a property u/s 2(14) of the Indian Income Tax Act.

(5) In the present case, the Tribunal noted that the shareholders of nine companies situated in India that control the oil and gas sector in India have the “property” of the right to manage and control that business by virtue of shareholding and further such rights are “rights in or in relation to an India company”. Therefore, the Tribunal held that any income arising “through or from” any property in India shall be chargeable to tax as income deemed to accrue or arise in India in terms of the provision of section 9(1)(i) of the Indian Income Tax Act. Noting that the taxpayer transferred this property to Cairn India Ltd partly in cash and partly in exchange of shares involving series of transactions, the Tribunal
rejected the taxpayer’s stand that it was merely a business reorganization process.

(6) Further, the Tribunal held that the assessee’s arguments that there was no increase in the wealth of appellant do not have any rationale as the value of the holdings of the appellant-taxpayer in Cairn India Ltd was unlocked due to the subsequent listing of the company on Indian stock exchanges.

(7) Similarly, the Tribunal rejected the taxpayer’s argument that there was no real income accruing to the taxpayer. Referring to the taxpayer's financial statements for year ended on 31st December 2006 and 2007, the Tribunal observed that the “assessee (taxpayer) has earned substantial gain on sale of the shares and also has gained on account of taxes too as according to the assessee itself such gain is not chargeable to tax.”

(8) The Tribunal also rejected the taxpayer’s view that it was a case of transfer by way of exchange and not that of sale as no specific amount for consideration was mentioned. According to the taxpayer, while computing capital gains in such a case of sale by exchange, the fair market value (FMV) of the asset received in consideration for the assets transferred should be considered as full value of consideration. Hence, as per taxpayer, the cost of acquisition should be stepped up to the fair value of the shares of Cairn India Holdings Ltd on the date of acquisition.

(9) The Tribunal accepted the submission of Indian Revenue that merely because the consideration is not stated in monetary terms in the various agreements and deed, it cannot be said that sales consideration as well as the cost cannot be determined of the transfer of the property for working of capital gain. In the present case, the price of the shares in each of the agreements is identified and the amount of acquisition recorded in the books of accounts also proves that the cost corresponded to the acquisition of the shares, argued the Indian Revenue.

(10) Referring to the provisions u/s 48,49 and 55 of the Indian Income Tax Act, the Tribunal clarified that “property held by the assessee (Taxpayer) and its mode of acquisition do not fall in any of the clauses which provides for taking the cost of acquisition in the hands of the assessee in these transaction being cost to the previous owner.” Also, the Tribunal disagreed with the taxpayer’s contention that as there was no timing difference between the acquisition and disposal of shares, the full value of consideration and the cost of acquisition was the same.

(11) The Tribunal upheld the tax officer's computation of capital gain by deducting from the full value of consideration, the cost of acquisition incurred by the taxpayer for the acquisition of the property. The Tribunal approved the tax officer's action in taking the cost of acquisition, which was derived by issues of shares as well as by the sale of debt. Accordingly, the Tribunal confirmed a capital gains addition of over INR 245 billion.
(12) Cairn further argued that since the India-UK DTAA was notified on 11 February 1994, the Indian domestic law as prevailing on that date (1994) should be applied. The company contended that since the retrospective amendment to section 9 made by the Finance Act 2012 was not in existence in 1994, the domestic tax law ought to be read ignoring the retrospective amendment. Rejecting the taxpayer's aforesaid argument around treaty benefit, the Tribunal held that:

(i) DTAA provision cannot make the domestic law static with respect to taxability of a particular income when unequivocally both states have left it to the domestic laws of the countries.

(ii) Tribunal flipped the question to taxpayer, framing an hypothetic question - Suppose if there was a beneficial exemption provided with retrospective effect under the domestic law, can non-resident assessee be also denied the benefit as it was also not the law at the time of notification of DTAA? The Tribunal answered this question in the negative.

(iii) DTAAs are mechanism of avoiding multiplicity of taxation globally of taxpayer. Therefore, if in the country of residence taxes are chargeable then the taxpayer must not suffer the tax burden in the country of source of income.

(13) Accordingly, the Tribunal, in principle, allowed the Indian Revenue’s submission that the shares of Cairn India Holdings Ltd, which were acquired by Cairn India Ltd from the appellant, derived their value solely from the assets located in India and, therefore, taxability u/s 9(1)(i) was triggered. Further, the Tribunal upheld that on transfer of shares of Cairn India Holdings Ltd from taxpayer to Cairn India Ltd, the entire control of oil and gas business of the Cairn group in India is transferred from the taxpayer to Cairn India Ltd, therefore, the liability to pay capital gains tax in India arises. However, the Tribunal deleted interest levied by Indian Revenue u/s 234A/B/C towards non-payment of tax in time as tax liability arose on account of a retrospective amendment.