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Government to Tame the Offset Route & Encourage Private Participation in Defence Production

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Transfer of Shares (of a Listed Company) between Non-Residents Exempt from Capital Gains Tax

The Delhi High Court ("DHC"), has in a recent judgment (delivered on February 27, 2013) affirmed the ruling of the Authority for Advance Rulings ("AAR"), delivered on May 2, 2011, stating that income arising out of transfer of a long term capital asset, such capital asset being equity shares of an Indian listed company (where the transaction of sale of such equity shares is chargeable to securities transaction tax), would be exempt from payment of tax in India.

The issue concerning taxation arose when Goodyear Tire and Rubber Company ("GTRC"), a company incorporated under the laws of USA, transferred seventy four (74%) shares of Goodyear India Limited ("GIL"), a public company in India listed on the Bombay Stock Exchange ("BSE"), to its Singapore subsidiary, Goodyear Orient Company (Private) Limited ("GOCPL") under a share contribution deed without any monetary consideration.

For the purposes of the transfer of shares, GTRC and GOCPL had approached the AAR, seeking a ruling/clarification on issues pertaining to GTRC's tax liabilities under the Income Tax Act, 1961 (the "Act") arising from the transaction of transfer of GIL's shares from GTRC to GOCPL without any consideration. However, opposing the argument that no consideration was payable for the transfer, the tax department contended that the consideration was present in the transfer in the form of "creation of a better business environment" which was stated to be the object of the transfer of shares. Thus, the income tax department contended before AAR that the transfer would result in capital gains and should be treated accordingly.

The AAR, however, ruled that no consideration would accrue or arise by transfer of shares and no profit/gain has accrued to GTRC by virtue of the said transfer, the applicability of Section 45 read with Section 48 of the Act (the charging provisions in respect of capital gains) does not arise. Furthermore, the AAR observed that since GIL is a company in which the public is substantially interested and its shares are listed on BSE, any income/capital gains arising from the transfer of its shares are otherwise exempt under Section 10(38) of the Act.

The Income Tax Department thereafter filed a writ petition before the DHC against the ruling of the AAR. The tax department also raised a contention before the DHC that the transfer of GIL's shares to GOCPL amounted to 'treaty-shopping', alleging that it was intended to circumvent payment of tax in India. The department based its argument on the India-Singapore Double Taxation Avoidance Treaty, wherein such transactions are only subject to taxation in Singapore as compared with the Indo–US agreement where tax implications arise in both the countries.

The DHC affirming the ruling of the AAR opined that if income arises out of the transfer of a long-term capital asset being an equity share in a listed company, the said income would in any event be exempt under Section 10(38) of the Act.

Government to Tame the Offset Route & Encourage Private Participation in Defence Production

After the recent allegations of corruption in the defence deals, the Government is considering a second look at the Defence Procurement Procedure, the Defence Production Policy and the Defence Offset Guidelines, 2012 ("Offset Policy"). The present Defence Procurement Procedure and Offset Policy requires that in any purchase over INR 300 crore from a foreign company, thirty percent (30%) of the estimated cost of the acquisition in 'Buy (Global)' category and thirty percent (30%) of the foreign exchange component in 'Buy and Make' with Transfer of Technology category should be ploughed back into India through offsets obligations. Offset obligations may be discharged with reference to eligible products and eligible services as described in the Offset Policy. Offsets are meant to improve indigenous manufacturing, engineering and technological base as well as to route investments into the domestic industry.

After the recent allegations of misuse of the Offset Policy for routing unauthorized commission payments under defence deals, the Government is considering removal of the software and other soft services out of the defence offsets. The proposed amendments would result in defence offsets being mostly clustered around product supply and maintenance services that are quantifiable unlike the software, training and other consultancy services which are difficult to value. Along with the change in offsets, the Ministry of Defence is also likely to approve a proposal to put 'Buy and Make (Indian)' as the top category for procurement. Under this category, the procurement would be made from an Indian vendor, including a private Indian company that forms a joint venture or even has a production arrangement with a foreign firm. However, there must be a minimum of fifty percent (50%) indigenous content.

The proposed amendments, stated above, are currently being formulated by the Ministry of Defence and if introduced can open up immense participation of Indian private sector and also curb the potential misuse of the Offset Policy. Presently, almost seventy percent (70%) of Indian defence purchases are from foreign companies, while most of the remaining is procured from Indian public sector units and ordinance factories. Indian private sector gets a very limited number of defence contracts. However, the proposed amendments may challenge the virtual monopoly enjoyed by foreign vendors and Indian defence public sector units in defence contracts.

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