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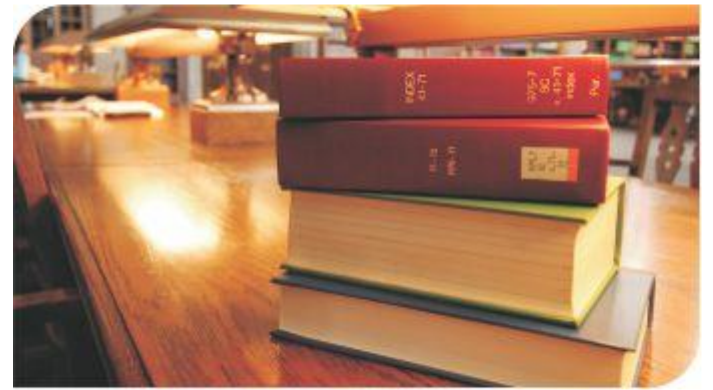

NANGIA ADVISORS

"India's value shifting regime in context of the Shell controversy"

Mr. Rakesh Nangia writes for the International Tax Review UK on value shifting - the Shell controversy so far and the challenges ahead

"In recent years, the tax authorities of many countries across the world have spotted various new issues in relation to cross-border-transactions between the entities of a multinational group. Given the noticeable trend, the latest in the list which has gained attention the world over is value shifting. Value shifting is a global tax concept and is viewed as a mechanism by taxpayers to obviate taxes through various schemes and arrangements.

Value shifting is virtual shifting of the market value of the underlying asset without change in its tax values from one party to another. This may be undertaken through stilted arrangement and series of transactions, which often do not attract substantial tax implications. An illustration can be the issuance of shares by a high valued company to an associated entity at a low value.

The tax authorities of many countries have canvassed practices of the taxpayer and have introduced anti-avoidance rules to plug such transactions and tax the virtual shift in values, even if there is no real taxable transaction."

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India's value shifting regime

Rakesh Nangia of Nangia & Co look at value shifting in the context of the Shell India controversy.

In recent years, the tax authorities of many counties across the world have spotted various new issues in relation to cross-border transactions between the entities of a multinational group. Given the noticeable trend, the latest in the list which has gained attention the world over is value shifting. Value shifting is a global tax concept and is viewed as a mechanism by taxpayers to obviate taxes through various schemes and arrangements.

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Value shifting in India

The Indian tax regime has specific taxing provisions to address value shifting. For instance the Income Tax Act, 1961 encompass certain transactions relating to the transfer of specified assets for an inadequate consideration and accordingly, impose tax in the hands of the transferee. Further, the Indian government has recently introduced the general anti-avoidance rules (GAAR) to counter cases of tax avoidance practices by taxpayers, though its implementation has been postponed.

Nevertheless, the Indian tax authorities have been challenging the valuation and the underlying methodologies adopted by the taxpayer for any transaction and make adjustments to impose higher taxes. With the widening of the definition of international transaction for application of transfer pricing (TP) provisions in India, the arm's-length price for such transactions has become the subject matter of debate in many cases.

The debate gains more significance in light of the multinational entities venturing into Indian markets as it creates lot of tax ambiguities in the new economic reforms which seriously intends to promote foreign investment in India.

One such case which has gathered lot of attention in the global tax arena is the recent controversy in the case of the multinational oil and gas group – Shell. The controversy fundamentally revolves around taxation on the undervaluation of shares issued by Shell India Limited to its overseas group entity, more specifically under the extant Indian TP regulations and seeks to tax Shell India on alleged issuance of shares at a discounted rate.

Shell controversy: The story so far

Shell India, having diversified businesses in India, was issued with a TP order from the tax authority alleging that the company undervalued its shares when raising money from the Shell group entity during the financial year 2008-09. Shell India issued 870 million equity shares at INR10 ($0.2) each (which was the par value) to Shell Gas BV. During the TP audit, the transfer pricing officer (TPO) asked Shell India to justify the pricing of the equity shares

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issued to Shell Gas BV. In response, Shell India justified the price of the equity shares based on discounted cash flow (DCF), as provided under the Indian foreign exchange regulations and the value per share was determined at INR6.93.

The TPO recomputed the price per share, using DCF method, but at INR183.44 and held that the company transferred its equity shares to its overseas group entity at a price below the fair market value. The difference in valuation, so arrived by TPO, was branded as a loan advanced by Shell India to its overseas group entity. While doing this, the TPO also alleged that Shell India ought to have charged interest on the same thereby resulting an overall adjustment to the tune of INR152 billion. Consequently, the TPO imposed tax on the short receipt of share capital as well as a return calculated on such short receipt.

Some of the key contentions of the TPO & Shell India are:

- On Shell India's contention of non-applicability of TP provisions to capital transaction, the TPO observed that issuance of shares to an overseas group entity falls under the amended definition of international transactions and hence, the TP provisions are applicable.
- On the methodology, the TPO held that the valuation was undertaken by him by following the DCF method, with few changes in underlying assumptions pertaining to the discount rate and terminal growth rate. Although, Shell India claimed that the share valuation was done in accordance with the erstwhile guidelines prescribed by the controller of capital issue (erstwhile CCI guidelines) as prescribed under the foreign

The Shell India controversy revolves around taxation on the undervaluation of shares issued by Shell India Limited to its overseas group entity

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Rakesh Nangia, a practicing Chartered Accountant with more than 33 years of professional experience, heads Nangia & Co, one of the top Indian advisory firms with expertise in dealing with wide range of corporate issues across diverse industries such as oil and gas, hospitality, telecom and healthcare.

Rakesh has rich experience in all fields of professional services, industrial sectors and diverse clients in varied practice domains including corporate, international and indirect taxes, mergers and acquisitions, regulatory and audit.

He is a member of various trade and business associations and a board member of the Indo-Canadian Chamber of Commerce. He is a regular speaker on taxation matters in seminars and conferences.

His mantra for success is being positive, perseverant and focused. He is known for his humbleness and the contribution to the society by helping the underprivileged children and women.

exchange control norms, the TPO rejected Shell India's reliance on erstwhile CCI guidelines and asserted that erstwhile CCI guidelines are not relevant for share valuation from the TP perspective and accordingly cannot bind the tax authority.

- On the issue of re-characterisation of the transaction, Shell India argued that the said share issue is a capital transaction and cannot be re-characterised. The TPO, on the other hand, denied any such attempt and asserted that Shell India has undersold its stake to its overseas group entity. This compromises India's asset base because of short receipt of capital and loss of share premium. The TPO further asserted that if the shares were allocated through private placements or IPO, Shell India would have commanded a higher premium because of its market capitalisation and brand strength. According to the TPO, under-valuation of shares has resulted in a reduction in the wealth of Shell India.

What lies ahead?

The reference to Shell India's case gains importance for a couple of reasons. First, is the amount involved on account of TP adjustment made by the tax authority and second, which is more significant, is the aggressive position taken by tax authority to look beyond the certified valuations for capital transactions and thus, imposing tax on virtual shift in the values.

To challenge the constitutional, jurisdictional, legality, validity and judicial propriety of the TP order, Shell India has filed a writ petition at a high court. In its grounds of appeal, Shell India has mentioned that the action of the tax authority is based on misrepresentation of the Act and hence, confiscatory in nature. It further states that the adjustment on account of re-characterisation of transaction is not permitted in India's TP regulations and such an action clouts arbitrariness and is unfair besides being illegal and is in sheer disregarded of the fact that as per the corporate and regulatory framework and laws, the alleged shortfall (share premium) can never be received by Shell India as the shares were issued at par value.

This matter is still to be disposed of by the high court and it is not apt to comment on the righteousness of the case or any facts thereto.

The Shell controversy adds another perspective to the TP issue and seeks to expand the scope of taxation in India, even in the absence of any specific taxing provisions to that effect. We only would like to emphasise that even in absence of any value shifting rules or implementation of the GAAR in India, the tax authorities may seek to impose notional tax on the transactions pertaining to the value shifting, which otherwise do not attract tax. The same could be extended to a situation where the shares are issued by a closely held company at a higher value to a foreign shareholder, since this results in shifting of value in favour of a company, although there is a specific provision to this effect under the Act only for a resident subscriber. This brings forth a situation wherein taxpayers could face the risk of being penalised because of the application of the same valuation method (DCF) by two different government authorities, albeit using different set of assumptions.

Another issue emanating from the Shell controversy is the power of the tax officer to re-compute the valuation methodology at which the shares are being issued and the underlying assumptions made by the independent valuer to arrive at the share price. To support the same, there are few recent judgments by quasi-judicial bodies holding that the valuation determined/accepted under other regulations in India cannot be used as a benchmark for determining the arm's-length price for tax purposes.

So, does it indicate that the price determination for the subject transactions shall be different for foreign exchange compliances vis-à-vis computing arm's-length price under Indian TP regulations? And that valuation could again be open for challenge by the revenue authorities? These are some of the questions that remain unanswered and many more are yet to be unveiled with the extremity of tax litigation in India. We would need these answers not purely from a tax viewpoint but in a larger spectrum of bringing certainty and definitiveness for foreign investors.

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