

India

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I. Foreign Investment

A. CONSOLIDATED POLICY ON FOREIGN DIRECT INVESTMENT

The change in foreign investment policy in India began in 1991 as a measure to counter the balance of payments crisis and to enhance India's foreign exchange reserves. Establishing the foreign investment promotion board ("FIPB") to facilitate foreign direct investment ("FDI") in India, enacting the Foreign Exchange Management Act ("FEMA 1999"), and repealing the former Foreign Exchange Regulation Act, 1973 ("FERA"), evidenced a fundamental shift in policy. Foreign investment into India was governed by FEMA 1999, regulations issued under the statute, and clarifications issued by the Department of Industrial Policy & Promotion ("DIPP").

1. Policy Changes

To promote FDI through a transparent policy framework, the DIPP published the first consolidated policy on March 31, 2010 to simplify the regulatory framework for foreign investment.¹ The consolidated FDI policy rescinded all of DIPP's earlier press notes, press releases, and clarifications in effect as of March 31, 2010. The new policy consolidates and subsumes all press notes, press releases, and clarifications as of March 31, 2010.

In light of the constant evolution of the FDI policy, the first consolidated FDI policy, issued on March 31, 2010, contained a sunset clause of six months and provided that it would be superseded by an updated policy issued on September 30, 2010. On that date, the DIPP issued Circular 2 of 2010² ("Consolidated FDI Policy") which subsumes and supersedes all earlier press notes and circulars (including the March 31, 2010 Circular) and reflects the FDI policy as of October 1, 2010. It will be subject to further revision on March 31, 2011.

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1. *Consolidated FDI Policy*, DEP'T OF INDUS. POL'Y & PROMOTION, MINISTRY OF COM. & INDUS. (India), ¶ 1.1.9 (Mar. 3, 2010), http://siadipp.nic.in/policy/fdi_circular/fdi_circular_1_2010.pdf [hereinafter *Consolidated FDI Policy 1*].

2. *Consolidated FDI Policy*, DEP'T OF INDUS. POL'Y & PROMOTION, MINISTRY OF COM. & INDUS. (India), (Sept. 30, 2010), http://dipp.nic.in/FDI_Circular/FDI_Circular_02of2010.pdf [hereinafter *Consolidated FDI Policy 2*].

The Consolidated FDI Policy introduces certain small but significant changes to the old FDI policy, with far-reaching implications on structuring foreign investment in India. The high-level issues emanating from a review of the Consolidated FDI Policy and the key changes to the regulatory framework of FDI policy in India are provided below.

a. Definition of Capital

The Consolidated FDI Policy defines capital to mean equity shares and fully, compulsorily, and mandatorily convertible preference shares and debentures. It also clarifies that although warrants and partly paid shares are not considered capital, they *can* be issued to persons residing outside India with the prior approval of the FIPB.³ The Consolidated FDI Policy further provides that foreign currency convertible bonds and depository receipts, although not included in the definition of capital, will be treated as FDI.⁴

b. Pricing of Instruments

The Consolidated FDI Policy provides that “Indian companies can issue equity shares” and “fully, compulsorily and mandatorily convertible debentures and . . . preference shares” in accordance with the extant pricing guidelines and valuation norms prescribed by the Reserve Bank of India (“RBI”). The policy also provides that the price of the capital instruments (including the conversion price of compulsorily convertible instruments) is to be determined upfront, in accordance with the extant pricing guidelines, at the time of issuance of the instruments.⁵

c. Investment by Foreign Institutional Investors

The Consolidated FDI Policy provides that Foreign Institutional Investors (“FII”)s registered under the Securities and Exchange Board of India (“SEBI”) and FII Regulations 1995, can invest both under the FDI route and under the FII route. It stipulates that the investments made under either route mentioned above will be counted towards the caps on FII investments, which are specified as a ten percent individual limit and a twenty-four percent aggregate limit.⁶ This change in policy may affect existing investments made by FII entities under the FDI route under the old FDI policy, if the aggregate investments made by such entities exceed the prescribed limits.

2. *Sector-Wide Changes to the FDI Policy*

Important sectoral changes under the Consolidated FDI Policy include (1) cigarettes and (2) cash and carry wholesale trading.

3. *Id.* ¶ 2.1.5.

4. *Id.* ¶ 3.2.3.

5. *Id.*

6. *Id.* ¶ 3.1.4.

a. Cigarettes

Although up to 100% FDI was permitted in the manufacture of cigars and cigarettes under the old FDI policy, the government had, pursuant to Press Note 2 of 2010,⁷ prohibited FDI in this sector. Consistent with the provisions of Press Note 2 of 2010, the Consolidated FDI Policy provides that companies engaged in the “[m]anufacturing of [c]igars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes” are now prohibited from receiving FDI.⁸

b. Cash and Carry Wholesale Trading

The Consolidated FDI Policy defines cash and carry wholesale trading as the “sale of goods/merchandise to retailers, industrial, commercial, institutional or other professional business users or to other wholesalers and related subordinated service providers.”⁹ It also provides that wholesale trading would be “sales for the purpose of trade, business and profession, as opposed to sales for the purpose of personal consumption. . . . The yardstick to determine whether the sale is wholesale . . . would be the type of customers to whom the sale is made.”¹⁰

The Consolidated FDI Policy provides that when undertaking wholesale trading, an entity (in which there is foreign investment) must comply with at least one of the following conditions:

- i. The entity must maintain full daily records of sales;
- ii. “[Wholesale trading] of goods [is] permitted among companies of the same group,” but “[wholesale trading] to group companies taken together should not exceed 25% of the total turnover of the wholesale venture;”
- iii. “[Wholesale trading] can be undertaken as per normal business practice, including extending credit facilities, subject to applicable regulations;”
- iv. “A wholesale/cash [and] carry trader cannot open retail shops to sell to the customer directly.”¹¹

The wholesale trading conditions were incorporated as a measure to check FDI in retail trading (in which FDI is prohibited), which is allegedly being carried on in the garb of cash and carry wholesale trading. The change in the regulations is intended to ensure that foreign retailers do not gain a foothold into the domestic retail market in the garb of wholesale trading.

The Consolidated FDI Policy also laid down rules for other sectors not covered under the previous policy, such as head-end in the sky (“HITS”)¹² and security agencies.¹³ The new Consolidated FDI Policy also clarified its application in relation to certain sectors such as construction and development projects.¹⁴ By consolidating the former FDI re-

7. Press Release, Dep’t of Indus. Pol’y & Promotion, Ministry of Com. & Indus. (India), Review of the Policy on Foreign Direct Investment in the Manufacture of Cigarettes Etc. (May 5, 2010), available at http://siadipp.nic.in/policy/changes/pn2_2010.pdf.

8. *Consolidated FDI Policy*, *supra* note 2, ¶ 5.1(h).

9. *Id.* ¶ 5.2.24.1.

10. *Id.*

11. *Id.* ¶ 5.2.24.1.2(c)-(f).

12. *See id.* ¶ 5.2.11.4.1.

13. *Id.* ¶ 5.2.21.

14. *See id.* ¶ 5.2.13.

gime, the new Consolidated FDI Policy simplifies the Indian foreign investment regulatory framework. It clarifies certain issues (such as foreign investment in warrants or the definition of real estate), and tightens FDI norms, such as restricting the definition of “wholesale trading” and permitting FDI into sectors initially excluded from the old FDI policy.

B. REVISED PRICING NORMS

Under the old FDI policy, the price for shares of unlisted Indian companies to a non-resident could not be less than the price computed by a chartered accountant (“CA”) in accordance with the guidelines issued by the former Controller of Capital Issues (“CCI Value”). As the CCI Value was based on historical performance parameters, it often tended to be relatively moderate.

On April 21, 2010, the Government of India amended the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (“FEMA 20”) to issue revised pricing guidelines for issue of shares to non-residents.¹⁵ Shortly thereafter, the RBI issued a circular dated May 4, 2010 (“May 4 Circular”) amending the guidelines for transfer of shares between residents and non-residents.¹⁶ The May 4 Circular provides that the minimum price for transfer of shares from a resident to non-resident, for listed companies, could not be less than the price computed in accordance with the SEBI regulations for preferential allotment (such as Chapter VII of the SEBI (Issue of Capital and Disclosure Requirements), 2000). For unlisted companies, the minimum price is to be not less than “the fair value determined by a SEBI registered Category-I-Merchant Banker or a Chartered Accountant as per the discounted free cash flow method.”¹⁷

With the amendment to the FEMA FDI Regulations and the provisions relating to transfer of shares from residents to non-residents and vice versa, the RBI has set a new benchmark for calculating price of shares which is based on future performance rather than historical data. Because the Discounted Cash Flow (“DCF”) Value would generally be higher than the CCI Value, the recent amendments would result in higher inflow of funds to India. But the change presents challenges to private equity valuations in ongoing deals, as well as closed private equity deals or joint ventures that provide for multiple investment tranches or other scenarios where a non-resident is to be issued further shares at a subsequent time. Whether this will work for companies across all sectors (such as insurance) remains to be seen.

15. See Notification, Foreign Exch. Dep’t, Reserve Bank of India, Foreign Exch. Mgmt. (Transfer or Issue of Security by a Person Resident Outside India) (Amendment) Reg., Annex-II to Circular No. 49/2010, FEMA 205/2010-RB, (Apr. 21, 2010), <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/N205050510.pdf> (India).

16. See Notification, Foreign Exch. Dep’t, Reserve Bank of India, FDI in India—Transfer of Shares/Preference Shares/Convertible Debentures by Way of Sale – Revised Pricing Guidelines, Circular No. 49/2010, RBI/2009-10/445 A.P. (DIR Series), 1 (May 4, 2010), <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/FDIE050410.pdf> (India).

17. See *Report of the Takeover Regulations Advisory Committee Under the Chairmanship of Mr. C. Achuthan*, SEC. & EXCH. BD. OF INDIA, (2010), <http://www.sebi.gov.in/commreport/tracreport.pdf>.

II. Securities Law

A. PROPOSED AMENDMENTS TO THE TAKEOVER REGULATIONS

The Takeover Regulations Advisory Committee (“TRAC”), constituted by the SEBI to review and recommend changes to the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (“Takeover Regulations”), submitted its report to SEBI on July 19, 2010 (“TRAC Report”).¹⁸ After a review of existing law governing substantial acquisition of shares and takeovers, the TRAC recommended a comprehensive overhaul of the existing legal framework.¹⁹ The TRAC suggested changes with regard to various aspects of the Takeover Regulations, including, *inter alia*, (i) triggers for open offers; (ii) indirect acquisitions; (iii) offer size; (iv) voluntary open offer; (v) option to delist; (vi) exemptions from open offer obligations; (vii) offer price; (viii) mode of payment; (ix) competing offers; and (x) execution of the agreement that triggers open offer. The key changes and implications of the TRAC recommendations are set out below.

1. *Triggers in Relation to Mandatory Offers*

a. Voting Rights Triggers

The TRAC has recommended an increase in the acquisition threshold for the initial trigger of a mandatory open offer from the current level of fifteen percent to twenty-five percent of the voting capital of a listed company.²⁰ The implications of this recommendation are that financial investors may acquire up to 24.9% of a listed company without triggering open offer obligations. Further, promoters holding less than a twenty-five percent stake, who can currently cross the twenty-five percent threshold under the creeping acquisition route, will attract mandatory open offer obligations at this threshold. But there may be a cause for concern for promoters with regard to acquirers holding just less than twenty-five percent because those acquirers could exercise significant voting rights due to the multiplier effect caused by absenteeism at general meetings.

b. Consolidation Triggers

Shareholders may continue to consolidate their shareholding under the “creeping acquisition” route of five percent per financial year (on a gross basis) between twenty-five percent and seventy-five percent, through negotiated purchases, preferential allotments, or on-market transactions.²¹ The illusory “greater control” threshold of fifty-five percent has been eliminated. Acquisitions in excess of five percent in a financial year will trigger an open offer. There is a hard cap on negotiated acquisitions in excess of seventy-five percent.

18. *See id.* ch. 1-6 (detailing the proposed takeover regulations).

19. *Id.* ¶¶ 2.8, 3.1.

20. *Id.* ¶¶ 2.17, 3.2.

21. *Id.* ¶¶ 3.7, 2(1)(g).

c. Control Trigger

De facto control as the primary trigger (regardless of shareholding) has been incorporated into the definition of "control," which is now referenced not just against the "right" but also the "ability" to control.²² As a result, the control trigger continues to be an elusive and subjective determination in each case. Control has, however, been provided an absolute connotation. "Greater control," as in the case of joint-to-sole control transactions, will not form a separate trigger under the proposed regime (but transfers would continue to be subject to the voting rights triggers or exemptions, as applicable).²³

d. Indirect Acquisitions

The TRAC has recommended that all indirect acquisitions that result in the ability to exercise voting rights in excess of the voting rights triggers or control over a target company will trigger a mandatory open offer.²⁴ Further, with a view to prevent direct acquisitions from being disguised as indirect transactions, the TRAC has recommended that where "the target company is a predominant part of the business or entity being acquired," such indirect acquisition would be treated on par with a direct acquisition for all purposes under the proposed regulations.²⁵

The TRAC also set out an objective test for "predominant part of the business," i.e. where the proportionate net asset value/sales turnover/market capitalization of the underlying listed target company represents more than eighty percent of the net asset value/sales turnover/deal value of the primary acquisition.²⁶

2. *Offer Size*

a. Mandatory Offers

All mandatory offers pursuant to the voting rights and control triggers described above would have to be made for every share in the target company outstanding as of the last day of the offer (i.e. a 100% offer).²⁷

b. Voluntary Offers

The offer must be made for a minimum of ten percent and is subject to a maximum that will take the holding of the acquirer and persons acting in concert with it to seventy-five percent.²⁸

3. *Minimum Level of Public Shareholding*

a. Offers Pursuant to the Initial/Control Triggers

Shares of the target company would be automatically delisted (i.e. without a separate delisting offer under the Delisting Regulations) if the post-offer shareholding of the ac-

22. *See id.* ¶ 4.

23. *Id.* ¶¶ 5.8, 5.1.

24. *Id.* ¶ 5(2).

25. *Id.* ¶ 5(2).

26. *Id.* ¶¶ 1.14, 7.1.

27. *Id.* ¶ 7(2); *see also id.* ¶ 2.10.

28. *Id.* ¶¶ 1.22, 1.26.

quirer is more than ninety percent and the acquirer has stated its intention to delist upfront.²⁹ An acquirer who has not stated his intention to delist or who has a post-offer shareholding between seventy-five percent and ninety percent would be required to ensure compliance with the minimum public shareholding requirement of twenty-five percent by either: (i) proportionately reducing the number of shares acquired in the open offer and under the triggering agreement;³⁰ or (ii) increasing the level of public shareholding to up to twenty-five percent within twelve months.³¹

b. Offers Pursuant to the Consolidation Trigger

Regardless of the post-offer shareholding, an acquirer would not be permitted to delist the target company pursuant to the open offer. A delisting may only be done under the SEBI (Delisting of Equity Shares) Regulations 2009 (“Delisting Regulations”).³² In the event of a post-open offer shareholding in excess of seventy-five percent, the acquirer must ensure the target company’s compliance with the twenty-five percent minimum public shareholding requirement.³³

4. Offer Price

The current regime permits a tolerance limit of twenty-five percent of the offer price payable to persons other than the target company (generally the exiting promoters) towards a non-compete fee, without the same being attributed to the open offer price. In line with its basic objective of ensuring equal treatment for all shareholders, TRAC recommended deleting this provision. All payments made by the acquirer in relation to the acquisition of shares would have to be captured in the offer price.³⁴ The commercial reality and legal basis that differentiates controlling shareholders with knowledge of the business from other public shareholders has not found favor with the TRAC. This cannot be in the best interests of the long-term public shareholders of the target company. Some flexibility for the payment of control premiums could have been permitted.

5. Withdrawal of an Open Offer

In addition to the existing grounds to withdraw an open offer (i.e. non-receipt of statutory approvals and death of sole acquirer), TRAC proposed that an open offer may be withdrawn where the underlying triggering transaction fails “for reasons outside the reasonable control of the acquirer, and such agreement is rescinded,” subject to full disclosure in the open offer documents.³⁵ Under the current regime, an acquirer may not withdraw an open offer because of failure of the underlying transaction. The TRAC rec-

29. *Id.* ¶¶ 1.23, 1.28, 7.5.

30. *Id.* ¶¶ 1.23, 1.27, 7.5.

31. See *id.* ¶ 7(4); see also *id.* ¶ 1.24 (discussing committee deliberations on delisting).

32. *Id.*

33. *Id.* ¶¶ 6.5, 23(1)(a)-(c).

34. Notification, Securities Contracts (Regulation) (Amendment) Rules, 2010, Gazette of India, Section II(3)(i) (June 4, 2010), available at http://www.finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/Amendment_Securt_contract_1957.pdf (India).

35. *Discussion Paper on the Requirement of Public Holding for Listing*, MINISTRY OF FIN. (India), (Feb. 1, 2008), <http://ideas.repec.org/p/ess/wpaper/id1373.html> (follow “download the selected file” button).

ommendation internalizes some commercial considerations by requiring the public shareholders to share some of the risk of failure.

B. MANDATORY TWENTY-FIVE PERCENT PUBLIC FLOAT

The Securities Contracts (Regulation) Rules, 1957 (the “SCRR”) have been amended, with effect from June 4, 2010, to provide for a mandatory public shareholding of at least twenty-five percent for all listed companies going forward (the “Amendment”).³⁶ The Amendment also sets out requirements for continuous listing and certain transitional provisions for companies with a public shareholding of less than twenty-five percent. The Amendment is in furtherance of a discussion paper issued by the Ministry of Finance in 2008 that called for imposition of a uniform public float of twenty-five percent at the time of listing of shares and thereafter on a continuous basis.³⁷

The key features of the Amendment are as follows:

- a. The minimum threshold level of public holding will be twenty-five percent for all listed companies.³⁸
- b. Existing listed companies having less than twenty-five percent public holding have to reach the minimum twenty-five percent level by an annual addition of not less than five percent to public holding.³⁹
- c. For new listings, if the post-issue capital of the company calculated at offer price is more than Rs. 4000 crore, the company may be allowed to go public with ten percent public shareholding and comply with the twenty-five percent public shareholding requirement by increasing its public shareholding by at least five percent per annum.⁴⁰
- d. A company whose draft offer document is pending with SEBI on or before the Amendment is required to comply with the twenty-five percent public shareholding requirement by increasing its public shareholding by at least five percent per annum, irrespective of the amount of post-issue capital of the company calculated at offer price.⁴¹
- e. A company may increase its public shareholding by less than five percent in a year if such increase brings its public shareholding to the level of twenty-five percent in that year.⁴²
- f. The requirement for continuous listing will be the same as the conditions for initial listing.⁴³
- g. Every listed company must maintain public shareholding of at least twenty-five percent. If the “public shareholding in a listed company falls below twenty-five percent at

36. Securities Contracts (Regulation) (Amendment) Rules, *supra* note 34 ¶ 2(ii)(a) (amending Rule 19(2)(b)(i) of the SCRR).

37. *Id.* (amending Rule 19(2)(b)(ii) of the SCRR).

38. *Id.* (amending Rule 19(2)(b)(ii) of the SCRR).

39. *Id.*

40. *Id.*

41. *Id.* ¶ 2(iii) (inserting Rule 19A(2)).

42. *Id.*

43. Subhkam Ventures (I) Private Ltd. v. SEBI, (2010) S.A.T. (India), *available at* <http://www.sebi.gov.in/satorders/subhkamventures.pdf>.

any time, such company shall bring the public shareholding to twenty-five percent within a maximum period of twelve months from the date of such fall.”⁴⁴

h. The Amendment is intended to provide additional liquidity to public shareholders and enhance the ability of minority shareholders (i.e. non-promoters) to exercise meaningful rights in publicly listed companies, but will cause a number of publicly listed companies in India that have a public float varying from ten to twenty-five percent to increase their public shareholding.

C. KEY JUDGMENTS

The important judgments under the Takeover Regulations and the Companies Act, 1956 (“Companies Act”) during 2010 are summarized below.

1. Case Law Under the Takeover Regulations

The *Subhkam Ventures* case⁴⁵ changed the regulatory landscape regarding rights associated with investments into public companies. In that case, private equity investor Subhkam Ventures challenged a SEBI direction to make an open offer because Subhkam’s acquisition of fifteen percent of MSK Projects, Ltd. gave it the veto right in MSK Projects, thereby triggering the requirement of making an open offer under Regulation 10 of the Takeover Regulations. Subhkam contended that it was merely a financial investor and acquisition of a larger stake would not result in a change in the control of the company under Regulation 12 of the Takeover Regulations. SEBI rejected Subhkam’s contention and ordered it to revise its offer document in accordance with the Takeover Regulations.

Subhkam appealed to the Securities Appellate Tribunal (“SAT”), which analyzed the distinction between “positive control” and “negative control” and held that control under the Takeover Regulations only covered “positive control.” The SAT, whilst considering the specific rights available to the concerned company, ruled that the right to appointment of a nominee director, standstill provisions, and protective rights given to the company were not equivalent to possessing or exercising control.⁴⁶ SEBI has appealed the case to the Supreme Court of India. The Supreme Court decision will also have implications for the SEBI Takeover Regulations.

2. Case Law Under the Companies Act

a. Western Maharashtra Development Corporation Case

In the *Western Maharashtra Development Corporation* (“WMDC”) case,⁴⁷ the Bombay High Court held that a “restriction on the transferability of shares in a private [c]ompany [must] be contrasted with cases involving public [c]ompanies, where the law provides for free transferability.” It also held that “free transferability of shares is the norm in the case of shares in a public company,” and that the provisions under Section 111A of the Compa-

44. *Id.* ¶¶ 7-9.

45. *W. Maharashtra Dev. Corp. v. Bajaj Auto Ltd.*, (2010) Bombay H.C., available at <http://bombayhighcourt.nic.in/data/judgements/2010/OSARBP18606.pdf>.

46. *Id.* ¶¶ 47, 52.

47. *Id.* ¶ 54.

nies Act are founded on the principles that the public must have the freedom to buy and shareholders must be free to transfer shares of a public company.⁴⁸ Regarding the enforceability of preemption clauses and their incorporation into the charter documents of a public company, the Bombay High Court held that a provision contained in the memorandum, articles, agreement, or resolution that seeks to impose restrictions on the right of a shareholder to transfer shares would be void. The court's judgment raises significant concerns in relation to the enforceability of transfer restrictions on shares of public companies (including pre-emption rights), whether incorporated in the charter documents or not, as well as the manner in which joint ventures and public M&A transactions are going to be structured in India.

b. Messer Holdings Case

In the *Messer Holdings Limited* case,⁴⁹ the Bombay High Court ruled on the legality of a private arrangement involving transfer restrictions between shareholders of a public limited company. The court considered whether a clause pertaining to a right of first offer is illegal in light of the principle of free transferability of shares under Section 111A of the Companies Act. The Court held that consensual arrangements entered into between shareholders that restrict the transferability of shares are valid (if they do not conflict with the articles of association). But even though such agreements are binding between the shareholders, they may not be binding on the company. The court also held that it is not mandatory to incorporate transfer restrictions into the articles of association to make them enforceable. The court distinguished between transfer restrictions on shareholders in general and agreements entered into between two identified shareholders (relating to their respective shareholding), and indicated that the latter need not be incorporated into the articles of association.

III. Tax

A. DIRECT TAXES CODE BILL, 2010

The Government of India, manifesting its intention to overhaul the existing tax regime encapsulated under the Income Tax Act, 1961 ("IT Act"), released the Direct Taxes Code Bill on August 12, 2009 ("DTC 2009")⁵⁰ for comments and suggestions. On June 15, 2010, the Ministry of Finance released a revised discussion paper on the draft Direct Tax Code.⁵¹ The revised discussion paper received positive feedback from industry players because it further simplified existing tax provisions and incorporated key proposals made by stakeholders.

48. *Messer Holdings Ltd. v. Shyam Madanmohan Ruia*, (2010) Bombay H.C., available at <http://indiankanoon.org/doc/464224>.

49. *Ministry of Finance Revised Discussion Paper on the Direct Taxes Code*, CENT. BD. OF DIRECT TAXES (India), (2010), <http://finmin.nic.in/dtcode/RevisedDiscussionPaper.pdf>.

50. *Direct Taxes Code*, SPOTLIGHT (Gov't of India, New Delhi, India) Sept. 2009, http://india.gov.in/spotlight/spotlight_archive.php?id=48; see also *Direct Taxes Code Bill, 2009* (Ministry of Finance, India), <http://india.gov.in/allimpfirms/alldocs/12779.pdf> (text of the bill).

51. *Direct Taxes Code Bill* § 1(3).

The Direct Taxes Code Bill, 2010 (“DTC 2010”),⁵² which was introduced in the Indian Parliament on August 30, 2010,⁵³ is proposed to come into force by April 1, 2012.⁵⁴ The salient features of the DTC 2010 are set out below.

1. *Corporate Tax*

DTC 2010 reduces the corporate tax rate to thirty percent for both domestic and foreign companies from the current tax rate of 33.22% (for domestic companies) and 42.23% (for foreign companies). No further surcharge or education assessment is proposed to be levied. Further, a foreign company is liable to pay branch profit tax at fifteen percent.⁵⁵ Other changes were made in the minimum alternate tax, the dividend distribution tax, and the wealth tax.

2. *Capital Gains Tax*

DTC 2010 provides for capital gains to be considered as income from ordinary sources for all taxpayers (including non-residents), which will be taxed at rates applicable to that taxpayer. The definition of “capital assets” under the IT Act has been replaced with the term “Investment Asset”⁵⁶ under DTC 2010. Investment assets do not include business assets like self-generated assets, the right to manufacture, and any other capital assets connected with business.

DTC 2010 prescribes deduction-based exemptions for equity shares or equity-oriented mutual funds.⁵⁷ First, on transfer of equity shares or equity-oriented mutual funds held for more than one year and where securities transaction tax (“STT”) has been paid, a deduction equal to 100% of the capital gains is applicable. Second, on transfer of equity shares or equity-oriented mutual funds held for less than one year and where STT has been paid, a deduction equal to fifty percent of the capital gains is applicable. For other assets held for more than one year, capital gains are to be computed after allowing an indexed cost of acquisition or improvement of such asset.

3. *International Tax*

a. *Transfer of Shares/Interest in a Foreign Company*

DTC 2010 seeks to expand the deeming provisions under the IT Act by including income arising from transfers outside India (of shares or interests in a foreign company) if the foreign company holds any assets situated in India, directly or indirectly.⁵⁸ But these provisions will apply only if the fair market value of such Indian assets represents at least fifty percent of the fair market value of all the assets owned by such foreign company anytime during the twelve months preceding such transfer.⁵⁹

52. Direct Taxes Code Bill, 2010, L.S. 110, 15th Lok Sabha (2010).

53. *Id.* § 111, second sched. ¶ D.

54. *Id.* § 314(141)(a).

55. *Id.* § 51.

56. *Id.* § 5(4)(g).

57. *Id.*

58. *Id.* § 4(3)(b).

59. *Id.* § 314(192).

b. Residency Test

DTC 2010 provides that a foreign company is treated as a resident in India, if “its place of effective management”⁶⁰ is situated in India, which has been defined under DTC 2010 as

(i) the place where the board of directors of the company or its executive directors . . . make their decisions; or (ii) . . . [if] the board of directors routinely approve the commercial and strategic decisions made by the executive directors or [company officers], the place where such executive directors or officers of the company perform their functions.⁶¹

c. Double Taxation Avoidance Agreements (DTAA)

DTC 2010 provides for the applicability of either the DTAA or DTC 2010, depending on which is more beneficial to the taxpayer except⁶² in cases where (i) General Anti-Avoidance Rule (“GAAR”) is invoked; (ii) Controlled Foreign Company (“CFC”) is invoked; or (iii) Branch Profits Tax is levied.

d. Transfer Pricing and Advance Pricing Agreements

The transfer pricing provisions contained in DTC 2010⁶³ are broadly similar to those contained in the IT Act. The definition of “Associated Enterprises” has been expanded to include two more criteria, namely (i) the provision of services by one enterprise to another, either directly or indirectly, and the conditions are influenced by such other enterprise, and (ii) “any specific or distinct location of either of the enterprises as may be prescribed.”⁶⁴

DTC 2010 also introduces advance pricing agreements (“APA”s).⁶⁵ An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (for example, method, comparables and appropriate adjustments thereto, and critical assumptions as to future events) for the determination of the transfer price for those transactions over a fixed period. It empowers the Central Board of Direct Taxes to determine the Arm’s Length Price (“ALP”)⁶⁶ in relation to such international transactions. The ALP is subject to safe harbor rules, which is defined to mean circumstances in which the tax authorities should accept the transfer price as declared by the taxpayer.

Interest, dividends (other than dividends on which dividend distribution tax is paid), royalties, or fees for technical services would be subjected to a twenty percent withholding tax. This is, however, subject to relief available under the respective DTAAAs.

60. *Id.* § 291(1), (8)-(9).

61. *Id.* §§ 116-17.

62. *Id.* § 118.

63. *Id.* § 117.

64. *Id.* § 291.

65. *Id.* at twentieth sched.

66. *Id.* § 123.

4. *Controlled Foreign Company*

DTC 2010 lists the provisions to compute income attributable to a CFC. It provides that the total income of a resident taxpayer will include income attributable to a CFC that has not been distributed by such CFC. DTC 2010 provides that a foreign company that has a tax rate of less than fifteen percent (i.e. fifty percent of the rate applicable to an Indian company—i.e. thirty percent) is classified as a CFC. It is also provided that the CFC regime will apply to a resident that fulfills, individually or collectively, any of the following criteria in a direct or indirect manner, namely, if the resident (i) holds at least fifty percent of voting power or capital of the CFC; (ii) has the power to secure application of fifty percent of income or assets of the CFC for its benefit; (iii) has the ability to “exercise dominant influence on the [CFC] due to [a] special contractual relationship;” or (iv) exerts “decisive influence in a shareholder meeting.” The CFC provisions will not be triggered if the foreign company is a listed entity, is engaged in active trade or business, or the specified income does not exceed INR 2.5 million. Additionally, a strict definition of “active trade or business” has been prescribed, while an underlying foreign tax credit mechanism has not been provided.

5. *General Anti-Avoidance Rule*

As per the GAAR provisions,⁶⁷ the Commissioner of Income Tax can declare an arrangement as impermissible if its main purpose is to obtain a tax benefit and it falls into any of the following categories: (i) lacks commercial substance; (ii) is not at arm’s length; (iii) represents misuse or abuse of the provisions of the DTC; (iv) is carried out in a manner not normally employed for bona fide business purposes. The arrangement would be presumed to be for availing tax benefits, even if the main purpose of a part or a step of the arrangement is to avail tax benefits, unless the taxpayer demonstrates that availing tax benefits was not the main objective of the arrangement. The GAAR provisions will apply as per the guidelines to be framed by the Central Government. Additionally, a Dispute Resolution Panel will be available in cases where GAAR provisions are invoked. The GAAR will override provisions of DTAA entered by India with various countries.

B. KEY JUDGMENTS

1. *E*Trade Ruling*

In *E*Trade Mauritius Ltd. v. Director of International Taxation*,⁶⁸ the issue was whether capital gains tax liability arises in respect to sales of shares of an Indian company by E*Trade Mauritius Limited (“E*Trade”), a company incorporated in Mauritius, to another Mauritius company. E*Trade was a subsidiary of E*Trade Financial Corporation, a holding company incorporated in the USA (“E*Trade USA”) that had been issued a Tax Residency Certificate by the Mauritius income tax authorities.

67. *Id.* ¶ 65-66.

68. *E*Trade Mauritius Ltd. v. Director of International Taxation* (Mar. 22, 2010), Authority for Advance Rulings (Income Tax), ((2010) 230 CTR (AAR) 428)), available at <http://www.lawyersclubindia.com/judiciary/By-virtue-of-Article-13-4-of-India-Mauritius-DTAA-capital-g-1332.asp>.

Relying on the principles laid down by the Supreme Court in the *Azadi Bachao Andolan* case,⁶⁹ the Authority for Advance Ruling (AAR) held that where “a resident of a third country . . . [seeks] to take advantage of the tax reliefs and economic benefits [under any tax treaty] . . . through a conduit entity, . . . the legal transactions entered into by that conduit entity cannot be declared invalid.”⁷⁰ The design of tax avoidance by itself is not objectionable if it is not prohibited by law. The AAR further held that the tax residency certificate issued by the Mauritius authorities was presumptive evidence of the beneficial ownership of the shares and the fact that the source of funds for the purchase of shares was traceable to the holding company (i.e. E*Trade USA) or that the holding company had played a role in suggesting or negotiating the sale, does not lead to a legal inference that the holding company in reality owned the shares and/or is the recipient of gains arising from transfer of shares. The AAR ruled that the capital gains on the sale of shares were only taxable in Mauritius as per the provisions of the DTAA.

2. *Vodafone International Holdings B.V. Case*

In this case,⁷¹ Vodafone Netherlands (“Vodafone”) acquired a sole share in a Cayman Islands company (“CGP”) for consideration of USD 11.1 billion from Hutchison International, Cayman Islands (“HIL”). CGP controlled sixty-seven percent in Hutchison Essar Ltd. (“HEL”) through intermediary Mauritius & Indian companies/contractual arrangements. The acquisition resulted in Vodafone acquiring control over CGP and its downstream entities, including HEL. HEL was a joint venture between Hutchison and Essar group to provide cellular telephone service in India. Vodafone, subsequent to approval from the Foreign Investment Promotion Board (“FIPB”), paid the consideration to HIL, without deducting any tax at source. The Assessing Officer issued notice to Vodafone contending that because the transaction was taxable in India, Vodafone was obligated to withhold tax on payment made to HIL. Vodafone contested the same in an appeal before the Bombay High Court.

The Bombay High Court, rejecting Vodafone’s appeal, observed that tax planning is legitimate so long it is not a colorable device or a sham transaction per *Azadi Bachao Andolan*.⁷² It also ruled that the controlling interest is an incident of ownership of shares and not a distinct capital asset. The court found that the transaction between HIL and Vodafone entailed transfer of various rights including indirect interest in HEL, options on companies holding shares in HEL, appointment of directors in HEL, use and right of “Hutch” Brand, non-compete agreement with Hutch Group, and preference share capital of HEL, which is not possible by transfer of merely one share of CGP. The court found that tax-withholding provisions could apply to a non-resident if there is sufficient territorial connection between the non-resident and India. The court directed the Revenue Authorities to apportion the income that resulted to HIL from the above transaction because

69. Union of India v. *Azadi Bachao Andolan* and Shiva Kant Jha (2003) 263 ITR 706 (SC).

70. *E*Trade* ¶ 9.2.

71. *Vodafone International Holdings B.V. v. UOI & Anr.* (W.P. No. 1325 of 2010), available at <http://www.indiankanoon.org/doc/1488702/>.

72. *Azadi Bachao Andolan*, 263 ITR at 706.

of a nexus with India. Revenue authorities have determined a tax liability of INR 120 billion.⁷³ Vodafone's appeal to the Supreme Court is pending.

73. *E.g.*, P.S. Patnaik, *India Court Tells Authorities to Fix Vodafone Taxes*, BLOOMBERG, <http://www.bloomberg.com/news/2010-09-27/indian-supreme-court-tells-tax-officials-to-respond-to-vodafone-appeal.html>.

