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Highlights

i. Apex Court rules against illegal transfer of lease through transfer of shares

ii. Delhi High Court rules on Transfer Pricing Adjustment

iii. Company Court not to intervene in sale of assets under SARFAESI Act

I. Apex Court rules against illegal transfer of lease through transfer of shares

In the case of State of Rajasthan v. Gotan Lime Stone Khanji Udyog Pvt. Ltd., the Supreme Court ruled on the established principle of lifting of corporate veil. Gotan Limestone Khanji Udhyog (GKLU) was a partnership firm with a mining lease from the Government, which it transferred to a private limited company Gotan Limestone Khanji Udhyog Pvt. Ltd. (GLKUPL). GLKUPL was incorporated through conversion of the partnership firm into a private limited company. The partners became the directors of the company, and GLKUPL sought permission to transfer mining lease stating that the incorporation was a mere change of form of its own business by converting itself from a partnership firm into a private limited company and the transfer of the lease from the firm to the company did not involve any consideration. After obtaining permission to transfer lease from the concerned authority,the shareholders of GLKUPL sold all of their shares in the company to a subsidiary of Ultra Tech Cement Company Limited (UTCL) for INR 160 crores. This meant that GLKUPL effectively sold the mining lease to UTCL, in the disguise of a transfer of shareholding. The Government of Rajasthan challenged the transaction before the Rajasthan High.

The division bench of the High Court upheld the transactions on the ground that the company is a separate legal personality and that a transfer of shares among shareholders does not mean transfer of the mining lease since the lease remains with the transferred company.

On appeal before the Supreme Court, the Supreme Court quashed the transaction by lifting the corporate veil of GLKUPL. The Court noted that in the present case there are two transactions. In first transaction of transfer of lease from the firm to the company, with the permission of the competent authority, only disclosure made while seeking permission for transfer is of transforming partnership business into a private limited company with same partners as directors without there being any financial consideration for the transfer and without there being any third party. In the second transaction, the entire shareholding is transferred for share price and control of mining lease is acquired by the holding company without any apparent price for lease.

The Court reiterated the doctrine of public trust in relation to the largesse and held that the lessee privately and unauthorizedly cannot sell its rights for consideration and profits from rights belong to State as it is an illegal transfer.

Technically lease rights are not sold, only shares are sold. No permission for transfer of lease hold rights may be required. However, the court observed that the declaration that no consideration was received which though apparently correct was actually false as the subsequent transaction of sale of shares was integral part of the first transaction of transfer of lease to private company, which soon thereafter became subsidiary of another company. The real transaction is sale of the mining lease for consideration without the previous consent of competent authority, as statutorily required. In view thereof, the Court opined that the partnership firm holding lease hold rights has successfully transferred the said rights to a third party for consideration in the form of share price which is nothing but price for sale of mining lease which is not allowed and for which no permission has been granted and which is patently illegal.

Source: CIVIL APPEAL No. 434 OF 2016, Arising out of SLP (Civil) NO. 23311 OF 2015

VA View

The view expressed by the Apex Court is a reiteration of the rule laid down in the case of Fox v. Bishop of Chester. (1824) 2 B 7C 635, where in the Court ruled that to carry out effectually the object of a statute, it must be considered as to defeat all attempts to do, or avoid doing in an indirect or circuitous manner that which it has prohibited or enjoined. In other words, anything which cannot be done directly cannot be done indirectly.

The doctrine of public trust mandates that a private person shall not benefit at the expense of public property. The State has to exercise its power of granting or refusing permission for exploitation of largesse in a fair and reasonable manner following doctrine of public trust. By lifting the corporate veil, the Supreme Court endorsed the pragmatic approach over the pedantic approach, of giving weight to substance over form.

II. Delhi High Court rules on Transfer Pricing Adjustment of AMP expenses

In the case of Maruti Suzuki India Ltd. vs. Commissioner of Income Tax, the Delhi High Court has pronounced a landmark ruling that Transfer Pricing Adjustment cannot be made on Advertising, Marketing and Promotion ("AMP") expenses incurred by a domestic manufacturer who has a license to use the brand of a foreign entity and that excessive AMP expenditure cannot be a basis for discerning the existence of an international transaction.

The taxpayer was an Indian company and a subsidiary of Suzuki Motor Corporation, Japan. The taxpayer had entered into license agreements with the parent company under which the latter granted license to the taxpayer to manufacture car models, provide technical know-how and right to use Suzuki's patents, trademarks, etc. The taxpayer paid the parent a bundled royalty as the consideration.

Upon reference by the Assessing Officer for determination of arm's length price, the Transfer Pricing Officer ("TPO") benchmarked the AMP expenses by applying the Bright Line Test, wherein the proportion of such expenses of the domestic entities are compared with that of comparable companies.

The TPO observed that the AMP expenses incurred were 1.87% of its turnover, whereas the average was 0.60% that was being incurred by comparable companies. The Transfer Pricing Officer concluded that transfer pricing adjustment would be required, as excess expenditure must be regarded as being incurred for promoting the brand "Suzuki" owned by SMC, the foreign parent. The DRP upheld the addition made by the TPO. The Assessing Officer thus passed the final order making an addition of AMP expenses.

On further appeal, the Income Tax Appellate Tribunal relied on the ruling of the Special Bench in LG Electronics India Pvt. Ltd. v. ACIT and upheld the transfer pricing adjustment of the revenue department. Thereafter the taxpayer filed an appeal before the Delhi High Court.

The Court held that the very basis of the Bright Line Test was negated by this very Court in an earlier case of Sony Ericsson Mobile Communications India (P.) Ltd. both for determining if there is an international transaction and secondly for the purpose of determining the ALP. The Court opined that the revenue department must establish the existence of international transaction without use of the Bright Line Test. The Court held in this case that existence of international transaction was deduced by the revenue department merely from the fact that the taxpayer had excess AMP spend after applying Bright Line Test. However, upon analysis of Sections 92B to 92F of the Income Tax Act, the Court held that since there is no machinery provided in the Act to determine the existence of international transaction involving AMP expenses, excessive AMP expenditure could not be used as a basis for pointing to the existence of an international transaction.

The Court also observed that under the Income Tax Act, 'international transaction' means, inter alia, a transaction "having a bearing on the profits, incomes or losses of such enterprises" and includes "a mutual agreement or arrangement" for allocation of any costs or expenses. Thus an 'agreement' or 'arrangement' or 'understanding' between the two entities must exist whereby one entity is obliged to incur AMP expenses to promote the brand of the other. Such an agreement is a necessary condition but the Revenue had failed to show any such 'arrangement' or 'understanding' between the two AEs. The Court noted that the taxpayer's AMP spending was only 1.87% of its sale whereas the parent's AMP expense worldwide was 7.5% of sales and therefore this belies the possibility of any 'arrangement' or 'understanding' between the taxpayer and the foreign parent.

The Court further placed reliance on the decision of Sony Ericsson (supra) and Rule 10B to hold that if the Indian entity had satisfied the Transaction Net Margin method i.e. the operating margins of the Indian enterprise are much higher than the operating margins of the comparable companies, no further separate adjustment for AMP expenditure is warranted.

Source: High Court of Delhi, ITA Nos. 110/2014 and 710/2015

VA View

This judgment is a significant development on the dispute relating to benchmarking of marketing intangibles resulting from AMP expenses incurred by multinational corporations who operate as a licensed manufacturer. The ruling lays down important principles on the creation of marketing intangibles through services rendered by domestic manufacturers. The Delhi High Court had earlier ruled upon the issue of marketing intangible adjustment in case of Sony Ericsson Mobile Communications India Pvt. Ltd and others who were all distributors of products manufactured by foreign associated entities.

The Delhi High Court has also subsequently held in cases relating to those taxpayers, namely, Whirlpool of India Ltd, Honda Siel Power Products Limited, Bausch & Lomb Eyecare India P Ltd, who are either manufacturers or engaged in manufacturing as well as distribution activity that where the existence of an international transaction involving AMP expense with an ascertainable price is unable to be shown to exist, even if such price is nil, the transfer pricing provisions under Chapter X of the Act cannot be invoked to undertake a TP adjustment exercise.

III. Company Court not to intervene in sale of assets under SARFAESI Act

In the case of Pegasus Assets Reconstruction P. Ltd. Versus M/s. Haryana Concast Limited & Anr. (civil appeal no. 3646 of 2011) the Supreme Court has ruled that Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ('the SARFAESI Act') is a complete code in itself, independent of the Companies Act in relation to monetization of secured assets. The bench were inter alia considering the question whether a Company Court under the provisions of Companies Act, can control the sale of a secured asset by a secured creditor in exercise of powers his under the SARFAESI Act.

Answering the aforesaid question in the negative, the Court ruled that there is no lacuna or ambiguity in the SARFAESI Act so as to borrow anything from the Companies Act as such exercise is already done by the legislature. If the view that Company judge is also competent to pass orders, that would lead to a situation of uncertainty and conflict between the two Acts. The Court observed that in case the borrower happens to be a company under winding up, the ecosystem of acts and rules under SARFAESI regime ensure that the Official Liquidator is in knowledge of the proceedings under the SARFAESI Act. The SARFAESI Act is so woven as to protect the interests of employees by keeping the official liquidator within the loop of proceedings as exemplified in the provisos to Section 13(9) of the SARFAESI Act, such a system extinguishes the requirement of any orders by the Company Judge for association of the Official Liquidator in order to protect the interest of workers and to realize their dues. The SARFAESI Act provides sufficient opportunity to the Official Liquidator by conferring on him, like all other aggrieved parties,a right of appeal under Section 17 before the Debts Recovery Tribunal and a right of further appeal under Section 18 before the Appellate Tribunal. The clear intention of the Parliament expressed in Section 13 of the SARFAESI Act on the non-intervention of the court or tribunal in enforcement of security interest and the redressal mechanism under Sections 17 and 18 of the SARFAESI Act signifies that the Act is a code in itself.

The second question before the Court was on the validity of an auction sale whose sale price is bettered by a later offer. Commenting on volatile and fluctuating nature of price of immovable property, the Court held that subsequent higher offers cannot be the basis for re-opening the confirmed sale if there was no illegality or irregularity in the conduct of auction.

VA View

The apex Court has reaffirmed the nature of the SARFAESI Act as complete code in itself. The avenue of the Company Court as a forum to intervene in the sale proceedings under the SARFAESI Act has come to an end in view of the ratio in the above case. The true nature of SARFAESI Act as a hassle free legislation for monetization of secured assets is reaffirmed herein. By allowing the sale to proceed as per SARFAESI Act and reiterating the pari passu charge on sale proceeds, the Court has found a way of serving the interest of the workers and bankers.

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