

Implications of Birla-AT&T-Tata tax judgment

Form over substance, no lifting the corporate veil, legal owner is the relevant owner, a Mauritius Tax Residency Certificate is sufficient evidence of beneficial ownership- these were all well-accepted tax concepts endorsed by Circular 789 and the Supreme Court's judgment in the Azadi Bachao Andolan. But the Bombay High Court believes otherwise. A two judge Bench of Justices Devdhar & Sayed have bowled a googly that promises to run out the Mauritius tax advantage.

Here is the back story.

In 2007, the Birla and Tata Group- both shareholders in Idea- exercised a Right of First Refusal (ROFR) to buyout AT&T stake in the Indian telecom company. Aditya Birla Nuvo agreed to purchase Idea shares from AT&T Mauritius and thereafter Tata Industries agreed to purchase AT&T Mauritius itself. As AT&T Mauritius had a tax residency certificate, Nuvo obtained a new withholding order from the Indian Tax Department. Tata Industry believed since theirs was an offshore transaction, there would be no tax liability. But, in 2008, the tax department issued orders against Nuvo, Tata Industries as well as AT&T. The matter went to the Bombay High Court and last week revenue won. The court determined that AT&T Mauritius was only a 'permitted transferee'. The beneficial owner was AT&T USA and hence the transactions were not eligible for Mauritius treaty benefits. It has allowed the tax department to now initiate assessment proceedings.

It's a 97 page judgment and hence we are not going to be able to examine every argument. Besides, the judges have ruled and so now all we can do, till further notice from the Supreme Court, is to understand the implications. To do that, CNBC TV18's Menaka Doshi speaks to Sudhir Kapadia of E&Y; Girish Dave, Former Mumbai I-T Commissioner- the Vodafone man as we call him; he also wrote the Tata order in this case; Nishith Desai, noted tax lawyer and G C Srivastava, Former Revenue man and Special Counsel in this case.

Doshi: The core issue that I want to raise first is that this judgement hinges on the fact that the joint venture partner was AT&T US, that is a US based entity and that AT&T Mauritius- the Mauritius entity- was only a 'permitted transferee'. Hence, the Mauritius tax advantage doesn't apply. What do you think will be the impact of this judgement on all foreign investment because lots of foreign investment transactions or structures are very similar to this existing structure?

Kapadia: I would like to believe that this is specific to the facts of this case for two reasons- one is it's not necessary that every joint venture would proceed in the sequence of events the way this particular joint venture proceeded and I think the large issue really is that typically speaking when you talk about shareholding under any legal understanding, what is shareholding? Shareholding should give you the rights of dividends, should give you the rights of disposal of shares, should give you the voting rights and if it is controlling, then it should give you the rights to have a controlling nominee on the board of the company in which you have invested. So as long as there is alignment of those rights, there is no reason, ordinarily speaking, to challenge the shareholding and we have had several cases and Mauritius was of course something we have seen recently. Even in the past, before Mauritius as well, there have been several instances where the courts, in our country, had to examine who is a real owner- the registered shareholder or somebody else. So it has always been facts specific.

Doshi: You will admit that based on what the 'Azadi Bachao Andolan' decision said, at least for the last decade in this country, we have been saying that form scores over substance. This judgment goes far beyond form and looks into substance of who the real beneficial owner is. Now in almost all cases of foreign investment, as you would be familiar with, the Mauritius company will be owned by non-Mauritius parent. Therefore, I ask, before we start talking about ownership, will this be applicable to other kinds of foreign investment in this country?

Kapadia: Let me put it this way, I think the revenue will clearly try and apply this in as many cases as they can.

Doshi: Would you agree that in every – well of course in every case the facts will not be similar- but would you say that broadly most foreign investments in this country are structured in this manner if they are using the Mauritius route and therefore this judgement will also be applicable to them?

Desai: I would put it this way that it is not only in the context of foreign investors, it is not unusual to have this kind of arrangement even in the domestic Indian context. When you embark on a new business what you do first- first you enter into memorandum of understanding (MoU). Both parties agree, in-principle, on certain points and then it is provided that finally when the MoU is implemented, that would be through a separately incorporated company; invariably by and large always it happens. What do you do when you set up a subsidiary company? One- you can fund as a parent company by way of equity capital or by loan capital. Two- when you fund it as an equity capital provider or a loan capital provider, you have to behave on an arms length basis. When you deal with subsidiary company, you also deal as you are dealing with third party and secure all the rights that normally a lender would provide. So it is not that unusual in my view.

Doshi: So this structure is commonly used not just for foreign investments but for domestic investments as well and therefore this judgement will be applicable across a large number of transactions; not just this specific one. Is that what you are trying to say?

Desai: Yes- loan capital or share capital; I will reserve some rights.

Dave: Mr. Desai is more experienced because he has written more such agreements. I have seen only few agreements and I would restrict my

comment only to those agreements which I have seen. It is quite specific, very specific and at least I have not gone through such detailed arrangements between the parties - such niceties have been discussed, all nuances have been covered and they are unique in one way, I would say.

Doshi: So it is specific to the facts of this case and that revenue will not use this against other similar transactions?

Dave: As Sudhir said the form in substance- this tangle has been going on and you cannot say that a decade after Azadi, the issue is settled. Not at all because courts have been looking at it- even in England, even in UK the courts have been looking at it in form and substance from fact-to- fact; from case-to-case.

Doshi: Would you agree with the point that Mr. Dave is making that this is going to be fact specific and not extrapolated to a whole bunch of transactions?

Srivastava: I firmly believe. This judgement is fact specific and if revenue can find that strong facts in other cases, they will have a case to make out. But to suggest that the form prevails and substance has to be totally disregarded- that controversy will go on because courts do get convinced by the existing facts and once they are convinced on the facts that who is the real owner who is the transferor, who is the beneficiary of the gains, then reliance on this judgement or that circular is not material- that's my experience as I see in the court.

Doshi: It's interesting you have brought us to the exact next point that we want to bring up in this discussion and that is who is the real owner and that seems to be at the core of this very judgement. The judges have very clearly said that the beneficial or real owner is the American entity and not the Mauritius entity because the American entity was party to the joint venture agreement. But in fact the shares were sold by the Mauritius entity and the American entity was not involved in that share sale. There is an intervening entity which in fact holds the Mauritius entity and that is not either part of the joint venture agreement but is involved in the share sale. I am just confused- have we further muddled this concept of ownership Mr Kapadia?

Kapadia: It muddles from a point of view of the fact that in whose hands the revenue has a right to tax a particular gain. Here it so happens that in one party the gain is exempt; in other party the gain is taxable. Let's say, for argument sake, if this was not Mauritius, it was some other jurisdiction where there is no capital gains tax exemption- of course there is no motivation then to go into it- but if a question were then to be asked to say in whose hands can I recover the tax as far as the revenue is concerned?

Doshi: It would be the US parent.

Kapadia: Yes, exactly.

Doshi: I thought Mr Dave that the Azadi Bachao Andolan decision told us that as long as the Mauritius company or entity had a tax residency certificate, it would be considered the beneficial owner and then there was no reason in fact to lift the corporate veil and try and discover who the real owner was beyond that. So this judgment, in a sense, while it says that the Azadi Bachao Andolan judgment is not applicable nor is Circular 789- this is in fact turning on its head everything that we have come to understand from the Azzadi Bachao Andolan decision?

Dave: Just try to look at as to what influenced the honourable judges in this particular case – There are two terms which they have frequently used- founder member and their authority, secondly the permitted transferee. These are two important terms which have been used in the joint venture agreement. Now if you look at the permitted transferee and founder member, founder members have capped, have retained all authority onto themselves and they have permitted a nominee to hold shares in their names. That is the crux. That is the essence of that judgment and the entire judgment is based on that premise that the Mauritius entity had no role. Who is capable of sailing a particular aspect?

Doshi: The Mauritius entity was the registered member of those Idea shares. The Mauritius entity was the one that participated in the share sale. So how do you disregard the Mauritius (Interrupted by guest)

Dave: So the settled position of law in Carew & Company as well as Bacha F Guzdar- they have gone, they have distinguished that in the context of this case.

Desai: If you look at ownership- legal ownership and beneficial ownership- the capital gains Article in the India-Mauritius Treaty does not talk about the beneficial ownership. Just as it talks about beneficial ownership in the context of Dividend Article. So some of those things may have to be really looked into and one has to see who is the legal owner of the (Interrupted by Doshi)

Doshi: So therefore does this judgment take a contrasting view from everything that we have understood in the last decade?

Desai: Absolutely. It does concern all the foreign investors and other investors- including in India-as to how do we organize our affairs. The whole point is that at point of time, I believe, in this case even 195 Certificate was given. How, as a prudent business person, on what do I rely? That is where my biggest dilemma today is. In what way I can function? To what extent I can look at the seller's beneficial ownership, legal ownership. For me, as a payer of the money, it has made my life a bit miserable at this point in time.

Srivastava: This 195 (2) certificate was given on the strength of what contention? It was only contended that here is a sale by Mauritian entity of the shares held in Indian company and it was on the basis of those limited facts. There was no other conclusion which the tax authorities

could have drawn except to say that income is not taxable as per Indo-Mauritius treaty.

Doshi: Would you agree that there is no other conclusion that could be drawn? Are you telling me that tax department didn't know that AT&T is an American company?

Srivastava: To say that Azadi has been obtained or what we understood in the last 10 years has been unsettled, that's not the case. Azadi, I believe for the first time, finds some interpretation here in this judgment. What Azadi laid down? Azadi said that the TRC given to Mauritian entities will not be enquired, that is a sufficient proof but (Interrupted by Doshi)

Doshi: But yet this judgment has enquired beyond the TRC. Gentlemen, we are coming back to the same point? Azadi said that TRC is enough; this judgment is saying no, it's not enough; we are going to look beyond it?

Srivastava: It has not gone beyond TRC. Mauritian entities residential certificate, residential status is intact. If Mauritian entity, being resident of Mauritius as it is and entitled to all treaty benefits, the question is if US entity is found to be the owner of shares, if US entity enjoys all shareholders rights, if US entity transfers the shares and gets the proceeds of the transfer then who is really the owner of those shares- that is the critical question.

Doshi: I am going to put this to Sudhir Kapadia to see if he agrees with this or not?

Kapadia: Point which you raised earlier is a very good practical one. Let's be clear whenever you look at a Mauritius entity, in 99.9% of cases, the ultimate investors in any Mauritius company are bound to be residents outside of Mauritius, that's a no brainer.

Doshi: I am sure that if I know that, then tax department knows that?

Kapadia: So that's a practical side of it.

Doshi: When they gave a no-withholding certificate, are you telling me that tax department thought that AT&T was located out of Mauritius?

Kapadia: Therefore I am, on this point, that what we are doing by taking actions like these and that is something to ponder over for the tax administration, for the law makers. We are only increasing this uncertainty.

Desai: The whole point is with regards to the ownership. Ownership is a bundle of rights. It is not a one single thing. Even as a lender and as a borrower, if I have given number of rights to the lender, it does not mean that I do not own the shares- even if I have 1% or whatever. If I am dealing with a lender, I may give right of voting, I may give right to do a number of things and in fact the parent company can be constituted as agent of the Mauritius company rather than vice versa. Because once I am the legal owner, that's the whole issue here, of course its very fact specific but the way in which I would look at it is that this is not an uncommon transaction. This is how the documents are done world over when big groups deal with each other. They start with notes at the parent company level but the ultimate implementation happens at the subsidiary company level.

Srivastava: Has Mauritian company given those rights or the Mauritian company has simply been allowed to hold the shares in their name.

Dave: You are trying to ignore the concept of permitted transferee in this case. What do you mean by permitted transferee? That means you are not the owner. You have been permitted to hold these shares in a nominal capacity.

Doshi: I am not trying to ignore anything; the judges have said it. I am just trying to understand what companies should understand from here onwards. Should they believe that a TRC will be good enough or should they no go back and re-visit all their shareholder agreements and say (Interrupted by Dave)

Dave: I would urge you to ask Nishith- how many cases he has used the term permitted transferee?

Doshi: So you have asked the question, I will ask Nishith Desai that.

Dave: I don't think that in so many case and agreements he has used permitted transferee.

Doshi: So the crux here is permitted transferee (Interrupted by Dave)

Dave: It is not the question of lender and borrower. Mauritius Company is not even borrower. This argument has been raised quite a lot of time. In almost all cases, the ingenious argument which goes is that the dividend has been declared. Whatever I have got- sale consideration is the dividend which has been paid to the other party or the repayment of loan. This is an ingenious argument because if you look at the history of those cases, for 10's of years they have not disclosed a single paisa dividend, a single rupee dividend. If you see their profit and loss account and balance sheet you will find USD 10 is the interest income; that's all. And suddenly, at the end of the liquidation, here in India, there is a bumper dividend. Now this is an ingenious argument. Court would certainly like to look into these aspects.

Doshi: In the Vodafone case we had the way the High Court comes up with apportionment judgement. In this case, does this judgement go one step further in fact by calling the Tata part of the transaction a colourable device? Do you think that this judgement goes one step further

than the Vodafone judgement and in fact sends out the message that if the underlying asset is Indian, you are going to have to pay tax or you are at least going to allow or have to allow for an assessment?

Dave: I don't think so that underlying asset has been the ultimate decision of the court. If you look at AT&T Mauritius, there is another provision in this Section which has not come up so lucidly in this judgement and that is Section 93. Mauritius company becomes subsidiary of the Tata. So Mauritius any income which is derived by Mauritius company can be attached with under Section 93 to the holding company.

Doshi: This is ingenious?

Dave: No, this is not ingenious. This has been argued by revenue; it has not so lucidly come in the ultimate judgement but it has been so argued.

Doshi: Does this judgement go one step further than in fact even the Vodafone judgement?

Kapadia: I think if you see the Vodafone judgement on attribution, it says it has to be attributed between Cayman and the Indian business. Here it is silent on attribution is what you are trying to say.

Doshi: (...interrupts...) because they are not getting into the merits of the case; they are just saying can assessment proceed or not. Yes, assessment can proceed because this is a colourable device. By calling it a colourable device, are they in fact therefore giving importance to the underlying asset which is located in India- that's a key takeaway I would like to understand?

Kapadia: I would look at it differently. I think that is a consequence. What is being taxed because of the fact that assets are in India is a consequence of a conclusion reached that it is a colourable device.

Srivastava: I would like to add that neither in Vodafone case nor in this case, there is any attempt to tax the underlying the assets. The colourable device concept has been upheld in this case not because of underlying assets but because the offer made was only of shares of Indian company. Now the mode of transfer was left whether – the offer document itself had that mode i.e. we could make transfer either directly through the shares of Indian company or come through the other mode of routing it through the Mauritian entity. Having that peculiar fact, it could be held nothing else but a colourable device to evade the taxes- that's the finding based on that.

Doshi: There is one quick point that I wanted to include but I think I will just add it to the wrap-up- the issue that this is a rarity that revenue can proceed against both the buyers and seller. Keeping that and everything else that we have discussed in the course of this conversation, what does this mean- not just for existing transactions that have used the Mauritian route but prospectively what transactions need to keep in mind or do you believe that it will get certainty only when the Supreme Court rules in the E-trade and Vodafone case?

Kapadia: Obviously there will be far more uncertainty because what will happen is that when an exit happens, if facts are similar or broadly similar, then revenue will obviously want to launch an attack and say the revenue should be...

Doshi: (...interrupts...) And therefore the impact will mostly be felt on strategic investments; not on other foreign investments?

Kapadia: Yes, absolutely but there is a second angle to this. Let's look it this way- what about the purchasers here? Whether it was Vodafone or it is Tata or Birla, we are talking of purchasers here- that is where the greatest difficulty arises that as a purchaser it is not your - you are fighting a battle for income which is legitimately belonging to a seller in the opinion of the revenue. In my view, from a policy standpoint, from a judicial standpoint, there has to be some kind of conclusion on this- that to what extent is the buyer or the purchaser responsible, liable and accountable.

Srivastava: From the buyer's perspective, of course, they are paying only out of the consideration which is ultimately payable to the seller. So withholding tax obligations are there as far as that is concerned. I believe they should be more open to withhold taxes or seek a withholding certificate after disclosing all the relevant facts which they have not done in this particular case and in that case probably more certainty may come in. But we will have to wait till the decision in the case of Vodafone or other cases pending before the Court.

Doshi: What do you think this judgement does for both existing investments that maybe looking for an exit, including prospective investments? Should they keep this judgement in mind while they put their structures down?

Desai: It creates tremendous uncertainty. We spend almost close to 30% of our time on tax indemnities negotiation in all mergers, acquisitions and major transactions and it is very difficult to anticipate what kind of arguments will be coming up and what interpretations will come up. After Azadi Bachao Andolan, everybody thought it settles the issue. This to some extent unsettles but uncertainty is creating a lot of problems in attracting the foreign investment and that we are finding a lot difficult and how will that apply in the context of Indian business people when they are now expanding abroad, how do they look at their investment? What do we do because principles will apply in the same way to foreign investor and the Indian investor? So our problem today is the uncertainty in the entire environment. On the top of it, we are also anticipating what will be the consequences of not-so-well drafted Direct Taxes Code and we have to consider so many different dimensions and tax is driving the whole business rather than the business consideration- all negotiations we are stuck on tax issues the max.

Doshi: That's a very genuine concern. I would like you to respond on what you think prospective investments, at least, should keep in mind so

that they don't fall in the same trap as this transaction has or do you believe that that it's only when the Supreme Court rules on Vodafone and E-trade will we have some certainty on the Mauritian route?

Dave: I would be frank to tell you and to respond to what Desai is saying. If you have a liberty to write an agreement, will you foreclose that liberty to the revenue officials to interpret and analyse that agreement. Why should you foreclose it? You have in your sharpest of mind; you have written an agreement with all liberties at your disposal. Why should you foreclose the revenue official or grant that liberty to analyse that agreement and if you find that there are some chinks in that...

Doshi: (...interrupts...) What should prospective transactions be careful about or do you think that finally certainty will only come through the Supreme Court?

Kapadia: From payer's perspective, we should address first. Uncertainty- if it is there from the seller's perspective, that's bad enough but from the payer's perspective...

Doshi: (...interrupts...) Both ends, we want FDI in this country and this all represents foreign direct investment?

Kapadia: 100%, but just look at it this way as Mr. Srivastava said that I have the sale consideration from which I can withhold the tax. Please don't forget when proceedings are launched, I am also asked to pay interest, there are potential penalties and I am virtually on a parallel track fighting the case right up to the Supreme Court as if it is my income, that is the consequence of this kind of a...

Doshi: (...interrupts...) So I am broadening this both from the buyer's as well as the seller's perspective. What do you think will be the outcome post this judgement?

Dave: The obligations are cast in the Act and Act has been rendered to us. So every person who is coming within the ambit of those obligations, he has to perform that obligation. If I have to deduct tax at source, I have to deduct tax at source.

Doshi: This is not a battle between corporate India and the revenue department. I am trying to use your expertise to understand, post this judgement, what should investors be careful about or do you believe certainty will only come through the Supreme Court route. I am reversing this. I am not asking the private sector professionals' for advice; I am asking the taxman's advice?

Dave: I don't think there would be certainty even after the Honourable Apex Court's judgement because they are all facts specific instances and the Supreme Court itself says in so many judgements that even a small variation of factor can change the complexion of the case. So there is no precedential value.

Doshi: So there is no solution in sight for this uncertainty?

Dave: Yes, I would say that if the Apex Court lays down some guiding principles in the context of these cases, then certainly there can be certainty.

Doshi: Did not do that in the case of Azadi Bachao Andolan; they did lay down guiding principles.

Dave: Azadi never went with a fact situation. It simply went with a Circular and its validity; it never went ahead with a particular fact situation. Now fact situations are coming before them, let them decide. They will certainly lay down some guiding lines; some guiding principles by which there would be some certainty.

Doshi: Give me a solution for this problem of uncertainty that both Mr Kapadia and Mr Desai have raised on behalf of corporate India as well as foreign investors in this country?

Srivastava: The question is that if we continue to believe that in the wake of Azadi Bachao Andolan and the Circular, all kinds of transactions, through Mauritius, irrespective of their facts and situation will not be taxable, then we are lending ourselves in trouble. Then the only option is that while rendering an advice or planning the transaction as such, one has to keep in mind that the parent may have the option of investing through a subsidiary in Mauritius. But that subsidiary has to have the factual matrix to substantiate that it does own the asset, it does transact into sale transactions and not be a mere name lender. That is the lesson we have to learn whether while planning the affairs or deciding upon the existing investments. If we fail to do that, probably yes, uncertainty will grow more. Azadi Bachao was never a license to all kinds of transactions routed through Mauritius irrespective of their fact situation. That is where possibly things have gone wrong.