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THE HIGH COURT OF DELHI AT NEW DELHI

% Judgment delivered on: 30.07.2014

+ **W.P.(C) 1648/2013 & CM NO.3105/2013**

ZAHEER MAURITIUS ..... Petitioner

versus

DIRECTOR OF INCOME TAX
(INTERNATIONAL TAXATION)-II ..... Respondent

Advocates who appeared in this case:

For the Petitioner : Mr Percy Pardiwala, Sr. Advocate Ms Rashmi Chopra and Ms Vriti Anand, Advocates.

For the Respondent : Mr Sanjeev Sabharwal, Sr. Standing Counsel with Mr Ruchir Bhatia, Jr. Standing Counsel.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE VIBHU BAKHRU

JUDGMENT

VIBHU BAKHRU, J

1. The writ petitioner under Article 226/227 of the Constitution of India, is a company incorporated under the laws of Mauritius, challenges a ruling dated 21.03.2012 (hereinafter referred to as the 'impugned ruling') of the Authority for Advance Ruling, (hereinafter referred to as 'AAR') in A.A.R. No.1048 of 2011. By the impugned ruling, the AAR held that the entire gains on the sale of equity shares and Compulsorily Convertible Debentures (CCDs) held by the petitioner are not exempt from income tax in India by virtue of the Double Taxation Avoidance Convention (hereinafter referred to as 'DTAA') with Mauritius and that the gains

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arising on the sale of CCDs are interest within the meaning of Section 2(28A) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act') and Article 11 of the DTAC and are taxable as such.

2. Brief facts of the case are that Vatika Limited (hereinafter referred to as 'Vatika') is an Indian company and is *inter alia* engaged in the business of developing and dealing in real estate. Vatika is the owner of a contiguous tract of land admeasuring 6.881 acres or 10,00,000 sq. ft situated in village Badshahpur Tehsil, Gurgaon (hereinafter referred to as the 'Land'), which has been reserved for being developed as a cyber park, to be used for software development activities and IT enabled services as per the provisions of Notification No. CCP (NCR)/GDP-III/2001/1555 dated 30.07.2001 as amended from time to time. SH Tech Park Developers Private Limited (hereinafter referred to as the 'JV Company') is an Indian Company and was incorporated on 04.07.2007 as a 100% subsidiary of Vatika.

3. The petitioner is a company incorporated under the laws of Mauritius and is a tax resident of Mauritius and is *inter alia* engaged in the business of investment into Indian companies engaged in construction and development business in India. The petitioner entered into a Securities Subscription Agreement dated 11.08.2007 (hereinafter referred to as 'SSA') and a Shareholder's Agreement dated 11.08.2007 (hereinafter referred to as 'SHA') with Vatika and the JV Company. As per the SSA, the petitioner agreed to acquire 35% ownership interest in the JV Company by making a total investment of ₹100 crores in five tranches. The petitioner agreed to subscribe to 46,307 equity shares having a par value of ₹10/- each and

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88,25,85,590 zero percent CCDs having a par value of ₹1/- each in a planned and phased manner. The SHA recorded the terms of the relationship between the petitioner, Vatika and the JV Company, their *inter se* rights and obligations including matters relating to transfer of equity shares and the management and operation of the JV Company. The said agreement also provided for a call option given to Vatika by the petitioner to acquire all the aforementioned securities during the call period and likewise, a put option given by Vatika to the petitioner to sell to Vatika all the aforementioned securities during the determined period.

4. Vatika and the JV Company executed a Development Rights Agreement dated 06.11.2007 (hereinafter referred to as 'DRA') in terms of which Vatika transferred the exclusive development rights, entitlements and interest in the Land to the JV Company for development of the Land, with the right to retain the sale proceeds thereof exclusively.

5. On 08.04.2010, Vatika partly exercised the call option and purchased 22,924 equity shares and 43,69,24,490 CCDs from the petitioner for a total consideration of ₹80 crores. Subsequently, the petitioner transferred further equity shares and CCDs to Vatika. The AAR noted that the Balance Sheet of Vatika for the year 2010-11 indicates that Vatika had acquired the entire CCDs subscribed to by the petitioner during the Financial Year – 2010-11, and the petitioner was left with only 23,383 equity shares of the JV Company.

6. On 12.05.2010, the petitioner filed an application under Section 197 of the Act before the Income Tax Officer requesting for a 'nil' withholding

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tax certificate to receive the total consideration from Vatika for transfer of equity shares and CCDs without deduction of tax. The Income Tax Officer by order dated 12.09.2010, held that the entire gain on the transfer of equity shares and CCDs would be treated as interest and tax at the rate of 20% (plus surcharge and cess) should be withheld on the same.

7. Thereafter, on 16.02.2011, the Petitioner filed an application before the AAR for advance ruling on the question:-

> *"Whether on the facts stated in the application and in law gains arising to the Applicant, being a tax resident of Mauritius on sale of equity shares and Compulsorily Convertible Debentures (CCDs) held by the Applicant in SH Tech Park Developers Private Limited, an Indian Company are exempt from capital gains tax in India under Article 13(4) of Double Taxation Avoidance Agreement between India and Mauritius ('DTAA')?"*

8. By the impugned ruling dated 21.03.2012, the AAR held as follows:

> *"We, accordingly, answer the question that the entire gains arising to the applicant on the sale of equity shares and CCDs are not exempt from capital gain tax in India under DTAC with Mauritius. The gains arising on the sale of CCDs being interest within the meaning of Section 2(28A) of the Act and Article 11 of the DTAC and are taxable as such."*

9. The learned counsel appearing for the petitioner submitted that the AAR had erred in passing the impugned ruling and holding that the amount of gains received/receivable by the petitioner resulting from transfer of the investments held by the petitioner in the JV company, was interest under Section 2(28A) of the Act. It was submitted that the AAR erred in not appreciating that there was no debtor and borrower relation between Vatika and the petitioner. The CCDs were held as a capital assets by the petitioner

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and the transfer of the said investment was a transfer of a capital asset and any gains arising therefrom were liable to be treated as capital gains. Consequently, such gains could not be subjected to income tax in India in terms of the DTAA between India and Mauritius. The petitioner further contended that the AAR erred in concluding that the transaction entered into between the petitioner, Vatika and the JV company was essentially a loan transaction, disguised as an investment in shares and CCDs. It was contended that the AAR erred in holding that the corporate veil ought to be lifted and in proceeding on the basis that Vatika and the JV Company were, essentially, a single entity. Based on this conclusion, the AAR had held that the debt owed by the JV company was in reality Vatika's debt and the amount received by the petitioner in excess of the investment made by the petitioner would amount to 'interest' paid/payable by Vatika for borrowing funds from the petitioner.

10. The learned counsel appearing for the respondent supported the decision of the AAR and submitted that the ruling was a reasoned one and was neither arbitrary nor perverse and thus could not be challenged under Article 226 of the Constitution of India. It was contended on behalf of the Revenue that the transaction entered into between Vatika and the petitioner was essentially in the nature of an External Commercial Borrowing (ECB) and that was clear from the structure of the SSA and the SHA entered into by the petitioner, Vatika and the JV company. It was contended that in terms of the said agreements, the petitioner was entitled to receive a fixed rate of return and that the duration of the investment would determine the quantum of return receivable by the petitioner. It was, thus, submitted that

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the transaction in question must be viewed as a loan transaction and the returns on the investment were simply interest, liable to be taxed in India.

11. The controversy in the present case revolves around the issue of whether the gains resulting to the petitioner from sale of CCDs held in the JV company are taxable as "interest" in its hands.

12. The AAR examined various decisions including the decision of the Supreme Court in the case of ***CWT v. Spencer & Co.***: **(1973) 88 ITR 429** and held that:-

> *"In view of the facts before us, and the law laid down by the Hon'ble Supreme Court, we are of the view that the CCD creates or recognizes the existence of a debt, which remains to be so till it is repaid or discharged".*

13. There is no dispute as to the nature of Compulsorily Convertible Debentures. A debenture indisputably creates and recognizes the existence of a debt and till it is discharged, either by payment or by conversion, the debenture would essentially represent a debt. A Compulsorily Convertible Debenture is a debt which is compulsorily liable to be discharged by conversion into equity. Any amount payable by the issuer of debentures to its holder would usually be interest in the hands of the holder. Black's Law Dictionary (7th Edition) defines 'interest' *inter alia* as compensation fixed by agreement or allowed by law for use or detention of money, or for loss of money by one who is entitled to its use; especially, the amount owed to a lender in return for the use of borrowed money. According to Stroud's Judicial Dictionary of Words and Phrases (5th Edition), interest means, *inter alia*, compensation paid by the borrower to the lender for deprivation of the

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use of his money. Concededly, gains arising from sale of capital assets would not be in the nature of interest. The expression 'interest' as defined under Section 2(28A) of the Act cannot apply to all gains that are received by a debenture holder (lender) irrespective of the transaction resulting in such gains. As an illustration, a lender may assign its debt to a third party and if such debt is held as a capital asset, the gain or loss arising from the transaction would be a capital gain/loss in the hands of a lender and would not be construed as interest. Similarly, any loss suffered by the lender in such transaction i.e. where a debt is assigned for a consideration less than the amount lent, would be a capital loss. Whether a Compulsorily Convertible Debenture is a loan *simplicitor* or whether it is in the nature of equity, is not material in determining whether the gain on the sale of the debentures by its holder is a capital gain or not. This depends entirely on whether the debentures are capital assets in the hands of its holder.

14. First of all, it is necessary to consider whether the investment - CCDs and/or the equity shares of the JV company - held by the petitioner, were capital assets in its hands. In the present facts, the petitioner has asserted that both equity and the CCDs it subscribed to were capital assets in its hands. This has also not been disputed by the Revenue before us. Although the written comments filed on behalf of the Revenue before the AAR stated that the gains received by the petitioner were business income, apparently that contention was not pressed and the AAR also did not refer to this contention. The principal dispute between the petitioner and the Revenue is whether the gains arising in the hands of the petitioner from transfer of its investments in the JV Company is 'interest' or 'capital gains'.

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15. Under normal circumstances, it is undeniable that gains arising from transfer of a debenture, which is a capital asset in the hands of the transferor, in favour of a third party, would be capital gains and not interest. In other words, if a debenture (which is a capital asset) is transferred by a holder to a third party, the gains that arise i.e. difference between the costs of purchase and the sale consideration would be capital gains in the hands of a transferor. The dispute in the present case arises only because it has been held that the transaction between the petitioner and the Vatika is a sham transaction and is essentially a transaction of loan to Vatika which has been camouflaged as an investment in shares and CCDs of the JV company.

16. The substratal controversy that needs to be addressed in the present petition is whether the AAR was correct in holding that the corporate veil ought to be lifted and that the JV Company and Vatika were essentially the same entity. And consequently, the amount paid/payable by Vatika in excess of the amount invested by the petitioner would be 'interest' within the meaning of Section 2(28A) of the Act and Article 11 of the DTAA between India and Mauritius.

17. Before proceeding further it is necessary to note certain facts. On 04.07.2007, the JV Company was incorporated as a wholly owned subsidiary of Vatika. At the material time of incorporation the authorised, issued and paid up equity capital of the JV Company was ₹1,00,000/- (Rupee one lac). Vatika was the owner of a tract of land which was proposed to be developed as a cyber park. In order to garner the investment in this project, the JV Company and Vatika entered into two agreements

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with the petitioner namely the SSA and the SHA on 11.08.2007. The SSA contemplated that a development agreement would be entered into between Vatika and the JV Company, whereby the development rights in respect of the project would be transferred by Vatika to the JV Company. Subsequently, on 06.11.2007, a Development Rights Agreement was entered into between Vatika and the JV Company in terms of which Vatika transferred the exclusive and unconditional development rights of the entire Land to the JV Company. This entitled the JV Company or its authorised representatives to enter upon the Land and carry out development and/or improvement at its sole discretion, subject to the applicable laws. The project constituted of three buildings, and the ownership rights including the rights of transfer and hypothetication of any asset developed by the JV Company on the Land (except one building which was excluded), were vested exclusively with the JV Company. The physical possession of the Land for the purpose of development was also agreed to be handed over to the JV Company. In terms of the said agreement, the JV Company was exclusively entitled to all proceeds from the commercialisation, sale, transfer, lease or disposal in any other manner of the project, the buildings (except the excluded building) or any part thereof. Essentially, the real estate project on the land in question now vested with the JV Company.

18. The terms of participation of the petitioner in the JV Company and, consequently, in the project were recorded in two separate agreements entered into on 11.08.2007 namely the SSA and the SHA. Under the SSA, it was contemplated that in the first instance (i.e. the First Closing Date) authorised share capital of the JV Company would be increased and Vatika

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would subscribe to 76,000 equity shares for an aggregate consideration of ₹7,60,000/-. The petitioner would also make its first tranche of investment in the JV company and be allotted 7350 equity shares of ₹10 each and 209,926,500 CCDs of ₹1 each. The petitioner would also subscribe to the shares and Compulsorily Convertible Debentures in 3 additional tranches. In aggregate, the petitioner would invest ₹100 crores and be allotted 46,307 equity shares, and 88,25,85,590 zero percent CCDs having a face value of ₹1.

19. The terms and conditions of the issue of CCDs were specified in schedule III to the SHA. The CCDs were compulsorily convertible into equity shares after expiry of 72 months from the date of the first closing (i.e. the date when the first tranche of investment was made by the petitioner). In addition, the CCDs were also convertible prior to 72 months at the option of the petitioner. On the expiry of 42 months from the First Closing Date, the petitioner was entitled to require the JV Company to convert 33,485,494 CCDs into equity shares. The petitioner was entitled to conversion of 37,526,847 CCDs, 42,346,809 CCDs and 48,159,116 CCDs after expiry of 48 months, 54 months and 60 months respectively. The SHA also recorded the agreement between the petitioner, Vatika and the JV Company with regard to the management of the JV Company.

20. The AAR has concluded that the entire transaction which is embodied in the SSA, SHA and other documents is a sham and the real transaction is only of the petitioner granting a loan to Vatika. The AAR arrived at the conclusion essentially on the following findings:-

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(a) That the SHA specified a fixed rate of return on the investment made by the petitioner.

(b) That the Board of Directors of the JV Company was not in control of its affairs which were managed by Vatika/its shareholders.

(c) That the entire transaction was structured as a investment into equity and CCDs to avoid the incidence of tax.

21. The AAR concluded that the agreements entered into (the SHA and the SSA) recorded the agreement that the petitioner would receive a fixed rate of return. For this purpose, the AAR relied upon Article 10 of the SHA which contained the covenants with regard to the call and put options. It would be, thus, necessary to refer to the relevant clauses which are quoted below for ready reference:-

*"**10. CALL AND PUT OPTION***

10.1 Vatika Call Option

*(a) In consideration of the mutual covenants of Vatika and the Investor contained herein, the Investor hereby grants to Vatika an option (the "**Call Option**") to acquire all, but not less than all, the Investor Securities (the "**Call Option Securities**") during the Call Period.*

*(b) The purchase price of the Call Option Securities (the "**Call Option Purchase Price**"):*

(i) if the Call Option is exercised on or prior to the expiry of the third anniversary of the First Closing Date, shall be the sum of (I) the Investor Investment Amount (less any Bought Back

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Subscription Amount); (II) the amount equal to the Accrued Return till the Completion Date; (III) the Equity Payment; and (IV) an amount equal to 8% per annum of the Investor Investment Amount (less any Bought Back Subscription Amount) calculated from the second anniversary of the First Closing Date till the Completion Date, less the Vatika Return, if any;

(ii) if the Call Option is exercised after the expiry of the third anniversary of the First Closing Date, shall be the sum of (I) the Investor Subscription Amount (less any Bought Back Subscription Amount); (II) the amount equal to the Accrued Return till the Completion Date; and (III) the Equity Payment, less the Vatika Return, if any.

xxxx xxxx xxxx xxxx xxxx

10.2 Investor Put Option

*(a) In consideration of the mutual covenants of Vatika and the Investor contained herein, Vatika hereby grants to the Investor an option (the "**Put Option**"), exercisable at any time on or subsequent to the fifth anniversary of the First Closing Date or in the event of a Material Default by the Company or Vatika which default has not been remedied or cured within thirty (30) days of notice of such default by the Investor, to sell to Vatika, all the Investor Securities ("**Put Option Securities**") and upon exercise of the Put Option, Vatika shall be obliged to purchase the Put Option Securities at the Put Option Purchase Price (as defined hereinafter).*

*(b) The purchase price of the Put Option Securities (the "**Put Option Purchase Price**") shall be the sum of (I) the Investor Subscription Amount (less any Bought Back Subscription Amount); (II) the amount equal to the Accrued Return till the Completion Date; and (III) the Equity Payment, less the Vatika Return, if any."*

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22. In our opinion, the aforesaid clauses cannot be read to mean that the petitioner was only entitled to a fixed return on the investments made by it in the equity and CCDs issued by the JV company. Article 10(1) of the SHA entitles Vatika to call upon the petitioner to sell its investment at a price to be computed in the manner as provided in the clause. If the option is exercised prior to the completion of three years from the First Closing Date, the petitioner would be entitled to the value of investment plus a fixed return as is computed in accordance with clause 10.1(b)(i) of the SHA. However, if this option was exercised after the expiry of three years from the First Closing Date, the price to be computed would also include a component of "equity payment" which was defined to mean an amount equal to 10% of the project value. Thus, if the option was exercised by Vatika after a period of three years from the First Closing Date, the petitioner would be entitled to a certain portion of the project value and consequently, a portion of the assets of the JV Company. Article 10.2 of the SHA contains a provision whereby the petitioner could call upon Vatika to purchase its investment. However, this option could only be exercised by the petitioner after the expiry of five years from the date of first closing. In the event that the petitioner exercised such option, it would be entitled to receive the price as computed in accordance with clause 10.2(b) of the SHA. This price would also include the component of "equity payment" (i.e. 10% of the project value). However, it is to be noted that Article 10 only provided for options either to Vatika to buy out the stake of the petitioner in the JV Company, or to the petitioner to exit the JV Company by calling upon Vatika to buy its shares. It is vital to bear in mind that it was not necessary that either Vatika or the petitioner exercise the options as

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available to them. By the very definition, call & put options were only options that were available to the contracting parties. In the event none of the options were exercised, the CCDs held by the petitioner would mandatorily be convertible into equity shares and the petitioner would be entitled to the benefits that would accrue to an equity shareholder in respect of the equity shares issued by the JV Company on conversion of the CCDs. In our view, merely because an investment agreement provides for exit options to an investor, would not change the nature of the investment made. It also cannot be ignored that the options were granted to the investor as well as to Vatika. A plain reading of the SHA indicates that it is essentially a joint venture agreement and it is common in any joint venture agreement for the co-venturers to include covenants for buying each-others' stakes. Although, the SHA enables the petitioner to exit the investment by receiving a reasonable return on it, and in that sense it is assured of a minimum return, the same cannot be read to mean that the CCDs were fixed return instruments, since the petitioner also had the option to continue with its investment as an equity shareholder of the JV Company.

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23. Article 11 of the SHA also provides additional rights to the petitioner including the right to sell its entire equity in the JV Company to a third party and recover the value as calculated under clause 11.2(d)(i) of the SHA. It is also necessary to bear in mind that the rights with regard to options as well as additional rights under Article 11 of the SHA were the mutual rights and obligations between Vatika and the petitioner and not the JV company. The JV Company would in any event, whether the options

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were exercised *inter se* Vatika and the petitioner or not, convert the CCDs into equity shares on completion of 72 months from the First Closing Date.

24. The next issue to be examined is whether the covenants of the SHA warranted a finding that the JV Company and Vatika were a single entity. A plain reading of the SHA indicates that the JV Company was to be managed as a joint venture between the petitioner and Vatika and the JV Company was not an alter ego of Vatika alone. Some of the relevant clauses of the SHA are quoted below:-

> ***"4. CORPORATE GOVERNANCE***
>
> *4.1 Board of Directors*
>
> *4.1.1 The Company shall have a Board comprising of five (5) members. Unless otherwise agreed in writing between the Parties and subject to Article 11.1(a)(ii), the composition of the Board shall be as follows:*
>
> *a) three (3) nominee Directors nominated by Vatika; and*
>
> *b) two (2) nominee Director(s) of the Investor.*
>
> *xxxx xxxx xxxx xxxx xxxx*
>
> *4.5 Board Meetings*
>
> *4.5.1 Frequency & Location*
>
> *The Board shall meet at least once every three (3) months, with each such meeting to be held in the National Capital Region or such other place as may be agreed in writing by at least one Investor Director.*
>
> *4.5.2 Quorum*
>
> *The quorum for a meeting of the Board shall be as required under the Act, subject to at least one (1) Investor Director and (1) Vatika Director being present at such meeting.*

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4.5.4 Voting

At any Board Meeting, each Director may exercise one (1) vote Except in respect of Affirmative Vote Items, the adoption of any resolution of the Board shall require the affirmative vote of a majority of the Directors present at a duly constituted Board Meeting. The Board shall not at any Board Meeting adopt any resolution covering any matter that is not expressly specified on the agenda for such Board Meeting unless a majority of the Directors present at such Board Meeting, which shall include at least one (1) Investor Director, vote in favour of such resolution.

xxxx xxxx xxxx xxxx xxxx

4.6 Affirmative Vote Items

*4.6.1 Subject only to any additional requirements imposed by the Act and Articles 4.6.2 and 11.1(b) below, during the term of this Agreement, neither the Company nor any Shareholder, Director, officer, committee, committee member, employee, agent or any of their respective delegates shall, without the affirmative written consent or approval of each of the Investor and Vatika whether in any Board Meeting, meeting of a committee of Directors, General Meeting, through any resolutions by circulation or otherwise, with respect to the Company, take any decisions or actions in relation to any of the matters set forth in the Schedule-II (the "**Affirmative Vote Items**").*

xxxx xxxx xxxx xxxx xxxx

4.7 General Meeting

4.7.1 An AGM shall be held each calendar year within three (3) months following the end of the previous Financial Year. The Board shall provide the Company's previous Financial Year's Financial Statements to all Shareholders at least one (1) month before the AGM is

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held to approve and adopt the Financial Statements. All other General Meetings, other than the AGM, shall be EGMs. The quorum for General Meetings shall be in accordance with the Act, subject to at least one (1) authorized representative representing the Investor and one (1) authorized representative representing Vatika.

4.7.2 *Subject to the Act, a minimum twenty one (21) Business Days prior written notice shall be given to all the Shareholders of any General Meeting, accompanied by the agenda for such General Meeting (unless the Investor and Vatika shall have given written approval for a meeting called at shorter notice, in accordance with the provisions of the Act).*

xxxx xxxx xxxx xxxx xxxx

4.9 *Certain Matters concerning the Project Documents*

4.9.1 *It is expressly agreed that, unless otherwise agreed by the Investor, in any Board Meeting the Vatika Directors shall refrain from participating in any discussion that concerns the exercise of the Company's rights under any Project Documents or any transactions contemplated thereby, and any decision taken by the Board in such case (even though it may be taken in the absence of the consent of Vatika or Vatika Directors) shall validly bind the Company.*

4.9.2 *Vatika and the Company acknowledge that no decision, consent, approval or notice given by the Company under the Project Documents shall be binding on the Company unless such decision, consent, approval or notice is previously approved, in writing, by the Investor or an Investor Director. Further, any notice or communication given by Vatika to the Company under the Project Documents shall be deemed to have been validly served on the Company only if such notice or communication is also provided to the Investor or an Investor Director.*

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4.9.3 Nothing in this Article 4.9 shall affect Vatika's ability to exercise its rights as a party to the Project Documents.

xxxx xxxx xxxx xxxx xxxx

5. STATUTORY AUDITOR AND INTERNAL AUDITOR

For the Financial Year commencing on the date of incorporation of the Company and ending March 31, 2008, the statutory auditor of the Company shall be Ernst & Young. For all subsequent Financial Years, the Company shall appoint and cause the appointment of either Ernst & Young or such other reputable firm of international accountants that is approved in writing by the Investor as the statutory auditors of the Company. The Company shall also appoint a reputed accounting firm acceptable to the Investor as the internal auditor of the Company.

xxxx xxxx xxxx xxxx xxxx

8. RELATED PARTY TRANSACTIONS

8.1 Vatika and the Company covenant that any related party transactions entered into by the Company shall be after full and adequate disclosure of all material aspects of such transactions and with the consent of the Investor which consent shall not be unreasonably withheld and in any event on an arm's-length basis and in compliance with all requirements of the Act and subject to procurement of any approvals that maybe required from any Governmental Authority.

8.2 Vatika and the Company shall ensure that all transactions with tenants, service providers, customers, vendors, contractors or the like, that are common between the Company and Vatika or its Affiliates, shall be on an arm's length basis.

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9.7 Bank Accounts

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The Company shall, and Vatika shall cause the Company to open and maintain a bank account or bank accounts in its own name with such bank or banks as may be determined by the Board. Such account or accounts shall be operated as the Board shall resolve from time to time. All payments to or by the Company shall be paid into or withdrawn from such account or accounts. It is agreed that all payments made by the Company (including any payments under the Construction Contract) shall be made only after such payments have been authorized, in writing by the Asset Manager."

25. Article 4 of the SHA contains clauses with regard to the manner in which the JV Company would be managed. As per clause 4.1.1, Vatika was entitled to nominate three directors and the petitioner was entitled to nominate two directors on the board of the JV Company. Clause 4.5.2 of the SHA provided that at least one director nominated by the petitioner and one director nominated by Vatika be present for constituting a valid quorum. In terms of clause 4.6.1, certain vital matters as specified in Schedule II of the SHA would require an affirmative vote of both Vatika as well as the petitioner. A perusal of Schedule II to the SHA indicates that it included an exhaustive list of matters that may be considered vital in relation to a company. Thus, by virtue of clause 4.6.1, all decisions that were considered important required the consent of both the petitioner as well as Vatika.

26. By virtue of clause 4.9, in certain matters concerning the project documents (i.e. relating to transfer of development rights by Vatika to the JV Company), the Directors of Vatika were obliged to refrain from participating in any discussion. This clause ensured that in certain matters

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where there was a possibility of a conflict of interest between Vatika and JV Company, the nominee directors of Vatika would not influence the decision of the JV Company. Article 8 also recorded that all transactions with related parties would be conducted on a Arm's Length Basis.

27. A plain reading of the SHA, including the above referred clauses, clearly indicate that the affairs of the JV Company were to be managed separately and distinctly from that of Vatika. The reading of the agreement as a whole clearly indicates that the petitioner was entitled to participate in the management and affairs of the JV Company, not only by appointing its nominee directors but also by ensuing independent auditors and an independent Asset Manager.

28. Since Vatika was also involved in developing the project, clause 9.7 of the SHA ensured that no payments would be made by the JV Company to Vatika under the Construction Contract without the authority of an independent Asset Manager which was defined as Westcourt Properties Private Limited. All the clauses clearly indicate that the affairs of the JV Company were to be managed independent of Vatika. In view of the above, we find the conclusion that when the corporate veil of the JV Company is lifted, Vatika and the JV Company were essentially one and the same entity to be wholly erroneous and not warranted. In our view, the terms of the SHA cannot be read to justify this conclusion.

29. Lastly, we must examine the finding that the present agreement has been structured only for the purposes of avoiding tax. Foreign Direct Investment (FDI) is permitted in the real estate sector, provided that certain

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mandatory conditions are met. According to Press Note 2 of 2005 issued by the Department of Industrial Policy & Promotion, 100% FDI under the automatic route was allowed for investments in townships, housing, built up infrastructure and construction-development projects subject to the guidelines specified therein. The guidelines specified under the Press Note are quoted below:-

> *"a. Minimum area to be developed under each project would be as under:*
>
> *i. In case of development of serviced housing plots, a minimum land area of 10 hectares*
>
> *ii. In case of construction-development projects, a minimum built-up area of 50,000 sq.mts*
>
> *iii. In case of a combination project, anyone of the above two conditions would suffice.*
>
> *b. The investment would further be subject to the following conditions:*
>
> *i. Minimum capitalization of US$10 million for wholly owned subsidiaries and US$ 5 million for joint ventures with Indian partners. The funds would have to be brought in within six months of commencement of business of the Company.*
>
> *ii. Original investment cannot be repatriated before a period of three years from completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB.*
>
> *c. At least 50% of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor would not be permitted to sell undeveloped plots."*

30. In terms of the Circular no.74 dated 08.06.2007 issued by the Reserve Bank of India, an instrument which is fully and mandatorily

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convertible into equity shares within a specified time would be reckoned as part of equity under the FDI Policy. The relevant portion of the said circular is quoted below:-

> "2. .... *It is clarified that henceforth, only instruments which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity under the FDI Policy and eligible to be issued to persons resident outside India under the Foreign Direct Investment Scheme in terms of Regulation 5 (1) of Foreign Exchange Management (Transfer and Issue of shares by a Person Resident outside India) Regulations, 2000 notified vide Notification No. FEMA 20/2000-RB dated May 3, 2000.*"

31. Thus, in terms of the policy of the Government, the petitioner could invest in a project of the requisite size/nature and an investment into CCDs would be reckoned as equity. The policy with regard to external commercial borrowings had other conditions and it is apparent that the petitioner found the investment in CCDs as the most appropriate route for making its investment in real estate, in accordance with the policy of the Government of India. In these circumstances, it ought not to be readily inferred that the entire structure of the transaction was designed solely for the purposes of avoiding tax.

32. It would also be relevant to note that if the gains are considered as payment of interest by Vatika, as is contended by the Revenue, the same would also mean that the quantum of interest is a deductable expenditure in the hands of Vatika. Viewed from this perspective, it would be erroneous to conclude that the whole transaction had been structured to ensure avoidance of tax on income.

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33. The Supreme Court in the case of ***Vodafone International Holdings BV v. Union of India and Anr.***: **(2012) 6 SCC 613** had held that Court must look at the entire transaction as a whole and not adopt a dissecting approach. The Supreme Court further held that the court cannot start with the question of whether the transaction is a tax saving device, but should instead apply the "look at test" to ascertain its true legal nature. The relevant extract from the said judgment of the Supreme Court is quoted below:-

> *"79. When it comes to taxation of a holding structure, at the threshold, the burden is on the Revenue to allege and establish abuse, in the sense of tax avoidance in the creation and/or use of such structure(s). In the application of a judicial anti-avoidance rule, the Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test only after it is able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant. To give an example, if a structure is used for circular trading or round tripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity. Similarly, in a case where the Revenue finds that in a holding structure an entity which has no commercial/business substance has been interposed only to avoid tax then in such cases applying the test of fiscal nullity it would be open to the Revenue to discard such interpositioning of that entity. However, this has to be done at the threshold.*
>
> *80. In this connection, we may reiterate the "look at" principle enunciated in Ramsay [1982 AC 300 : (1981) 2 WLR 449 : (1981) 1 All ER 865 (HL)] in which it was held that the Revenue or the Court must look at a document or a transaction in a context to which it properly belongs to. It is the task of the Revenue/Court to ascertain the legal nature of the transaction and while doing so it has to look at the entire transaction as a*

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whole and not to adopt a dissecting approach. The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/saving device but that it should apply the "look at" test to ascertain its true legal nature [see Craven v. White (Stephen) [1989 AC 398 : (1988) 3 WLR 423 : (1988) 3 All ER 495 (HL)] which further observed that genuine strategic tax planning has not been abandoned by any decision of the English Courts till date].

81. Applying the above tests, we are of the view that every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue/courts should keep in mind the following factors: the concept of participation in investment, the duration of time during which the holding structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; the continuity of business on such exit.

82. In short, the onus will be on the Revenue to identify the scheme and its dominant purpose. The corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device."

34. In the present case, there is sufficient commercial reason for the petitioner to have routed its investment in the real estate project through equity and CCDs. The pre-mature exit options as recorded in the SHA and the minimum return assumed by Vatika on its investment are clearly commercial agreements between the parties. These by itself do not change the legal nature of the transaction entered into between the parties. The terms of the arrangements between Vatika and the petitioner reveal that the JV was a genuine commercial venture, in which both partners had

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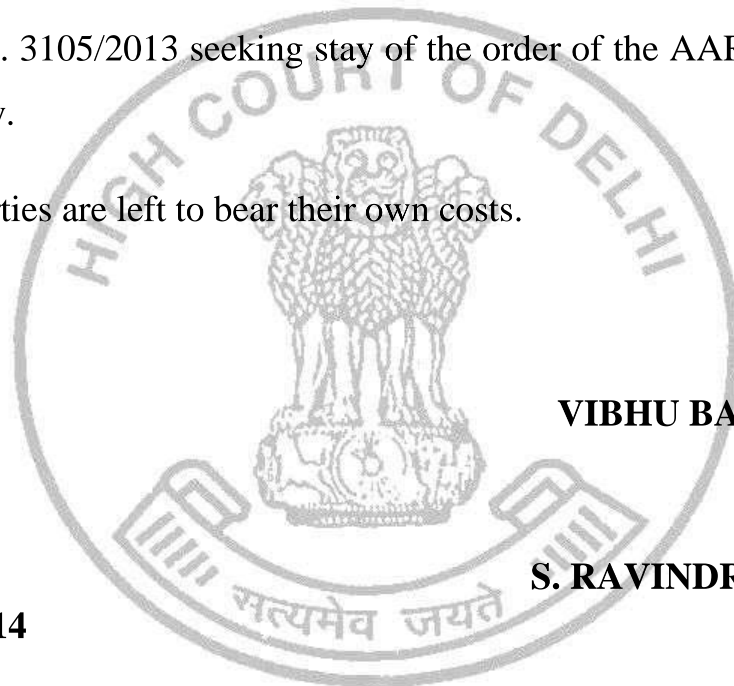
management rights. The call and put options were defined commercial options capable of being elected by the parties. In our opinion, there is, thus, no reason to ignore the legal nature of the instrument of a Compulsorily Convertible Debenture or to lift the corporate veil to treat the JV Company and Vatika as a single entity.

35. In view of the above, the writ petition is allowed and the impugned ruling is set aside.

36. CM No. 3105/2013 seeking stay of the order of the AAR is disposed of accordingly.

37. The parties are left to bear their own costs.



VIBHU BAKHRU, J

S. RAVINDRA BHAT, J

JULY 30, 2014
RK/MK