

India

**December,
2008**

Corporate Update – December 2008*

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TAX

Income-Tax

The Vodafone Case- Mumbai High Court ruling -
Taxation of capital gain on the transfer of shares of a foreign company
holding shares in an Indian Company

Facts and Background

Recently, Mumbai High Court pronounced a judgement in a much awaited case relating to taxability of capital gain, on sale of shares, made by Hutchinson Telecommunications Limited (HTIL) to Vodafone International Holdings B.V. (VIH). The shares as sold by HTIL were of a Cayman Island company namely CGP Investments (CGP) which was owning, through it's various subsidiaries, shares of an Indian company namely Hutchinson Essar Limited (HEL).

No Indian tax was withheld at source, out of payment of sale consideration to CGP by VIH. The Indian tax department issued show cause notice to VIH, for having failed to deduct tax at source, on capital gains, which it alleged were chargeable to tax in India on sale of shares.

The basic questions as arose in this case were-

(a) Whether VIH, a non-resident company, located in Netherlands as purchaser of shares was liable to withhold applicable taxes, in terms of provisions of Indian Income-tax Act out of sale consideration, paid to another non-resident company, also located outside India;

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(b) Whether transaction of sale of shares by CGP, attracted liability to tax in India on capital gain as derived by CGP, in terms of provisions of Indian Income-tax Act, 1961? It may be noted that as the sale of shares was of a company,

located in Cayman Island, no tax treaty was applicable, as the seller was of a non-treaty partner country.

(c) Whether the transfer of shares (controlling interest) by CGP resulted in extinguishment of assets of HEL, the Indian company and thus attracted provisions of Indian Income-tax Act?

A writ was filed by VIH in the Bombay High Court challenging the show cause notice on the following grounds:

- (1) There is no obligation to withhold tax u/s 195 in an offshore sale transaction involving two non-residents in respect of a capital asset not situated in India and payment also being made outside the country.
- (2) The show cause notice is without jurisdiction as both before and after 2008 amendment of section 201, the petitioner was not required to withhold taxes and cannot be deemed to be an assessee in default.
- (3) The show cause notice is without jurisdiction as the 2008 retrospective amendment of section 191 and 201 are unconstitutional.
- (4) In any case the transaction in question is not chargeable to tax in India and therefore VIH was not under an obligation to deduct tax u/s 195.

In short, the Court had to address the issue of maintainability of the writ and the chargeability to capital gain tax of sale of shares, of a company located outside India, by one non-resident to another non-resident.

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In the decision as pronounced, the Bombay High rejected the writ filed by VIH, challenging the show cause notice, on the following reasons:

(1) Prima-facie CGP through the transaction has earned income liable for capital gain tax in India as income was earned by transfer of its business/economic interests in HEL, an Indian company.

(2) Transfer is of interests in India:-

- (a) Revenue had made out strong prima-facie case that the transaction amounts to transfer of a capital asset and not merely a transfer simplicitor of controlling interest ipso facto in a corporate entity;
- (b) Transaction resulted not only in extinguishment of HTIL's rights in HEL, the Indian company but the extinguishment of its asset viz, its interest in HEL so as to fall within the ambit of definition of transfer under section 2(47);
- (c) That subject matter of transfer as contracted between the parties is not actually the shares of a Cayman Island company but the interest/asset situated in India;
- (d) That prima-facie apart from the acquisition of controlling interest, VIH, inter alia acquired an enduring benefit, and a beneficial interest in the license granted to HEL by Department of Telecommunications in India;
- (e) Profit or gain from the transfer of a company in India has to be regarded as a profit of the company which actually controls it. Income accrued not to CGP but to HTIL and was treated as profits of HTIL and distributed to its shareholders in Hong Kong.

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(3) State may levy taxes against person not within the territory of that State-Effects Doctrine of the US relied upon.

(4) VIH has willfully failed to produce the primary Sale Agreement dated 11.02.2007 and other agreements entered into between VIH and HTIL. In its absence it could not be possible to appreciate the true nature of the transaction and therefore constitutional validity of the income-tax provisions under challenge cannot be gone into.

(5) Taxability of transaction cannot be determined on the basis of affidavits and counter affidavits in a proceeding under Art. 226 of the constitution. There is a hierarchy of authorities before whom the petitioner can get adequate redress-alternate remedy.

(6) Petitioners rights are fully safeguarded u/s 195(2), 195(3) and 197 and the only thing required to be done was to file an application before the Assessing Officer under those provisions for determining requirement of withholding of taxes.

(7) Adverse inference could be drawn as repeated demands made for production of original documents not complied with. When a party approaches the courts it must place all the facts before the court. The present petition lacks particulars as to the nature of the agreement dated 11.02.2007 and all other agreements preceding or following the same entered into by HTIL and or VIH.

(8) Decision of Supreme Court relied upon which laid down that the constitutional validity of provisions must be in the context of certain facts and not in the abstract or vacuum – and where the facts were lacking- the petition was liable to be rejected.

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Even though consequent upon the judgement of High Court, the tax department would go into facts and determine the taxability of amount, the prima facie view taken by the High Court regarding chargeability of capital gain, on such facts, has raised a very substantial issue for decision by Supreme Court. On similar facts, in the past, capital gain has not been levied in India, even in the case of non-treaty countries.

It is expected that VIH will file a petition in the Supreme Court against the High Court judgement. It is to be seen whether the Supreme Court will-

- (a) admit the appeal and
- (b) give it's decision on merits regarding chargeability of tax on capital gain or permit the tax department, as held by the High Court, to investigate the facts and give it's decision thereafter, which then would be challenged in the normal course

This decision of Supreme Court would be keenly awaited.

The tax department is proposing to investigate similar deals made by other companies, in the previous years and invoke similar proceedings as in this case.

TRANSFER PRICING – DECISION OF APPELLATE TRIBUNAL

SONY INDIA (P) Ltd. ITAT Delhi 'H' Bench

114 ITD 448

FACTS

Sony India Private Limited (“taxpayer”) was engaged in assembling and distribution of CTVs and audio products. The taxpayer also distributed other high-end electronic goods.

The taxpayer did not own any intangibles and did not invest in R&D. But it bore all the risks of an independent assembler and distributor.

The taxpayer imported finished goods and other electronic components from its Associated Enterprises (AE) and claimed such transaction to be at Arms Length Price (ALP) by using foreign AEs as the tested party and applying Transactional Net margin Method (TNMM);

Transfer Pricing Officer (TPO) accepted the ALP determined by taxpayer but rejected the TP analysis done by the taxpayer;

TPO asked taxpayer to make a fresh analysis taking taxpayer as the tested party.

The TPO rejected the fresh analysis so provided by the taxpayer and challenged the same on many grounds. TPO determined revised ALP and accordingly AO made an adjustment to the total income of the taxpayer in conformity with the order passed by TPO.

The aggrieved taxpayer filed appeal before CIT (A).

CIT (A) upheld certain adjustments made by AO;

The taxpayer and revenue authority filed an appeal before the Appellate Tribunal (ITAT).

During the proceedings the taxpayer did not rely on its TP documentation but instead raised an objection on ALP computed by TPO.

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ITAT RULING

The loss making companies can not be excluded from the list of comparable companies since the incurrance of loss is a normal part of business.

However a consistently loss making company can be rejected and can not be taken as comparable.

For the purpose of selecting a company having transaction with related party, ITAT held that for the purpose of comparison, what is to be judged is the impact of related party transaction vis-à-vis sales and not the profit since profit is influenced by large number of other factors.

It further held that Indian TP regulation provides the option to assessee to choose ALP varying 5% from the arithmetic mean. Adjustment by AO can be made only after accounting for \pm 5% of the arithmetical mean.

Adjustment on account of working capital, import duties paid, R&D/ intangibles risk is acceptable provided the same should be made in a reasonable and appropriate manner.

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Validity of electronic filing of return of
income on 30th September 2008 in respect of which the electronic
acknowledgement bears the date stamp of 1st October 2008.

CBDT's press release dated 22nd December, 2008 on the above subject is attached, for information
and guidance.

CBDTPressRelease_2
3122008.pdf

Definition of 'Charitable Purpose'
under Section 2(15) of the Income-Tax Act, 1961

CBDT has clarified the definition of 'Charitable Purpose' – A copy of the Circular No. 11/2008 as
issued by CBDT is attached.

ITAXCIR-11
(19.12.2008).doc

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LEGAL

New law

Enactment of Limited Liability Partnership Act

The Parliament has enacted the Limited Liability Partnership Act. The Presidential assent is awaited. The date of coming into effect of this Act is to be notified.

The salient features of the LLP Bill, 2008 are as under:-

(i) The LLP will be an alternative corporate business vehicle that would give the benefits of limited liability but would allow its members the flexibility of organizing their internal structure as a partnership based on an agreement.

(ii) The proposed Bill does not restrict the benefit of LLP structure to certain classes of professionals only and would be available for use by any enterprise which fulfills the requirements of the Act.

(iii) While the LLP will be a separate legal entity, liable to the full extent of its assets, the liability of the partners would be limited to their agreed contribution in the LLP. Further, no partner would be liable on account of the independent or un-authorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business decisions or misconduct.

(iv) LLP shall be a body corporate and a legal entity separate from its partners. It will have perpetual succession. Indian Partnership Act, 1932 shall not be applicable to LLPs and there shall not be any upper limit on number of partners in an LLP unlike a ordinary partnership firm where the maximum number of partners can not exceed 20.

(v) An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. Since tax matters of all entities in India are addressed in the Income Tax Act, 1961, the taxation of LLPs shall be addressed in that Act.

In brief, the advantages and disadvantages are as under:-

Advantages:

1. It has a legal entity separate from its Partners.
2. The liability of Partners will generally be limited, to the extent of their agreed contribution, unlike the case under the Partnership Act.

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However, 'designated Partners' will incur more liabilities as provided in Section 8. In case of fraud, unlimited liability will arise.

3. The LLP will continue to exist even if a Partner resigns or otherwise ceases to be a Partner.

4. Interest in LLP is transferable.

Disadvantages:

1. The LLP is to be registered with the RoC. Records like accounts etc. may be open to inspection, depending upon the rules to be framed.

2. Failure to get the accounts prepared, audited and filing with RoC will attract penalties.

3. The LLP can be wound up just like a company, with the approval of the Tribunal.

4. Most of the provisions of Companies Act will apply to LLP, leading to more statutory regulations and controls.

General:

An existing firm established under the Partnership Act may be converted into LLP.

Company Law

The Central Government vide its Notification no. GSR 11(E) dated 5th Jan., 2009 has amended the Companies (Appointment and Qualifications of Secretary) Rules, 1988.

Pursuant to this amendment, with effect from 15th March, 2009, the Companies having paid-up capital of Rs. Five crores or more shall be compulsorily required to appoint a qualified whole-time company secretary. Prior to this amendment, companies having a paid up capital of Rs. Two crores or more were required to appoint a whole-time company secretary.

A copy of the above Notification is attached.

COMPANIES.doc

Requirement for attestation of documents done away with in respect to Countries which are signatory to the Hague Convention:

Hitherto, foreign companies from countries other than the Commonwealth countries, were to get the required documents notarized and also attested by the Indian Embassy abroad, for incorporation of companies or establishment of Branch Office/Project Office/Liaison office in India.

The requirement of getting the documents attested by the concerned Indian Embassy was a time-consuming process which resulted in delays.

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Some of the foreign companies had earlier brought to our notice that the requirement of attestation by the concerned Indian Embassy was not required in terms of the Hague convention to which they were signatories. We had accordingly taken up the matter with the Registrar of Companies (ROC). However, the ROC informed us that unless the relevant rule under the Companies Act was amended by the Government of India, they had to insist on attestation by the Indian Embassy.

We are happy to inform that the Government of India has since amended the rule vide Notification No. GSR 835(E) dated 4th December, 2008. According to this amendment, attestation of documents by the Indian Embassy abroad has been done away with.

A copy of the said Notification is attached.

List of countries which are signatories to the Hague Convention is also attached.

NOTIF.PDF

Hague Convention.doc

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FEMA(Foreign Exchange Management Act)

EXTERNAL COMMERCIAL BORROWINGS

RBI has recently liberalized the ECB policy with effect from January 02,2009. A gist of the liberalizations is given below:

S. No.	Present Position	Liberalized Position as of January 02, 2009						
1	<p>All-in-Cost ceilings for ECB's in respect of Approval Route:</p> <table border="1"> <tr> <td>Average Maturity Period</td> <td>All-in cost ceilings over 6 Months LIBOR*</td> </tr> <tr> <td>Three years and Upto five years</td> <td>300 bps</td> </tr> <tr> <td>More than Five Years</td> <td>500 bps</td> </tr> </table> <p><i>*for the respective currency of borrowing benchmark.</i></p>	Average Maturity Period	All-in cost ceilings over 6 Months LIBOR*	Three years and Upto five years	300 bps	More than Five Years	500 bps	Eligible borrowers proposing to avail of ECB beyond the All-in-Cost ceilings (as existing earlier) are required to approach the RBI under the Approval Route.
Average Maturity Period	All-in cost ceilings over 6 Months LIBOR*							
Three years and Upto five years	300 bps							
More than Five Years	500 bps							
2	Specific prohibition on development of 'integrated township' [defined as per Press Note No.3 (2002) Series] ECB.	Development of 'integrated township' recognized as a permissible end-use of ECB. Corporates engaged in the development of integrated township permitted to avail of ECB under the Approval Route.						
3	Corporates in the services sector (hotels, software sector) allowed to avail of ECB up to per financial year for import of capital goods Approval Route.	Corporates in the service sector (hotels, hospitals and software sector) permitted to avail of ECB up to USD 100 million per financial year under the Automatic Route for foreign currency and/or rupee capital expenditure for permissible end-use. However, the prohibition on proceeds of ECB for acquisition of land would continue to be in force.						
4	NBFC's permitted to avail of ECB for minimum period of five years to finance import equipments for leasing to infrastructure projects	NBFC's exclusively engaged in financing of the infrastructure sector to avail of ECB's from multilateral/regional financial institutions and Government-owned development financial institutions for on-lending to borrowers in the infrastructure sector under the Approval Route.						

Note: RBI shall review all the liberalizations shown above in June, 2009.

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