Flipkart on Sale – Will Taxman 'cart' tax on Walmart Entry?

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Prepared by:

Synthesis Group, Mumbai

Empanelled Member of SUFI

Steel Users Federation of India

52B, Plot No. 56, Ashok Chambers,
Devji Ratansy Marg, Masjid Bunder
(East), Mumbai – 400009
Tel: 022-43430300
Email: info@sufi.org.in

Flipkart on sale – Will Taxman 'cart' tax on Walmart Entry?

CA Samir Sanghvi
Partner, Synthesis Group and SUFI Tax expert.

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Background:

On 9th May 2018, SoftBank chief Masayoshi Son made a historic announcement about the biggest e-commerce deal in the history of the world — the "**Flipkart-Walmart deal".**

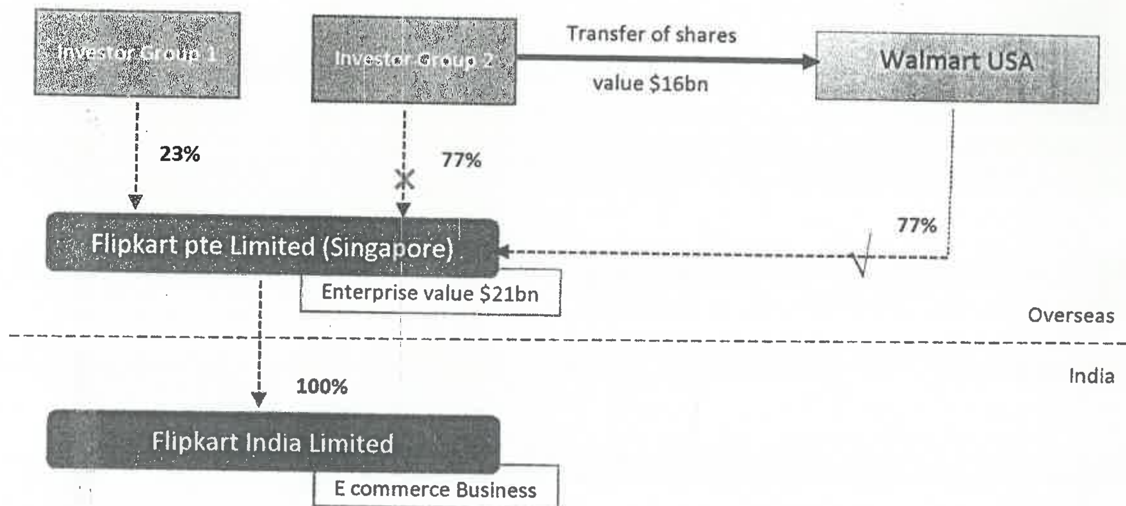
According to the announcement,

> *"Walmart will pay approximately $16 Bn for an initial stake of about 77% in Flipkart. The remainder of the business will be held by some of Flipkart's existing shareholders, including co-founder Binny Bansal and investors Tencent Holdings Ltd, Tiger Global Management LLC, and Microsoft Corp."*

Currently, transaction is subject to regulatory approvals and deal papers are not available in public domain, therefore, it would be difficult to assert any authenticity of the transaction. At least, Indian tax authorities will have all guns loaded this time after learning a big lesson from Vodafone's acquisition of telecom business from Hutchison-Essar.

Although, currently we have limited access to information, but based on some media statements, the facts can be summarised as under:

Available Facts:



It seems Investor Group 2 comprises of various investors such as Tiger Global LLC, SoftBank, Naspers, E-bay, Accel Partners, Sachin Bansal, Binny Bansal, Tencent holdings and others, where except both Bansal, major investors are expected to spread in overseas countries like USA, Mauritius, Singapore, Netherlands, Jersey, China, Japan primarily.

Flipkart India is a capital asset based in India, while Flipkart Singapore is the strategic shareholder of Flipkart India. Flipkart Singapore also operates Flipkart Malaysia, Flipkart Middle East, and other companies outside India.

Let's discuss the first and foremost Tax Complexities of The Walmart-Flipkart Deal-

Transfer of shares of Indian company to attract capital gain tax in India:

The Act provides that taxes must be withheld by the buyer if the share purchase agreement is being entered with a non-resident.

Tax rates applicable in India for Flipkart Investors:

Investor	Tax Residency	Long term Capital Gain (Holding period > 24 months)		Short term capital Gain	
		Act Tax	Treaty Rate	Act Tax	Treaty Rate

Resident (Bansal)	India	20%	NA	30% / 25%	NA
Overseas (based on available information)-					
Softbank US, Ebay	USA	10%	10%	40%	40%
Tiger Global Fund LLC (through Mauritius Fund)	Mauritius/Singapore[1]	10%	Nil	40%	Nil
	Mauritius/Singapore[2]	10%	5%	40%	20%
Softbank Vision Fund, Tencent Holdings	Hongkong / Jersey[3]	10%	10%	40%	40%

It is equally important to understand domestic provision. As virtually substantial value of Flipkart Singapore is derived from Flipkart India business, Section 9(1)(i) of the Act will be applicable to foreign investors selling their stakes in Flipkart Singapore to Walmart US.

According to Section 9(1)(i), *(popularly known as the Vodafone tax)*, any income accruing or arising, whether directly or indirectly[4], inter-alia, through the transfer of a capital asset situated in India, shall be deemed to accrue or arise in India. Since the amendment came after the Hon'ble Supreme court ruling in Vodaphone case[5].

The salient features of the amended provision are-

1. If a foreign company has an operational subsidiary in India, shares of the foreign company are 'deemed to be situated in India' for taxation purpose;
2. Shares of the foreign company are deemed to be situated in India, only if the shares derive its value substantially from the assets located in India. Thus, Section 9(1)(i) also covers income arising from "indirect transfers";
3. Source in relation to an income is construed not to be restricted to 'location of transfer' but where 'value, which was subject to transaction', was acquired or derived from;

Before drawing any conclusion on taxation aspect, it becomes important to understand meaning of the term **"substantially form assets located in India"**:

"The share or interest of a foreign entity shall be deemed to derive its value substantially from the assets (whether tangible or intangible) located in India, if on the specified date *(i.e. Latest audited Balance sheet date or transaction date, as explained later)*, the value of Indian assets:

a) exceeds the amount of `. 10 Crore (equivalent US $ 1.46 million appx. @conversion rate of US $ 1 = ` 68.57); and

[1] Acquisition before 1st April,2017.
[2] Acquisition between 1st April,2017 and 31st March,2019.
[3] Countries having no treaties as on date
[4] Through multiple layers
[5] Vodafone International Holdings B.V. v. Union of India [2012] 204 Taxman 408

b) represents at least 50% of the value of <u>all</u> the assets owned by the foreign company or entity."

Accordingly, the capital gains arising to overseas investors of Flipkart Singapore on transfer of a shares deriving its value substantially from assets located in India will be taxed on <u>proportionate</u> basis to be worked out as per Rule 11UC of the Income Tax Rules,1962 (herein referred to as "Rules").

<u>Rule 11 UC</u>: Gains attributable to assets located in India = **A*(B/C)**

Where,

A = Capital Gain from transfer of shares of foreign entity **(Flipkart Singapore)** computed in accordance with Indian laws, *as if such share/ interest is located in India.*
B = Fair Market Value ('FMV') of assets located in India (as on specified date) **(shares of Flipkart India held by Flipkart Singapore)** from which the shares derive its value substantially, computed in accordance with rule 11UB.
C = FMV of global assets of the foreign company (as on specified date) **(Flipkart Singapore)** computed in accordance with rule 11UB.

Note:

1. The capital gain in respect of shares of Indian Company acquired by utilising foreign currency shall be computed by initially computing capital gain in foreign currency and then converting the capital gain in Indian currency without application of Indexation.
2. The capital gain will be computed proportionate to FMV of the gross assets in India as well as globally held by Foreign company without considering liabilities.

We summarise criteria defined under Rule 11UB for determining FMV of assets -

Particulars	Broad Criteria for determining FMV
Listed shares of Indian Company with no right of control or management	Observable Price on the Stock Exchange with highest volume of trading
Listed shares of Indian Company with right of control or management	The market capitalisation based on observable price of Indian Company shares on the Stock Exchange with highest volume of trading
Unlisted shares of Indian Company or interest in Partnership	FMV of Indian company computed by merchant banker or an accountant as per Internationally accepted valuation methodology for valuation on arm's length basis
Other assets (tangible assets not referred above plus intangible assets)	The price it would fetch in open market if sold on the specified date as determined by merchant banker or an accountant

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Note –

Specified Date under different scenarios =

Suppose, date of transfer is 15th May,2018. Latest Balance sheet date preceding transfer date is 31st March,2018-

Book value of Assets		Specified Date
On 31st March, 2018	**On 15th May, 2018**	
X	Less than 15% of X	31st March,2018
X	More than 15% of X	15th May, 2018

Let's understand the complex formulae with the help of Illustration:

Name of Transferor	P Ltd. (Mauritius)		
Name of Transferee	Q Inc.(USA)		
Transferred Asset	6% Shares of Z Pte. Limited (Singapore) having operational 100% subsidiary Z Pvt. Ltd. in India with tangible and intangible assets		
Date of transfer	15th May,2018		
Capital Gain on transfer of shares	` 10 thousand Crores		
			` In thousand crores
	Situation 1	Situation 2	Situation 3
Book value of Assets of Z Pte Limited on 15th May,2018			
- In India	56	57	10
- Outside	58	59	8
Book value of Assets of Z Pte Limited on 31st March,2018			
- In India	60	60	11
- Outside	40	40	4
FMV of Assets of Z Pte Limited on 15th May,2018			
- In India	85	69	18
- Outside	90	67	3
FMV of Assets of Z Pte Limited on 31st March,2018			
- In India	70	61	15
- Outside	80	41	2

Solution:

Step 1:

Determination of specified date- ` In thousand crores

		Situation 1	Situation 2	Situation 3
Book value of Global Assets of Z Pte Limited				
- 31st March,2018	A	100	100	15
- 15th May,2018	B	114	116	18
Whether (b) exceeds (a) by more than 15% of (a)		No	Yes	Yes
Specified Date		31st March,2018	15th May,2018	15th May,2018

Step 2:

'Substantial value' test- ` In thousand crores

		Situation 1	Situation 2	Situation 3
FMV of Global Assets of Z Pte Limited on specified date				
- In India	C	70	69	18
- Outside	d	80	67	3
Global Assets (c + d)		150	136	21
% of Indian Assets on specified date		46.67%	50.74%	85.71%
Substantial value test?		No	Yes	Yes

Step 3:

Computation of Capital Gain taxable in India: ` In thousand crores

		Situation 1	Situation 2	Situation 3
% of Indian Assets on specified date		46.67%	50.85%	85.71%
Proportionate Taxable Capital Gain out of `10 thousand crores in India		Nil	5.085	8.571

Though the Act has clarified its stand on taxing such overseas acquisitions, the provision of Section 9(1) r.w. Rule 11UB raises new challenges such as-

- How to compute FMV of Indian assets in multi-layered structures with businesses in different countries?
- Whether to consider 'convertible Preference Shares' as capital or liability?
- FMV of intangibles is subjective perception and varies between Countries, culture, traditions as well as regulatory processes.
- Most importantly, since there is no cross confirmation over data furnished by the merchant bankers or accountants across the Globe except their certificates, chances of manipulation of data for tax evasion cannot be ruled out completely.

Relief from glitches of 'Indirect transfers':

Tax exemption is available from 'Indirect transfer' in following two circumstances-

1. **Cap on Indian Assets test:** In case FMV of Indian Assets are either less than ` 10 crore or 50% of Global Assets of Foreign Company.
2. **Cap on Non-resident shareholding test:** In case of any foreign entity that is transferred indirectly owns Indian assets through other Company, if that foreign entity along with its associates at any time since last 12 months-
   a) Neither holds the right of control or management;
   b) Nor holds voting power exceeding 5% in the company directly holding the Indian assets.

Conclusion:

Foreign investors of Flipkart Singapore would not get any tax exemption from 'Indirect transfer' under the domestic Act due to non-fulfilment of first test. However, subject to non-fulfilment of second test, Investors can go for treaty benefits keeping in mind Hon'ble Andhra Pradesh High-court ruling in Sanofi Pasteur Holding SA[6] and AAR ruling GEA Refrigeration Technologies GmbH[7]. In such case, Walmart need not withhold tax as income may not attract tax in India relying Hon'ble Supreme court ruling in GE Technology Centre P. Ltd.[8] However, the interpretation of the GAAR provisions on indirect transfers can change the scenario.

The exact withholding tax figures relating to the deal will, however, be clear only once the acquisition filings come in the public domain. However, the Investors can explore either to obtain Advance ruling or Lower withholding tax order from Indian revenue to avoid litigation.

Way forward:

[6] 354 ITR 316 (AP)
[7] AAR No. 1232 of 2012 (New Delhi)
[8] 327 ITR 456 (SC)

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Compared to the Vodafone-Hutch Essar deal which occurred over 10 years ago in 2007, today's laws and treaties are far clearer and conducive to international deals. Since the deal is very complex and stakes are high, chances of invoking litigation till the Supreme Court of India can't be ruled out. However, some entrepreneurs believe that with India having signed treaties with various countries, there is a 'hope' that the tax complexities can be resolved without going into litigation. However, the Indian government, which is promoting investment in India with its tagline 'Make in India' and 'Start up India', will have to come with necessary timely clarifications to make such deal easy for doing business in India.

For clarification, you can reach us -
CA Samir Sanghvi
Empaneled Tax Expert for SUFI
Steel Users' Federation of India (SUFI)
2/3, Ashok Chambers, Devji Ratanshy marg,
Carnac Bunder, Masjid East, Mumbai – 400 009.
India.
Cell – 9821009143.