DRAFT VALUATION RULES FOR INDIRECT TRANSFERS IN INDIA

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BACKGROUND

Section 9 of India's Income-tax Act, 1961 (the "I.T. Act") provides, *inter alia*, that capital gains arising from a transfer of a capital asset are taxed in India if the capital asset is "situated" in India. Thus, capital gains arising from a transfer of shares[1] of an Indian company are taxable in India, unless otherwise provided by a relevant tax treaty. However, prior to 2012, an issue arose on the taxability of capital gains arising upon the sale of shares of a foreign company that indirectly (*i.e.*, through intermediate entities) owns shares in an Indian company.

The landmark *Vodafone*[2] case addressed this issue. Vodafone International Holdings BV, a Dutch company, acquired a 67% stake in an Indian company, Hutchinson Essar Limited ("HEL"), by purchasing a 100% stake in the Cayman Islands company, CGP Investments (Holdings) Ltd. ("CGP") in 2007. CGP, a subsidiary of Hutchinson Telecommunications International, owned HEL's assets through a complicated network of intermediate entities. The taxpayer contended that the transaction was an offshore transaction with no nexus to India and thus did not pay tax on capital gains arising from the transaction.

The Indian tax authorities contended that capital gains from the transaction would be subject to Indian taxation, since it involved an indirect transfer of Indian assets. The matter reached the Supreme Court of India in 2012. The Supreme Court held in the taxpayer's favor and observed that the transaction is beyond India's territorial tax jurisdiction and, thus, not subject to tax in India.

RETROACTIVE OVERRIDE OF VODAFONE

Retroactive amendments were made to the I.T. Act in 2012, thereby overriding the Vodafone decision. These amendments tax capital gains arising from a transfer of a share or interest in a foreign entity that, directly or indirectly, derives its value substantially from assets located in India. Three years later, the Finance Act, 2015[3] clarified that shares or interest in a foreign company or entity (a "Foreign Entity") shall "derives its value substantially from the assets located in India" if the fair market value ("F.M.V.") of these assets

- exceeds INR 100 million, and
- represents at least 50% of the F.M.V. of the Foreign Entity's total assets.

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1 Under Indian tax law, shares are situated where the company is incorporated.

2 *Vodafone International Holdings B.V. v. Union of India & Anr.*, Civil Appeal No. 733 of 2012, Supreme Court of India, January 20, 2012.

3 Finance Act, 2015 inserted Explanation 6 into Section 9(1)(i) of the I.T. Act.

In connection to the above indirect transfer provisions, the Central Board of Direct Taxes issued draft rules[4] ("Draft Rules") on May 23, 2016, providing for the manner of determining the F.M.V. of the Indian and global assets, and the associated reporting requirements under the I.T. Act. The general public was invited to provide comments and suggestions regarding the Draft Rules until May 29, 2016.

F.M.V. OF ASSETS IN INDIA

The Draft Rules provide different methods for computing F.M.V. depending on the type of asset.

Shares of a Listed Indian Company (Without Right of Management or Control by the Foreign Company)

Where the shares are listed on a recognized stock exchange, the F.M.V. is the "observable price"[5] of the shares on the "specified date."[6] Where the shares are listed on more than one recognized stock exchange, the price of the shares is to be computed with reference to the recognized stock exchange that records the highest volume of trading in the shares during the period taken into consideration for determining the price.

Shares of a Listed Indian Company (With Any Right of Management or Control by the Foreign Entity)

F.M.V. shall be computed by market capitalization based on the observable price, plus the book value of liabilities of the Indian company on the specified date, divided by the total number of outstanding shares.

Shares of an Indian Company Not Listed on a Recognized Stock Exchange or an Interest in a Partnership Firm, Limited Liability Partnership, or Association of Persons

F.M.V. on the specified date shall be determined by a merchant banker or an accountant, in accordance with any internationally accepted pricing methodology for valuation of shares on an arm's length basis, increased by the liabilities, if any, considered in the determination.

"The Draft Rules provide different methods for computing F.M.V. depending on the type of asset."

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4 *I.e.*, Rule 11UB, Rule 11UC, and Rule 114DB, which are proposed to be inserted in the Income-tax Rules, 1962.

5 The observable price is the greater of

- the average of the weekly high and low of the closing prices of the shares quoted on the said exchange during the six months period preceding the specified date, or
- the average of the weekly high and low closing price of the shares quoted on the said exchange during the two weeks preceding the specified date.

6 Clause (d) of Explanation 6 to Section 9(1)(i) of the I.T. Act defines the specified date as

- the date on which the accounting period of the Foreign Entity ends, which precedes the date of transfer of a share or an interest; or
- the date of transfer, if the book value of the assets of the Foreign Entity on the date of transfer exceeds the book value of the assets, on the date referred to above, by 15%.

Other Assets

F.M.V. shall be the estimated price the asset would fetch if it is sold in the open market on the specified date, as determined by a merchant banker or an accountant, increased by the liabilities, if any, considered in such estimation.

F.M.V. OF ASSETS OF THE FOREIGN ENTITY

The F.M.V. of the assets of the Foreign Entity shall be computed as follows.

Transfer Between Unrelated Parties and Consideration

The F.M.V. shall be the value determined on the basis of a valuation report, as increased by the aggregate amount of liabilities, if any, that have been reduced for computing the value of the assets.

In Any Other Case

Shares of a Foreign Entity Listed on a Stock Exchange on the Specified Date

F.M.V. shall be the market capitalization based on the observable price, increased by the book value of liabilities on the specified date.

Shares of a Foreign Entity not Listed on a Stock Exchange on the Specified Date

F.M.V. of all the assets of the Foreign Entity shall be the fair market value of the Foreign Entity and its subsidiaries on a consolidated basis, as determined by a merchant banker or an accountant, as per the most appropriate internationally accepted valuation methodology as increased by the book value of liabilities of the Foreign Entity on the specified date.

INCOME ATTRIBUTABLE TO INDIAN ASSETS

Section 9 of the I.T. Act[7] further provides that capital gains arising from the transfer of shares or an interest in a Foreign Entity shall be taxable in India only to the extent the gains are reasonably attributable to assets located in India. The Draft Rules provide for the method of computation of income reasonably attributable to assets in India, using the following formula:

A x B / C		
A	=	Income from the transfer of the share or interest in the Foreign Entity computed in accordance with provisions of the I.T. Act as if such share or interest is located in India
B	=	F.M.V. of assets located in India as on specified date from which the share or interest referred to in A derives its value substantially (to be computed as discussed above)
C	=	F.M.V. of all the assets of the company or entity as on specified date (to be computed as discussed above)

7 Explanation 7 to Section 9(1)(i) of the I.T. Act.

The transferor of the shares or interest in the Foreign Entity is also required to furnish an audit report[8] verified by a Chartered Accountant. The report must provide the basis for apportionment in accordance with the formula above, and it must certify that the income attributable to assets located in India has been correctly computed. Failure to furnish the report will result in all the income being deemed attributable to assets located in India. Resultantly, the all capital gains arising from the transaction will be taxable in India.

REPORTING REQUIREMENTS

Section 285A of the I.T. Act, as introduced by the Finance Act, 2015, requires that the Indian entity through or in which the Foreign Entity derives substantial value must report certain information to the jurisdictional assessing officer.

The Draft Rules[9] have identify specific reporting requirements,[10] including but not limited to the following:

- Name, address, entity type, residential status, previous year, assessment year, and Permanent Account Number of the Indian entity
- Name, country of incorporation, and tax residency of the immediate, intermediate, and ultimate holding companies
- Whether the share or interest in the Foreign Entity derives its value substantially from assets located in India, which are held in or through the Indian concern
- Whether the transaction has the effect of transferring the right of management or control over the Indian entity
- Details of the transaction, including consideration
- Basis for determining the location of the share or interest being transferred
- Details of the value of Indian assets and global assets of the Foreign Entity

According to the Draft Rules, the information must be submitted within 30 days if the transfer has the effect of directly or indirectly transferring management or control of the Indian concern, and within 90 days in other cases.

Further, the Indian entity is required to maintain the information and relevant documents for a period of eight years from the end of the relevant assessment year.

CONCLUSION

The issuance of the Draft Rules is a welcome move, as they clarify various terms introduced in section 9 of the I.T. Act *vide* the Finance Act 2015. Despite the slow

[8] Form 3CT.

[9] Rule 114DB of the Income-tax Rules, 1962.

[10] Information is to be furnished on Form 49D by the Indian entity to the jurisdictional assessing officer.

legislation process, introduction of the Draft Rules will go a long way in reducing potential litigation and simplifying compliance procedures.

Uncertainity still exists about the outcome of indirect transfers that were finalized prior to the 2015-2016 tax year – since the computation and reporting requirements inserted by the Finance Act, 2015 and the Draft Rules are only prospective, whereas the law introduced in 2012 had retroactive effect.

"Despite the slow legislation process, introduction of the Draft Rules will go a long way in reducing potential litigation and simplifying compliance procedures."

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