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TAX FLASH NEWS

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Settlement amount received by FIIs for giving up the 'right to sue' is not taxable under the Income-tax Act

Background

Recently, the Authority for Advance Rulings (the AAR) in the case of Aberdeen Claims Administration Inc.[1] (the applicant) held that the settlement amount received by Foreign Institutional Investors (FIIs) who had invested in the Indian company's shares/American Depository Receipts (ADRs), for giving up the 'right to sue' the Indian company, is a capital receipt. Such an amount is not assessable as income because it does not replace any business income. Therefore, the settlement amount received by the applicant is not taxable under the provisions of the Income-tax Act, 1961 (the Act).

Facts of the case

- In the case of Aberdeen U.S., during the period of 2003-09, investment funds managed by Aberdeen or its affiliates (Aberdeen Investors) purchased the shares of Satyam Computer Services Limited (Satyam) listed on the Bombay Stock Exchange/National Stock Exchange (common stock) and Satyam's ADRs listed on the New York Stock Exchange.
- On 7 January 2009, the Chief Executive Officer of Satyam submitted his resignation letter to Satyam's board wherein he accepted that Satyam's financial results were manipulated over a period of years. Consequently, the Aberdeen Investors disposed of Satyam common stock and ADRs.
- Subsequently, Aberdeen Claims Trust and Aberdeen Claims Trust II (Claim Trusts) were formed under Pennsylvanian laws, having the applicant as the trustee of both the Claim Trusts to investigate and prosecute the claims of various Aberdeen Investors against Satyam.
- On 17 November 2009, the applicant, as the trustee of the Claim Trusts initiated legal action[2] against Satyam, in the United States District Court for the Eastern District of Pennsylvania (Aberdeen Complaint).
- Thereafter, the Aberdeen Complaint was transferred for consolidation (for pre-trial purposes) with the Class Action, in a multi-district litigation created in the United States

[1] Aberdeen Claims Administration Inc., In re [2016] 65 taxmann.com 246 (AAR)

[2] Aberdeen Claims Administration Inc. v. Satyam Computer Services Limited (No.09-cv-5453)

District Court for the Southern District of New York (New York Court) to consolidate the pending lawsuits filed against Satyam, in Class Action[3].

- In February 2011, Satyam executed and entered into an Agreement of Settlement (Class Action Settlement Agreement) with the lead plaintiffs of the Class Action including the applicant. Subsequently, the applicant filed the second amended complaint in the New York Court detailing the claims of the applicant/Aberdeen Investors against Satyam.

- On 21 March 2011, the New York Court entered an order preliminarily certifying a class for settlement purposes (Settlement Class) in connection with the Class Action. The New York Court also set forth the procedures and deadlines for class members to request exclusion from the Class Action Settlement Agreement.

- On 15 August 2011, the applicant filed a request to opt-out/exclusion from the Settlement Class before the New York Court. In September 2011, the New York Court passed its final orders and judgments certifying the Settlement Class and approved the Class Action Settlement.

- In July 2012, the applicant entered into a settlement agreement with, *inter alia*, Satyam Computer Services Limited (Aberdeen Settlement Agreement) in relation to the settlement amount of USD12 million and a supplemental consideration of USD1.5 million (Aberdeen Settlement Amount). Subsequently, the New York Court passed a consent order stating that the applicant's request for exclusion from the Settlement Class is valid and exclusive to the Aberdeen common stock investors.

- On 24 August 2012, the applicant filed an application for advance ruling[4] in respect of the taxation of the Aberdeen Settlement Amount under the Act.

- In October 2012, the applicant along with Satyam and Citibank N.A., as its escrow agent entered into an escrow agreement for the transfer of the Aberdeen Settlement Amount to an escrow.

- The events leading to the settlement are similar in the case of Aberdeen U.K.

- A similar question was involved in the case of Lead Counsel of Qualified Settlement Fund[5] (the QSF), wherein the AAR has analysed various arguments relating to taxation of the settlement amount received from Satyam and PwC in similar circumstances.

AAR's ruling

- In the case of the QSF, the AAR, among other things, held as follows:

  - The settlement account received as per the court order is not a periodical monetary return. As it is against the surrender of 'right to sue', it is neither linked with income generating apparatus i.e. shares of Satyam, nor related to any business activity carried out by it.

  - Accordingly, the settlement amount has to be characterised as capital receipt and therefore, it falls outside the scope of income chargeable to tax unless it is specifically brought within the ambit of income by way of specific provisions of the Act.

  - Section 2(24) of the Act specifically includes 'any capital gains chargeable under Section 45' within the ambit of income. A capital receipt would be chargeable to tax only if it falls under Section 45 of the Act (as capital gains) though a capital receipt as such is not taxable[6].

  - Section 6 of the Transfer of Property Act, 1882 (TOPA) states that 'property of any kind may be transferred, except as otherwise provided by this Act or by any

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[3] Satyam Computer Services Limited (No.09-md-2027)
[4] Aberdeen Claims Administration Inc. (AAR Application No.1364/2012)

[5] Lead Counsel of Qualified Settlement Fund (A.A.R. No 1060 & 1078 of 2010 dated 12 January 2016)
[6] Dhruv N. Shah v. Commissioner of Income Tax [2004] 88 ITD 118 (Mum)

other law for the time being in force.' Section 6(e) notes that 'a mere right to sue cannot be transferred.'

- Therefore, a 'right to sue' is property and thus a capital asset as defined under Section 2(14) of the Act, but is not transferable. There cannot be any transfer of a 'right to sue' under Indian law and any capital receipt arising from a 'right to sue' cannot thus be considered as a capital gain under Section 45 of the Act.

- In view of the Supreme Court's decision in the case of Mrs. Grace Collis[7], a 'right to sue' can be considered for the purpose of capital gains. This has been clarified by the Explanation 2 to Section 2(47) inserted by Finance Act, 2012 but effective from 1 April 1962.

- However, the charging section and the computation provisions under section 48 must go together. The Supreme Court in the case of B.C. Srinivasa Setty[8], held that the charging section and the computation provisions together constitute an integrated code. When there is a case to which the computation provisions cannot apply at all, it is evident that such a case was not intended to fall within the charging section.

- The Supreme Court also held that none of the provisions pertaining to the head 'capital gains' suggests that they include an asset in the acquisition of which no cost of acquisition at all can be conceived.

- In the case of the QSF, it was held that if the 'right to sue' is considered as a capital asset covered under the definition of 'transfer' within the meaning of Section 2(47) of the Act, and its cost of acquisition cannot be determined, the computation provisions have failed and capital gains cannot be calculated. Therefore, a 'right to sue' cannot be subject to income tax under the head 'capital gains'.

[7] CIT v. Mrs. Grace Collis and other [2001] 248 ITR 323 (SC)
[8] CIT v. B.C. Srinivasa Setty [1981] 128 ITR 294 (SC)

- In the case of Aberdeen Investors, views expressed in the judgment mentioned above are reiterated since the relevant facts are almost identical.

- The nature of settlement agreement in the case of Aberdeen U.S. and Aberdeen U.K. is the same, and therefore, the view in the case of the QSF is taken as in the case of Aberdeen U.K.

- According to the 'surrogatum principle', the character of receipt of an award of damages or an amount received in settlement of a claim as capital or revenue depends on what such an amount was intended to replace. If the replaced amount would not have been otherwise taxable, the settlement amount may also not be taxable. However, the 'surrogatum principle' does not apply to amounts received in pursuance to a fraud.

- Further, in this case, two important facts are noted. One, at the time of the investment in the shares of Satyam, Aberdeen Investors were registered as FIIs under the FII regulations with the Securities and Exchange Board of India (SEBI). FIIs were not carrying out any trade in securities, and this position was settled by this AAR in the case Fidelity Northstar Fund[9].

- The facts of the present case also show that the shares were purchased as investors and not as traders. In their books of accounts also, the shares have been treated as a capital investment.

- The CBDT Circular[10] quotes three principles laid down by the AAR in the case of the Fidelity Group, in order to determine whether the shares are held as an investment or as stock-in-trade.

- The first principle is how the shares were valued in the books of accounts i.e. whether they were valued as stock-in-trade or held as an investment. In this case, the books of accounts show that the shares were held as the investment.

[9] Fidelity Northstar Fund [2007] 288 ITR 641 (AAR)
[10] CBDT Circular No.4 of 2007

- The second principle is to verify whether there are substantial transactions, their magnitude, etc., maintenance of books of accounts and finding the ratio between purchases and sales. In this case, the shares of Satyam were purchased, held as an investment and sold only after the fraud became public.

- The third principle suggests that ordinary purchase and sale of shares with the motive of realising profit would lead to an inference of trade/adventure in the nature of trade. Where the object of investment in the shares of companies is to derive income by way of dividends, etc. the transactions of purchase and sale of share would yield capital gains and not business profits.

- This principle also suggests that in this case the object of the investment is not to have business profit because the shares of Satyam were not being purchased and sold at regular intervals.

- The settlement amount is relatable to Satyam shares i.e. if the shares would not have been purchased, the question of class action or 'right to sue' would not have arisen. However, this does not mean that the settlement arrived with the approval of the U.S. Court is to compensate the business receipt of Aberdeen Investors.

- The Aberdeen Investors entered into a settlement agreement with Satyam considering the time, effort and costs involved in litigation and the agreement provided for a full, final and complete resolution of all claims asserted or which could have been asserted with respect to the released claims.

- The Aberdeen Investors fully, finally and forever waived, released, discharged and dismissed each and every of their legal claims against Satyam and PwC. This was also agreed on vice versa.

- Consequently, the settlement amounts have been received not as a part of the business profit, or to compensate the future income, but due to the surrendering of the claim against Satyam and PwC. Even in accordance with the 'principle of surrogatum', such an amount is not assessable as income because it does not replace any business income.

- Accordingly, it is concluded that the settlement amount received by the applicant is not taxable under the provisions of the Act.

Our comments

Recently, the AAR in the case of the Lead Counsel of QSF held that the capital asset 'right to sue' cannot be transferred in terms of Section 6(e) of the TOPA. Even if surrendering of the 'right to sue' can be treated as transferable in terms of Section 2(47)(ii) of the Act i.e. transfer due to the extinguishment of any rights, its cost of acquisition cannot be determined. Accordingly, the computation provisions fail, and therefore, the settlement amount cannot be charged to tax under Section 45 of the Act.

In the present case, the facts were similar and therefore, the principles laid down in the above case were reiterated. Further, it was held that the settlement amounts have been received not as a part of the business profit, or to compensate the future income, but due to the surrendering of the claim, and therefore, it is not assessable as business income. Accordingly, the settlement amount received by the applicant is not taxable under the provisions of the Act.

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