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Indian Advance Ruling Authority taxes indirect transfer of Indian shares but upholds eligibility to India-Mauritius tax treaty

In two separate decisions pronounced recently, the Authority for Advance Rulings ("AAR") in India has considered the taxability of a transaction involving an indirect transfer of an Indian company and a claim for the capital gains exemption under the India - Mauritius tax treaty.

While the AAR upheld the validity of the India - Mauritius tax treaty based on specific facts of the case, it ruled in favor of taxing an indirect share transfer on the grounds that the transaction was devised as a means to avoid Indian tax.

The key aspects of these decisions are discussed in this Newsalert.

The Sanofi Ruling

- Merieux Alliance France ("MA France") formed a wholly owned subsidiary in France ("ShanH France") after negotiations with Groupe Industrial Marcel Dassault ("GIMD France").
- MA France subsequently acquired the shares of an Indian company, Shantha Biotechnics Ltd, ("Shantha India") and assigned these shares to ShanH France. Thereafter, GIMD France acquired a 20% stake in ShanH France from MA France.
- MA France had appointed a Director on the Board of ShanH France and also participated, through ShanH France, in managerial and technical decisions related to Shantha India.

- MA France and GIMD France entered into an Agreement with Sanofi Pasteur Holding, France ("Sanofi") to actively participate in Shantha India's business and later sold their shares in ShanH France to Sanofi France.

- MA France and GIMD France filed an application with the AAR seeking a ruling on the taxability of the sale of shares in ShanH France, a French company, to Sanofi, another French company.

- The AAR held that -

    - Notwithstanding the legal validity of a transaction, if the purpose was to create a legal smoke screen to avoid paying a legitimate tax, the legal effect of the transaction in the context of the taxing statute has to be considered.

    - In this case, a permissible commercial arrangement was adopted to acquire the shares and the underlying assets and control of an Indian company.

    - Thereafter, in the guise of dealing with shares of a subsidiary formed for the acquisition, the underlying assets, business, and control of an Indian company changed hands.

    - As a consequence, assets and a controlling interest in Shantha India were transferred to Sanofi, without a direct change of ownership of Shantha India.

    - Although the transfer of shares of ShanH France may have commercial and business validity, that does not prevent the AAR from reviewing the transaction in the context of Indian tax law / tax treaty and assessing its efficacy from a tax standpoint.

    - A review of the transaction and related documents suggests that the transaction is an arrangement to avoid tax, and consequently, the gain from the transaction should be subject to tax in India. This would be a purposive construction of the provisions of Article 14(5)[1] of the India-France tax treaty as opposed to a literal interpretation.

The Ardex Ruling

- Ardex Investments Mauritius Limited ("Ardex Mauritius"), a Mauritius tax resident company, held 50% of the equity shares in Ardex Endura (India) Private Limited ("Ardex India"). Ardex Mauritius was a wholly owned subsidiary of Ardex Holdings UK Ltd. ("Ardex UK").

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[1] Article 14(5) of the India-France tax treaty provides that gains from the alienation of shares (representing at least a 10% participation) of a company which is a resident of a Contracting State may be taxed in that Contracting State.

- Ardex Mauritius proposed to sell its entire stake in Ardex India to Ardex Beteiligungs GmbH Germany ("Ardex Germany") at fair market value.

- Ardex Mauritius applied to the AAR to determine the taxability of the proposed sale in India in light of the exemption under the India-Mauritius tax treaty.

- The Indian Revenue authorities contended that the transaction should be taxed in India on the following grounds:

    - The only asset of Ardex Mauritius was the shares that it held in Ardex India.

    - Apparently, the sole purpose of routing the investment through Mauritius was to take advantage of the India-Mauritius tax treaty.

    - By piercing the corporate veil, it was evident that Ardex UK had invested the funds into India. Therefore the India-UK tax treaty (instead of the India-Mauritius tax treaty) should govern the taxability of gains on the sale of Ardex India's shares.

- The AAR, after reviewing the specific facts, opined that -

    - Ardex Mauritius was incorporated in 1998 and had made substantial investments in Ardex India in the following years.

    - Ardex UK had acquired Ardex Mauritius [which was at the time known as Norcos Investments (Mauritius) Limited] from a third party in 2001.

    - Ardex Mauritius held the shares in Ardex India legally and following relevant procedures.

    - Ardex Mauritius was a tax resident of Mauritius and held a valid Tax Residency Certificate ("TRC") from the Mauritius authorities.

    - In view of the Indian Supreme Court Ruling in the landmark decision of *Azadi Bachao Andolan* (which supported the claim of tax treaty benefits upon production of a TRC), the India-Mauritius tax treaty applied to Ardex Mauritius.

    - Given that the shares in Ardex India were held for a considerable period of time, and given the technical position in law (as laid down by the Supreme Court decision above), the sale of Ardex India shares will not be subject to capital gains tax in India under the provisions of the India-Mauritius Tax Treaty.

    - Ardex Mauritius should, however, file a tax return in India with respect to the transaction.

Conclusion

- Apparently the AAR sought to apply the "substance over form" principle in deciding both these cases. While they opined that the Sanofi transaction appeared to be designed to avoid Indian tax, they ruled that the India-Mauritius tax treaty should be respected provided that the structure had not been established with a view to avoid Indian tax.
- With the Indian Supreme Court likely to rule on the much-awaited Vodafone case in the coming weeks and the Indian Government considering the introduction of General Anti-Avoidance Rules in April 2012, tax payers should consider the commercial rationale for transactions involving the movement of underlying Indian assets as they plan their Indian structures.

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