The Authority for Advance Rulings (AAR) rules on taxability of foreign-to-foreign company mergers and indirect transfers

31 August 2016

Background:

The AAR on 17 August 2016 issued a ruling that addressed several important issues, including the taxability of foreign-to-foreign mergers, applicability of the non-discrimination article and the scope of India's indirect transfer provisions. This Ruling was issued in respect of an Application made by Banca Sella Holding S.p.A, (Applicant/BSS), an Italian company. Briefly, the transaction involved the merger of Sella Servizi Bancari S.C.P.A (SBSS) (also an Italian company) into the Applicant. This resulted in:

a) The shareholders of SBSS receiving shares of the Applicant;
b) The 15% shareholding of the Applicant in SBSS getting cancelled; and
c) The Indian branch of SBSS getting transferred to the Applicant.

The transaction is depicted below:

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Key Conclusions:

a) On the taxability of SBSS upon the 'transfer' of its Indian branch to the Applicant:

The AAR ruled that in the absence of any consideration accruing to SSBS, no capital gains could be computed. In this regard, it relied on the decision of the Supreme Court in CIT vs B.C. Srinivas Shetty (128 ITR 294) and PNB Finance Ltd. vs CIT (307 ITR 75) (which held that if the computation provisions break down, the charge to tax must fail).

It also accepted the contention of the Applicant that the Non-discrimination provision in Article 25 of the India-Italy treaty would apply in the current facts. This Article provides that an Italian national cannot be subject to any taxation which is more burdensome than the taxation to which an Indian national may be subject to in same circumstances and conditions. Applying this rule, the AAR concluded that the exemption available to an Indian amalgamating company on transfer of capital assets to the amalgamated company under section 47(vi) of the Income-tax Act, 1961 (Act) should be available to SSBS as well.

b) On the taxability of the Applicant on account of extinguishment of the 15% shares held by it in SBSS

The Applicant contended that the gains arising on the transfer of its shares in SBSS would be taxable in India, only if the shares of SBSS derived value substantially from assets located in India. In this case, the value of assets in India was stated to be about 5.75% of the total assets of SSBS. However, the ruling was sought only on the limited legal question as to the meaning of the term '*derive its value substantially from assets located in India*'. On this point, it was contended that since the entire capital gains from the transfer of shares in a foreign company which derived value substantially from assets located in India would be chargeable to tax in India, the word 'substantial' must be understood to mean 'almost wholly'.

This argument was however not accepted by the AAR, which noted that the term 'substantial' should mean at least 50%. In arriving at this conclusion, the AAR referred to the dictionary meaning of the word 'substantial', which referred to it as 'of considerable importance, size or worth'. It also noted that the Delhi High Court had settled this issue in the case of DIT vs Copal Research (371 ITR 114).

As regards the taxability, the AAR held that in any event, there would be no liability to capital gains as no consideration accrued to the Applicant as a consequence of the extinguishment of shares.

c) On the taxability of the shareholders of SSBS

The AAR concluded that gains arising to shareholders of SSBS would not be taxable in India under Article 14(5) of the India-Italy treaty. Under this Article, gains from transfer of shares of a company resident in Italy are not taxable in India.

d) On the applicability of transfer pricing

The AAR relied on its earlier ruling in Amiantit International Holding Ltd., *In Re:* (322 ITR 678) and held that transfer pricing provisions would not apply if there was no charge.

Comments:

Although the Ruling covers a wide range of issues, the key conclusions relate to the non-discrimination article and the meaning of the term 'substantial'.

In particular, the use of the 'non-discrimination' article to make foreign mergers tax neutral in India will have far reaching consequences. Although section 47 of the Act provides tax neutrality to a wide range of re-organizations, it is not comprehensive and does not deal with several situations (including foreign mergers/demergers involving assets other than shares of Indian companies, and shareholder level exemptions in case of mergers and demergers of foreign companies deriving substantial value from India). This Ruling will help provide some clarity in such cases.

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Although the Delhi High Court in the *Copal Research* case had examined the scope of the term 'substantial', it did not explicitly set out the threshold for substantiality. It merely noted that anything below 50% could not be substantial. This Ruling however addresses this issue explicitly by holding that 'substantial' will mean at least 50%. To this extent, it will have far reaching ramifications, especially for transactions which took place prior to insertion of Explanation 6 to Section 9(1)(i) of the Act by Finance Act 2015, which declared that share or interest would be deemed to derive its value substantially from India if it represents at least 50% of the value of all assets owned by the company.

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