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The Palmer Case – Is it an 'ALP' Charge on Share Acquisitions?

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Preamble

1. A recent ruling[1] of the Bangalore Income-tax Appellate Tribunal ('ITAT') in Palmer Investment Group Ltd. ('PIGL') has shed light on certain complexities in applying transfer pricing provisions to share acquisition transactions. In this discussion, we examine the key findings from this ITAT ruling and emphasize:

a. The potential for interesting inferences when some of the provisions are literally interpreted.

b. The risks of anti-avoidance regulations, such as the TP provisions, functioning as a 'charge' rather than serving as a 'check'.

c. The importance of considering the factors of comparability adequately when determining the arm's length price ('ALP').

Summary of the ruling

2. Facts as emerge from the ruling are summarized below:

a. PIGL is a tax resident of the British Virgin Islands ('BVI'). It is a subsidiary of United Spirits Limited ('USL'), an Indian company that is listed on the National Stock Exchange and the Bombay Stock Exchange.

b. PIGL held shares in USL amounting to 3.35% of the total shares of USL.

c. On **09.11.2012,** Relay BV, part of the Diageo Group, entered into a share purchase agreement ('SPA') with USL promoters and promoter group companies including PIGL to transfer a portion of the USL shares

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to Relay BV. The price agreed for the transfer in the SPA was Rs. 1440 per share. This transfer was completed on **04.07.2013**, that is, in FY 2013-14 relevant to AY 2014-15.

d. Since USL was a listed company, considering SEBI Regulations, the Diageo Group was required to make an open offer to the public shareholders of USL.

e. One of the terms of the SPA was that if pursuant to such open offer, the Diageo Group could not own at least 25.1% of USL, USL promoter and promoter-controlled entities would sell shares to the Diageo Group such that Diageo's shareholding in USL exceeds 25.1%.

f. On **28.11.2013,** the shareholding of Relay BV in USL was 26.37%; this was pursuant to acquisition of shares from the stock market and other promoter entities (including PIGL).

g. In accordance with the SPA, PIGL consummated the share sale to Relay BV at Rs. 1440 on 04.07.2013.

h. Since the transaction was taxable in India, PIGL discharged and reported the capital gains and corresponding tax considering this amount as the sale consideration. It also reported, on a conservate basis, the transfer of shares as an international transaction in its Form 3CEB.

3. PIGL's case was picked up for transfer pricing scrutiny. The Transfer Pricing Officer ('TPO') held that:

a. The transfer of shares by PIGL to Relay was a transaction with an associated enterprise, and hence an international transaction that required compliance with the ALP.

b. What PIGL is transferring is controlling interest and not simpliciter shares.

c. The Discounted Cash Flow ('DCF') Method and not the stock market price is to be applied to compute the ALP of the controlling interest.

4. Considering the above, the TPO proposed a TP adjustment of approx. Rs. 262.28 crores. The draft assessment order ('DAO') was passed factoring this adjustment. PIGL filed objections before the Dispute Resolution Panel ('DRP') against the DAO. The DRP affirmed the findings of the TPO, albeit, with a modification to the projections adopted, in that, the DRP directed that the TPO had considered projections for the DCF as of 09.12.2012 and the DRP directed that projections of 09.11.2012 be considered. The final assessment order ('FAO') was passed factoring these directions. This FAO was challenged before the Bangalore ITAT.

5. On the TP adjustment, the ITAT held as follows:

a. The transfer of shares by PIGL to Relay BV is a transaction between associated enterprises ('AEs'), since after the transaction, these entities became AEs and per the Act, TP regulations apply for all transactions for the whole year even though the AE relationship is at any time during the FY.

b. The ITAT confirmed that there has been a transfer of controlling stake under the SPA entered into by PIGL and its associates with Relay.

c. Hence, the price agreed by the parties that was based on the prevailing market price of USL shares is not appropriate and the TPO's DCF analysis as modified by the DRP is correct.

6. We have discussed below several intricacies raised by the facts and observations in the ITAT order.

A fictitious AE relationship

7. A literal reading of the law would imply that two enterprises are AEs as soon as a relationship is triggered at any point in time during a FY. This throws up an interesting, albeit absurd, scenario. Consider two unrelated parties who have been transacting for many years at mutually agreed prices. One of them wishes to acquire more than 26% shares in the other for various commercial reasons, say in February of the financial year. Does this mean that the terms of their prior transactions now fall under controlled conditions and fail to comply with the ALP? This appears to apply the ALP retrospectively

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when commercially and by contract law, the transactions were not between AEs.

8. ALP is defined to mean a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, i.e. in uncontrolled conditions. In this backdrop,

a. Is it appropriate to presume 'tax avoidance' despite the relationship being established by a legal fiction?

b. Would it be appropriate to consider that there is no legislative intention to apply the provision retrospectively; and the 'bias' if any can be only prospective.

c. Would it be appropriate to not adopt the literal interpretation and 'iron out the crease'[2] without altering the law but by holding a more reasonable and certainly rational view of it.

Deeming the terms underlying a transaction - transfer of 'controlling interest'

9. In PIGL's case, the ITAT held that by transferring the 3.35% stake that it held in USL, PIGL has 'contributed and assisted Relay BV in acquiring controlling interest in USL along with other associates'. Thereafter, the ITAT held that 'transfer of shares in stock exchange cannot be equated with transfer of shares involving transfer of control'. In so holding, the ITAT noted that 'if non-associated enterprises had entered into a similar agreement, they would not have agreed for the transfer of shares at the stock exchange price as it involves transfer of control'. The basis for this point is not apparent from the ITAT order.

10. In the findings, it appears that the ITAT has deliberated whether the transaction is that of a transfer of shares under the SPA or a transfer of controlling interest under the SPA. After the SC ruling in Vodafone, section 2(14) was amended to include 'rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever'. It appears that the ITAT has concluded (although there is no specific statement either way) that the transaction is a transfer of shares. However, there is an elaborate discussion on controlling interest including the SC's approach in Vodafone (supra) and observations that PIGL contributed controlling interest to Relay vide the SPA and Relay had acquired the same. The ITAT thereafter has held that a control premium is to be factored in computing the ALP, clearly indicating that a control premium is an attribute of the arm's length price. This throws up interesting points for discussion, apart from whether control premium, especially the way the ITAT finally decides in its order, is an attribute of the arm's length price.

11. On 'controlling interest', the SC in Vodafone[3] had observed as follows:

Ownership of shares may, in certain situations, result in the assumption of an interest which has the character of a controlling interest in the management of the company. A controlling interest is an incident of ownership of shares in a company, something which flows out of the holding of shares. A controlling interest is, therefore, not an identifiable or distinct capital asset independent of the holding of shares. The control of a company resides in the voting power of its shareholders and shares represent an interest of a shareholder which is made up of various rights contained in the contract embedded in the Articles of Association. The right of a shareholder may assume the character of a controlling interest where the extent of the shareholding enables the shareholder to control the management. Shares, and the rights which emanate from them, flow together and cannot be dissected. In the felicitous phrase of Lord MacMillan in IRC v. Crossman [1936] 1 All ER 762, shares in a company consist of a "congeries of rights and liabilities" which are a creature of the Companies Acts and the Memorandum and Articles of Association of the company. Thus, control and management is a facet of the holding of shares. Applying the above principles governing shares and the rights of the shareholders to the facts of this case, it is apparent that this case concerns a straightforward share sale. VIH acquired upstream shares with the intention that the congeries of rights, flowing from the CGP share, would give VIH an indirect control over the three genres of companies.

12. Thus, the SC had held that 'controlling interest' is not a property as is generally and legally understood. To override this finding, as stated earlier, section 2(14) of the Act was amended .

13. In PIGL's case, the ITAT has held that by transferring the mere 3.35% stake that it held in USL, PIGL

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has 'contributed and assisted Relay BV in acquiring controlling interest in USL along with other associates'.

14. In the above backdrop, the following ought to be noted:

a. The ITAT has considered that PIGL has transferred a 'controlling interest' which has a distinct value independent of a simplicitor share. Is it appropriate to state that, not shares, but controlling interest has been transferred, especially when the SC has stated that "Shares, and the rights which emanate from them, flow together and cannot be dissected."

b. Without prejudice to the above, is it also appropriate to state, in the first place, that a 'controlling interest' has been transferred since:

- PIGL is a mere 3.35% shareholder.
- The SPA does not refer to any transfer of controlling interest.
- The minimum threshold to be transferred by all Promoter and Promoter controlled entities is also stated in the SPA as 25.1%. In this backdrop, how appropriate is to consider 25.1% as controlling interest, especially when, in typical corporate understanding, to negate a special resolution of a Company, the shareholders need a 26% voting power?
- The final shareholding of 26.37% is an outcome of multiple share purchases and not the SPA per se. So is it appropriate to attribute the controlling premium, solely to / because of the entire 3.35% holding? What about the holdings which individually contributed to the 26.37% shareholding? Also, should it be only to the extent of 0.9% holding (26% - 25.1%), being the quantum of shareholding that has actually contributed to the additional rights culminating in the controlling interest?

c. PIGL's case is also an example of a case where one statutory arm of the Indian executive found the transaction appropriate while another statutory arm found it inappropriate.

d. It does appear that the tax authorities have gone beyond the explicit terms of the contract / SPA to deem that the transfer is that of a controlling interest rather than shares. Here, it appears that a party unconnected to the contract is transcending the terms of the contract to deem an attribute therein. Here, a pertinent question is how appropriate is it for tax authorities or even a court to add such attributes to an agreement negotiated between parties? This is especially when TP provisions only provide that the factors of comparability contemplate only that the contractual terms be considered while determining the comparability – they do not permit that a comparability exercise that 'deems' the existence of certain terms (particularly in a case where the agreement was negotiated between unrelated entities & the AE relationship is a deeming fiction of law).

e. This approach seeks to recharacterize the transaction itself which is not permitted under extant TP law, nay, under the Act, except in the context of thin capitalization and the GAAR. It does appear that this approach is not merely a contest of the 'look at' or the 'look through' approach, but much beyond this.

Determining the arm's length price – use of the DCF methodology

15. While a more rational judicial view on the above matter is awaited, taxpayers have no choice but to determine the ALP in such fictitious AE scenarios. While routine transactions are easily benchmarkable, transactions such as transfer of ownership interests result in real difficulties.

16. PIGL's facts are a case in point. PIGL adopted the stock exchange price to value the shares that it owned in USL. Market quotations are implicitly held to be good comparables. The reasons are not spelt out but are obvious – they are determined by market forces; that they are beyond theoretical academic models of valuation; and more importantly, reflect the actual price at which third parties would transact. Despite this, PIGL's approach was rejected.

17. Further, the ITAT went on to hold that if non-AEs had entered into a similar agreement, they would not have agreed for the transfer of shares at the stock exchange price as it involves transfer of control. Here, the basis for such an unequivocal finding is worth pondering, especially when the concept of 'controlling interest' is not recognized in commercial law and how parties would have agreed to negotiate

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such an unrecognized concept has no precedence, let alone comparability information.

18. On the other hand, the ruling affirmed the Revenue's approach for adopting the DCF method for valuing the USL shares. To adopt this approach, reliance was placed on the 'Other Method'. The 'Other Method' contemplates 'any method which takes into account the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts'. While a market quotation would more easily satisfy the above stipulation, it is worth pondering:

a. Whether for a listed share, would there be takers for a DCF valuation? If yes, should this not be demonstrated? How appropriate is a the DCF itself as a valuation methodology, especially of a listed share, given the inherent subjectivity in the discount factor, terminal value and growth, which are three key assumptions underlying the DCF. Conventionally, the DCF methodology determines the enterprise value and the buyer & seller consider this as the basis for negotiating an equity value? Is the DCF a better consideration of the buyer & seller perspective as compared to the stock market price?

b. Is it appropriate for the tax authorities to take data from external sources (not validated by the Company) for projecting cash flows?

c. Can 'same or similar uncontrolled transaction, with or between non-associated enterprises, under similar circumstances, considering all the relevant facts' be identified for controlling interest, which is a specific fiction created by the tax authorities and not a legal concept, especially for a listed company of the nature and size of USL?

d. Is it appropriate to value controlling interest by way of the DCF method? An application of a control premium in the range of 30% to 50% is it a part of the DCF methodology? Moreover, a rationale for this range is not mentioned; hence, the question is why a higher or lower number was not identified. Further, the basis for this approach appears to be a ruling of the Mumbai ITAT in Lanxess which had adopted this approach based on a research report of a certain Mr. Phillip Sounders Jr, PHD which had purportedly undertaken research in respect of several public quoted companies. The timing, geography, context and veracity of this report is not discussed in the ITAT's ruling (surprisingly, it is neither discussed in the ruling in Lanxess).

e. If DCF can be considered, why not the net asset value ('NAV') method, a far simpler approach with certainty as it bases itself solely on the assets of the entity.

19. It is now well recognized that quoted prices can be taken as comparables provided these are genuine, bona fide and issued by reputed organizations. In fact, Rule 10D(3)(c) specifically provides that price publications including stock exchange and commodity market quotations are some of the documents that would be considered as substantiating the ALP computation and TP documentation. The legislature itself, in Rule 11UA recommends the stock market price as the prescribed methodology for determining the fair market value.

20. The locus classicus on this matter, the Gujarat HC ruling in Adani Wilmar Ltd. (363 ITR 338), specifically held that the HC held that per Rule 10D(3)(c) price publications as long as the same were authentic and reliable, would be relevant materials. Mere base of the organisation would be of no consequence unless it is pointed out that such quotations lack basis. In this backdrop, reliance on quoted prices of stock markets does appear an appropriate benchmark. How appropriate to reject these on the premise that was to be tested is 'controlling interest' is a point for thought?

Determining the arm's length price – at what point in time?

21. The SPA was entered into on 09.11.2012 while the transfer of shares was completed on 04.07.2013. At the time of entering the SPA, the sale price was fixed at Rs. 1,440 per share. The ITAT held that the average market price during the tendering period, that is between 10.04.2013 and 26.04.2013, reflects and includes the value of the shares including controlling interest. It is indeed a point worth considering that a price fixed earlier in the SPA could be not reflective of the ALP but the price subsequent to the SPA that reflects market changes due to the SPA ought to be considered, especially since the SPA was 'completed' on 04.07.2013.

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22. What is also worth pondering is that the ITAT confirmed the DRP's finding that the projections for the DCF workings should be considered as of 09.11.2012 (that is, the date of the SPA) to determine the ALP. However, to corroborate the DCF working as of this date, the ITAT has considered the subsequent price movement in the stock market. How appropriate is this?

23. Some points that are relevant here are:

a. Whether the parties could have, commercially and per securities law, renegotiated the sale price of the shares?

b. If yes, what was the context for the renegotiation not being undertaken? Would this be a relevant factor in determining the arm's length price, by way of an adjustment?

c. If no, subject to validation by a securities law expert, the ruling appears to indicate that parties are required to do the impossible, especially when post the tendering period, the parties appear to be disabled by securities law from changing the price agreed in the SPA.

d. What if the open offer had led to a reduction in the stock market price? The agreement was locked-in with a price of Rs 1,440 as compared to the average stock market price of Rs 1,336 on the date of signing the SPA. Can it be contested that the Rs 104 which was paid higher was for what the tax authorities argue as the control premium? Or would it be 'convenient' to take the shelter of section 92(3) to not warrant a downward adjustment? Would this have been the response if PIGL had so claimed during the proceedings before the TPO / AO?

Conclusion

The ruling calls out the nuances of the arm's length principle, an economic concept, when enmeshed with tax and non-tax law. Considering the larger picture of tax policy and tax controversy, it also calls into discussion the premise of cross border anti-avoidance when the income is likely to be consolidated in an Indian entity (PIGL was a subsidiary of USL, an Indian company and a listed company) with limited possibilities of flight. It also highlights the importance of showcasing the relevance and interplay of commercial realities and impact of the securities law on transactions. Most importantly, this case exemplifies the need to ensure that an anti-avoidance regulation does not operate as a charging provision and restricts its application as a 'check' of compliance. This ruling also highlights the need for a philosophy and framework for the circumstances when there is a need to look 'beyond' (and not merely 'looking at' or 'looking through') the form of the arrangement, given that it is well settled that this is a right available only when the Revenue demonstrates that there is a mala fide intent and the actual conduct of parties were different from the contractual arrangements.

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[1] [TS-117-ITAT-2023(Bang)-TP]

[2] To quote Lord Denning in Seaford Court Estates Ltd. v. Asher, (1949) 1 KB 481; (1949) 2 All ER 155; (AC) see also Asher v. Seaford Court Estates Ltd., (1950) All ER 1018; 1950 AC 508. (HL); all of this quoted in his 'The Discipline of Law'. These observations are also cited with approval by the Supreme Court in BWSSB v. Rajappa (1978 AIR SC 548)

[3] 341 ITR 1

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