DTAA Vindicated: Sign of Times to Come?

Introduction

The interpretation and implementation of the provisions of a Double Tax Avoidance Agreement (**"DTAA"**) has been controversial since the Vodafone-Hutch deal in 2007. In that case, the Income Tax Department (**"IT Department"**) introduced retrospective amendments in order to tax transactions with an Indian nexus, which, foreign companies viewed as a retroactive measure in the path to greater liberalization and a deterrent to investing in India. However, the recent decision of the Andhra Pradesh High Court (**"the Court"**) where they disallowed a claim of INR 7 billion (*USD 130 million*)[1] by the IT Department against Sanofi Pasteur Holding SA (**"Sanofi"**), the apprehensions of foreign investors post-Vodafone will, hopefully, stand alleviated to a certain extent.

The present newsletter discusses the facts leading up to the case, the rationale for the decision of the Court and the implication for other foreign companies contemplating acquisitions overseas, having an India component. Please note that at the time of preparing this Newsletter, the judgment of the Court was not available for review and reliance has been placed on the contents of the order of the Authority for Advance Ruling as well as media reports on this case.

1. Factual Matrix

In 2006, two French companies, Merieux Alliance and Groupe Industriel Marcel Dassault (**"the Sellers"**) formed a joint venture in France named ShanH, which, shortly after its incorporation, acquired 90% stake in Hyderabad based Shantha Biotechnics Limited (**"Shantha"**). Thereafter, in August 2009, Sanofi acquired ShanH from the sellers in France for approximately USD 736 million, and indirectly, acquired 90% stake in Shantha. In essence, this was a transfer of shares between two non-residents. In August 2008 itself, the IT Department carried out a survey under section 133A[2] of the Income Tax Act (**"IT Act"**). From the information culled out during the survey, the IT Department formed an opinion that by the transfer of shares from the Seller in France, Sanofi acquired ownership of Shantha in India. Accordingly, it notified Sanofi that it had an obligation to deduct and deposit tax before making the payment for acquisition of ShanH since the underlying assets, i.e., shares of an Indian company, were being transferred and, therefore, the deal was subject to Indian tax laws.

In response, Sanofi stated that the transaction has been consummated in France and no tax liability arose in India due to the transfer of shares between two non-resident companies. The IT Department issued a show-cause notice to Sanofi demanding why Sanofi should not be

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[1] 1 USD = 55 INR approximately

[2] Section 133A of the IT Act provides the tax department with the power to enter and carry out a survey at the premises of a person of company within its jurisdiction and to seek any information which may be relevant for any proceeding under the IT Act, including seeking and inspecting the books of accounts and or any documents present

proceeded against as an *assessee-in-default* under section 201(1) of the Act and also asked the Sellers to provide relevant documentation to ascertain the tax obligation in India. On receiving the show-cause notice, the Sellers filed an application for advance ruling from the Authority for Advance Ruling (**"AAR"**)[3] on the question of whether the transaction is taxable in India, specifically on the following issues:

i. In terms of the provisions of the Double Taxation Avoidance Agreement (**"DTAA"**) between India and France, read with section 90 of the IT Act, whether capital gains arising from the sale of shares to Sanofi is liable to tax in France or in India?

ii. Without prejudice to the above, whether controlling interest (*assuming while denying that it is a separate asset*) is liable to be taxed in France under Article 14(6) of the DTAA?

After hearing the Sellers and the IT Department, the AAR decided in favor of the IT Department holding that ShanH's only assets were the shares it held in Shantha. Therefore, the sale of its shares essentially led to change in control and ownership in an Indian company. The AAR observed that the purpose for formation of ShanH appeared to be only to hold shares in Shantha, leading it to believe that ShanH was a façade created for avoiding capital gains tax in India. Subsequently, Sanofi approached the Court challenging the decision of the AAR.

2. Contentions of the parties

2.1 Sanofi's arguments

Sanofi contended that pursuant to the Indo-French DTAA, the transaction is not taxable in India. As per Article 14(5) of this DTAA gains on transfer of shares in a company, representing more than 10% of shares in that company, is to be taxed in the contracting state to which the company belongs.[4] Sanofi relied on the provisions of section 90 of the IT Act and argued that the provisions of the IT Act itself provide for application of the DTAA, and, therefore, the claim of the IT Department is bad in law. Opposing the contentions put forth by the IT Department during the AAR proceedings touting ShanH as being a tool for avoiding tax in India, Sanofi mentioned that ShanH was incorporated to streamline investments of the Sellers into India and participate in the managerial and technical aspects of Shantha.

Furthermore, it was formed in 2006 when the sale of 2009 was not contemplated. Sanofi tried to establish that ShanH was essentially an independent functioning company in France. A part of its argument was that it is legally permissible for two companies to form a joint venture for the purpose of making fresh acquisitions and that this was not an attempt to avoid or evade tax in India. It further mentioned that this was not a case of treaty shopping as the tax payable in France on capital gains is disadvantageous since in France, shares had to be held for two years prior to sale to qualify as long term capital gains whereas this period is only

[3] In India, a company has the option to approach the AAR in order to get a tax issue determined before partaking in a transaction or carrying out an activity on which, the tax implication is not certain

[4] Article 14(5): Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of at least 10 per cent in a company which is a resident of a Contracting State may be taxed in that Contracting State

one year in India. Sanofi argued that it was seeking its lawful benefit under the DTAA and not attempting to evade or avoid tax.

2.2 IT Department's contentions

The IT Department's primary contention was that ShanH was a façade created for avoiding capital gains tax in India. The fundamental contention was that the only asset of value that ShanH has is its shareholding of Shantha, inferring that creation of an investment company was done mainly as a façade to avoid tax. The IT Department argued that where the underlying asset for any transfer taking place abroad is in India, such a transaction is liable to tax in India. According to the IT Department, ShanH was merely a paper company with no employees or office space and was created only to act as a vehicle to avoid taxation in India. If shares of an Indian company are transferred freely between two non-residents leading to change in control and ownership of an Indian company and without attracting any tax in India, this, would defeat the purpose of section 195. Under section 195 of the IT Act, any person whether in India or abroad (*including a company*), makes a payment to a foreign company, for a transaction taxable in India, is under an obligation to deduct withholding tax payable in India before making the payment and, thereafter, deposit the tax so deducted with the IT Department. The IT Department felt that since this transaction clearly related only to the assets in India, it is taxable in India and, accordingly, Sanofi should be held in violation of section 195.

Responding to Sanofi's arguments on the application of the DTAA, the IT Department contended that the gains from transfer of more than 10% of a company may arise in France; however, the situs of the underlying assets is in India and must not be ignored. Since the assets transferred are located in India, the capital gains arise and are taxable in India. The IT Department tried to take support from the amendment to the IT Act under the Finance Act, 2012, making all transactions since 1964 involving transfer of underlying assets in India taxable and reiterated that the underlying assets is in India and, as a result, the transaction must be taxed in India.

3. The Court's ruling and rationale

After hearing both parties at length, the two judge bench of the Court decided in favor of Sanofi and quashed the ruling of the AAR. Based on the facts, the Court determined that ShanH is in fact an independent entity which actively participates in the management of Shantha and was not created as a façade to evade tax. The Court also accepted that ShanH was incorporated in 2006, the sale took place in 2009 and held that there was no intention to avoid tax in India. For arriving at this conclusion, the Court examined whether there was intent to avoid tax by the companies and the genuineness of the claims re the participation in Shantha was legitimate. This decision establishes that courts need to assess the intention of the parties and whether the underlying intention of parties it to transfer an asset in India or whether the international transaction contemplated simply touches an aspect in India.

On the question of capital gains, the Court held that as ShanH is an independent foreign entity, transfer of its shares outside India does not attract any tax in India. It set aside the contention of the IT Department vis-à-vis applicability of the IT Act which brought within its purview all transactions since 1964. Section 90(2) clearly prescribes that the provisions of the

IT Act will apply to an assessee who falls under a double tax avoidance agreement only to the extent to which they are beneficial to the assessee. In this case, section 90(2) read with Article 14(5) of the DTAA clearly prescribes that tax on capital gains is taxable in France, and the Court accordingly overruled the order of the AAR and quashed the order of the IT Department against Sanofi demanding INR 7 billion.

Conclusion

The decision of the Court provides relief to Sanofi and similarly positioned foreign companies anticipating overseas transactions with an Indian component. This judgment clearly establishes the superior status of the DTAA against the provisions of the IT Act, and to a certain extent, also provides additional parameters based on which an overseas transaction will be scrutinized. These include ascertaining the intent of the parties as well as whether the foreign entity owning Indian assets is a mere paper company or an independent and functioning unit.. While it is open for the IT Department to file an appeal before the Supreme Court, considering the decision of the Court is well reasoned, it will be interesting to see if the IT Department appeals and, if yes, then the grounds on which it prefers the appeal

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