Between the lines...

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I. Online privacy takes a hit as Google ordered to share foreign-stored data

Thomas J. Rueter, a United States Magistrate Judge has rekindled the debate on online data privacy by allowing sharing of electronic data stored in servers of U.S. companies located outside the United States with the U.S. Government. The decision was pronounced on February 3, 2017.

Background

The Court had issued search warrants in August 2016 to Google, Inc. (**"Google"**). These warrants required Google to disclose certain data, associated with Google accounts of individuals residing in the United States, to an agent of the Federal Bureau of Investigation in Pennsylvania. It was alleged that the Google accounts were used to commit fraud and theft of trade secrets in violation of federal law. Google disclosed the data stored on its servers located in the United States but declined to disclose the electronic records stored outside the United States.

Legal framework

The Stored Communications Act (**"SCA"**) allows the Government to obtain customer information and records from a provider. Rule 41 of the Federal Rules of Criminal Procedure provides for the procedures for issuance of search and seizure warrant.

Arguments

Google took the stance that it was not required to disclose data which was stored outside the United States. Google contended that only data stored within the United States was required to be disclosed with respect to a warrant issued

under the SCA, which it had already disclosed to the Government. However, it may be worth noting that before the recent decision of a panel of the United States Court of Appeals for the Second Circuit in the Matter of Warrant to Search a Certain E-Mail Account Controlled and Maintained by Microsoft Corporation, 829 F.3d 197 (2d Cir. 2016) (**"Microsoft case"**) came out (the case on which Google relied upon), Google used to comply with search warrants commanding the production of user data stored on servers located outside the United States. Google stated that the order was an *"unconstitutional prior restraint on speech".* Google further contended that it did not have the capability to determine data location for all its services.

The Government on the other hand stressed on the critical importance of obtaining electronic data of criminal suspects residing in the United States.

Observations of the Court

The Court took note of the Second Circuit decision in the Microsoft case which emphasised on the principle of construction followed by the United States Supreme Court in the case of ***Morrison v. Nat'l Australia Bank Ltd.****, 561 U.S. 247 (2010)* (**"Morrison case"**). The Second Circuit in the Microsoft case had observed that the presumption against extraterritorial application of United States statutes, which was analysed in the Morrison case, was *"strong and binding".* The view taken in the Microsoft case was that the warrant provisions of the SCA did not contemplate extraterritorial application. Therefore, the Second Circuit in the Microsoft case concluded that the SCA focused on user privacy and it was an unlawful extraterritorial application of the SCA in directing Microsoft to seize customer communications stored in Ireland.

The Constitution of the United States, through the Fourth Amendment, protects people from unreasonable searches and seizures by the government. The Court in this case was of the opinion that the disclosure of the electronic data as per the warrants did not constitute a search or a seizure of the targets' data in a foreign country.

The Court ruled that there will be no seizure in execution of the two search warrants under which data will be transferred electronically from a server located in a foreign country to a data centre of Google located in California. The reasoning given by the Court is that there will be no meaningful interference with the account holder's possessory interest in the user data. According to the Court, in the process of data transfer, the interference was de minimis and temporary.

The Court distinguished the ruling in the Microsoft case by holding that, in the instant case, there was no evidence regarding the precise location of the servers which stored the electronic data requested by the two search warrants, as opposed to the Microsoft case in which the entire user data of a presumably Irish citizen was located in only one data centre situated in Ireland and remained stable at that centre for a significant period. The Court noted that because of the changeable and divisible nature of Google's cloud technology, the presumption that the data had a discernible physical location could not be made in this case as was the assumption in the Microsoft case.

The Court viewed this case as a *"permissible domestic application of the SCA"* as though the electronic data transfer was to happen abroad, the search of data disclosed by Google under the warrants was to happen in the United States.

With regard to the aspect of sovereignty of foreign states, the Court observed, *"Even if the interference with a foreign state's sovereignty is implicated, the fluid nature of Google's cloud technology makes it uncertain which foreign country's sovereignty would be implicated when Google accesses the content of communications in order to produce it in response to legal process."* According to the Court, *"no foreign nation's sovereignty will be interfered with in any ascertainable way at the time the two warrants at issue are executed because the searches will be conducted in the United States."*

Decision

The Court concluded that compelling Google to disclose the data under the warrants did not constitute an unlawful extraterritorial application of the SCA. The Court granted the Government's motions to compel Google to comply with search warrants.

VA View

With this decision, which is a departure from the view taken in the Microsoft case, we now have conflicting views on the issue of online data privacy in the United States. This decision is a cause of concern for millions of users of Google and other internet platforms as it raises a red flag on protection of privacy. This decision is not good news for the technology companies in the United States either as it directly poses threat to the user base of these companies.

Amidst serious concerns around the world over the access by the U.S. federal agencies of online user data, decision in the Microsoft case provided a ray of hope in the battle for protection of privacy. This decision has set a cat among the pigeons and privacy advocates might argue that it is time for the United States to adopt practices which strike a balance between national security considerations and privacy of users.

Google is set to appeal the decision and we might have to wait for some more time for this issue to be resolved.

II. SEBI amends regulations: Compensation agreements now require nod of public shareholders

Background

The Securities and Exchange Board of India (**"SEBI"**), in its Board Meeting dated September 23, 2016, had decided to initiate the public consultation process on corporate governance issues arising out of compensation agreements with respect to listed companies. SEBI had noticed that some private equity firms/investors were sharing certain gains made at the time of selling the shares with key personnel of listed entities by entering into compensation

agreements. SEBI pointed out that such practice whereby private equity funds/investors were giving performance linked incentives to key personnel of a listed entity without shareholder nod could potentially lead to unfair practices.

SEBI came out with a consultative paper on corporate governance issues in compensation agreements on October 4, 2016. SEBI proposed that such compensation agreements that incentivize key personnel should be put for approval before the board of directors and shareholders and suggested necessary amendment to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (the **"LODR Regulations"**).

Based on the consultative paper and the comments received thereon, SEBI Board approved the proposal to amend the LODR Regulations in its meeting held on November 23, 2016. The stated intent of SEBI was to enforce disclosures and shareholder approval for all such compensation agreements.

Finally, the proposal took concrete shape in the form of a formal amendment to the LODR Regulations. The SEBI (Listing Obligations and Disclosure Requirements) (Third Amendment) Regulations, 2016 (the **"Amendment Regulations"**) were notified on January 4, 2017.

Amendment to Regulation 26

The Amendment Regulations have inserted sub-regulation (6) to Regulation 26 of the LODR Regulations. Highlights of the amendment:

- **New compensation agreements-**
  - Employees including key managerial personnel or director or promoter of a listed entity cannot enter into any compensation agreement with any shareholder or any other third party without prior approval from the Board of Directors and public shareholders by passing an ordinary resolution.
- **Subsisting or expired agreements-**
  - Any subsisting or expired compensation agreement entered during the preceding three years from January 4, 2017 should be disclosed to the stock exchanges for public dissemination.
  - Subsisting compensation agreements (as on January 4, 2017) require board approval in the forthcoming board meeting. Upon such approval, public shareholders must approve the same through an ordinary resolution in the forthcoming general meeting.
- **Interested persons barred from voting-**
  - Interested persons involved in the transaction covered by the compensation agreement cannot cast their vote in the general meeting.
  - Term *'interested person'* is defined to mean any person holding voting rights in the listed entity and who is in any manner, whether directly or indirectly, interested in a compensation agreement or proposed compensation agreement.

VA View

As per SEBI, there have been practices in the past where certain private equity firms have entered into side agreements with top management and key managerial personnel by which such firms (allotted shares on a preferential basis) would share a certain portion of the gains above a certain threshold limit made by them at the time of selling the shares and also subject to the conditions that the company achieves certain performance criteria and the employee continues with the company for a certain period.

It is not unusual for private equity funds to incentivize promoters/ MDs/ CEOs of investee companies, based on performance of such companies. However, when such reward agreements are executed between the private equity investor and the respective promoters of the listed entity, without any prior approval of the shareholders, it may potentially lead to lead to unfair practices. Such reward agreements are a common practice globally, however, they could raise corporate governance issues thereby impacting the shareholders.

Such compensation agreements will now require shareholder approval as also those which were entered before the amendment.

III. Exiting start-ups to become less taxing – CBDT eases norms for SEBI registered Category I & II AIF's

The characterization of income from transfer of shares/securities, namely whether it is business income or capital gains has always been the subject matter of litigation. Though a host of precedents have laid several parameters to distinguish shares held as investments from the shares held as stock-in-trade but the ratio decidendi of such cases are very fact specific and cannot be applied universally.

Previously, the Central Board of Direct Taxes (**"CBDT"**) had provided guidance vide its Instruction No.1827, dated 31.08.1989 to the Assessing Officers (**"AO"**), for determining whether a person is a trader or investor in stocks. It was clarified therein that the various tests laid down by the Courts in this regard may be referred for guidance in determining the nature of the asset in the hands of the assessee. The aforesaid instructions were updated by the CBDT vide Circular No. 4 of 2007, dated June 15, 2007.

However, disputes continued to exist on the application of these principles to the facts of each case since the taxpayers found it difficult to prove the predominant intention in acquiring such shares/securities. Thus, in order to reduce litigation and maintain consistency in approach in the assessments proceedings, the CBDT issued a clarificatory Circular No. 6/2016 dated February 29, 2016 wherein it was instructed that the income from transfer of listed shares and securities, which are held for more than twelve months would be taxed under the head *"Capital Gains"* unless the taxpayer itself treats these as stock in trade and transfer thereof as its business income. It was further stated in all other situations, the issue was to be decided on the basis of the existing circulars issue by the CBDT on this subject.

Thereafter, a need was felt to streamline the taxability of transfer of unlisted shares as well. Accordingly, the CBDT issued another instruction dated May 2, 2016 providing that income from transfer of unlisted shares, would be considered under the head *"Capital Gains"*, irrespective of the period of holding. The CBDT, however, carved out the following three exceptions for the AO to take an appropriate view on the characterization of income:

1. the genuineness of transactions in unlisted shares itself is questionable; or

2. the transfer of unlisted shares is related to an issue pertaining to lifting of corporate veil; or

3. the transfer of unlisted shares is made along with the control and management of underlying business.

The CBDT noted that several Alternative Investment Funds (**"AIF's"**) majorly invest in new set ups or startups and in order to safeguard the interest of its investors, such AIF's may be required to exercise some form of control and management over the underlying business of the startups. Accordingly, based on the representations received and in a bid to encourage investments in startups, the CBDT has now clarified that the aforesaid 3rd exception, that is the exception relating to transfer of unlisted shares along with the control and management of the underlying business as mentioned in the CBDT instruction dated May 2, 2016, would not be applicable to Securities and Exchange Board of India (**"SEBI"**) registered Category I and II AIF's.

Accordingly, the income from transfer of unlisted shares resulting in transfer of control and management of underlying business for SEBI registered Category I & II AIF's would be assessed under the head *"Capital Gains"* only irrespective of the period of holding.

VA View

This comes as a welcome move, especially at a time when India is rationalizing complicated statutes in an effort to move up the ladder in the Ease of Doing Business index. The certainty in taxation at a lower tax rate will facilitate easy exits for most AIF's and will encourage foreign investors to invest in the booming Indian start-up ecosystem.

It would be pertinent to note that transfer of shares resulting in transfer of control and management of underlying business by Category III AIF's [which include Hedge funds, Private Investment in Public Equity (PIPE) funds, etc.] will continue to be taxed as per the earlier guidelines.

IV. Major setback for Hubtown as NCLT dismisses petition, imposes exemplary costs

The National Company Law Tribunal, Mumbai Bench, in its decision in the case of ***Mr. Vyomesh M. Shah & Anr. vs. M/s. Vinca Developers Private Limited &Ors.*** (pronounced on January 17, 2017), has dismissed an oppression and mismanagement case filed by individual promoters of Hubtown Limited (**"Hubtown"**) and has imposed exemplary costs on the Petitioners. Hubtown had also lost before the Supreme Court of India in November, 2016 (case referred below).

Background

The Company Petition in this case was filed under the provisions on prevention of oppression and mismanagement under the Companies Act, 2013 (the **"Act"**). The Petitioners sought certain reliefs under Sections 241 and 242 of the Act, directions to modify and substitute the Articles of Association of M/s. Vinca Developers Private Limited (**"Vinca"**), removal of nominee directors of Nederlandse Financierings- Maatschappjj Voor Ontwikkelingslanden N.V. (**"FMO"**), etc.

The Petitioners argued that the investment structure adopted by FMO for its foreign investment in India was in breach of the Foreign Exchange Management Act, 1999 and regulations thereunder (**"FEMA"**). The Petitioners prayed that all rights accruing to FMO on its investment in Vinca should be set aside holding that FMO exercising its rights for realisation of its money was oppressive conduct against the Petitioners. The Supreme Court had directed Hubtown in the case of ***IDBI Trusteeship Services Limited vs. Hubtown Limited*** (decided on November 15, 2016) to deposit the principal sum of INR 418 Crores invested by FMO or give security for the said amount. This case was covered in our December, 2016 edition.

FMO had made an investment in certain equity shares and compulsorily convertible debentures (**"CCDs"**) of Vinca. Such investment by FMO was utilized by Vinca to subscribe to certain optionally partially convertible debentures (**"OPCDs"**) issued by Rubix Trading Private Limited (**"Rubix"**) and Amazia Developers Private Limited (**"Amazia"**).

An unconditional, absolute and irrevocable corporate guarantee in favour of IDBI Trusteeship Services Limited (**"IDBI"**) was issued by Hubtown inter alia for the benefit of Vinca (the **"Guarantee"**). IDBI had alleged that Amazia and Rubix committed several defaults under the said debenture trust deeds and redemption notices were issued. Amazia and Rubix however failed to pay the sums due and payable in terms of the debenture trust deeds.

The learned Single Judge of the Bombay High Court found the Guarantee as illegal and unenforceable holding the investment as contravening FEMA. However the Supreme Court had observed that there was no contravention of FEMA as the payment under the Guarantee was to the debenture trustee which was an Indian company for and on behalf of Vinca which was another Indian company.

Arguments

The Petitioners pointed out that they had started Vinca by investing INR 12.50 Crores and afterwards FMO had made an investment in Vinca of INR 418 Crores in violation of FEMA. The Petitioners further pointed out that Articles of Vinca provided for certain reserved matters for which decisions could only be taken with the approval of one of the nominee directors of FMO. The Petitioners argued that these provisions were made in the Articles to ensure absolute control of FMO over all issues pertaining to the CCDs, their conversion and the OPCDs. The Petitioners also expressed the inability of Vinca in conducting its Board meetings as FMO had iterated that it was 99% shareholder of Vinca pursuant to conversion of CCDs and therefore, the meetings conducted by the Petitioners were bad in law.

The Petitioners further submitted that the nominee directors of FMO were opposed to discussion on any reserved matter and did not extend cooperation in conducting board meetings, etc. resulting in obstruction in the working of Vinca. The Petitioners also levied the allegation that nominee directors of FMO were abusing their position by acting against the interest of Vinca. Furthermore, even after the Debenture Agreement was terminated, the debenture trustee went ahead and filed a summary suit and winding up petition against Hubtown as they were acting on the directions of the FMO nominee directors.

Observations of the Tribunal

The Tribunal did not find any merit in the Petitioners' submissions that there was non-cooperation on FMO's part for holding board meetings and annual general meeting as the Petitioners could not substantiate their allegations.

The Tribunal noted that Petitioners had voluntarily entered into agreement and aligned articles for the purpose of investment by FMO into Vinca and now it could not be argued by them that several voluntarily agreed provisions were oppressive against them.

The Tribunal ruled, *"It is a strange case- the petitioners want an order from this Bench to rewind not only the covenants with FMO, but also Articles of the company, so that FMO could not even get back their principal sum that was invested in the year 2011. Therefore, this Bench need not say in many words, who is oppressive against whom."*

The Tribunal observed that this case was an abuse of the process of law to prevent FMO from realizing its money.

Decision

The Tribunal finally observed that, *"contractual rights conferred upon FMO cannot be whittled down by setting up a case under Section 241 of the Companies Act, 2013."*

The Tribunal found no cause of action and hence, dismissed the petition. The Tribunal imposed exemplary costs of INR 50,000 on the Petitioners for filing *"this vexatious and frivolous litigation"*.

VA View

The woes for Hubtown continue with this petition being dismissed by the National Company Law Tribunal, soon after it received a major setback by the Supreme Court. The Tribunal has made stringent observations in this case, stressing on the return of the sums invested by FMO. This case was a failed attempt by the individual promoters of Hubtown to avoid compliance with the Supreme Court judgment delivered in November, 2016 whereby direction was issued to deposit the principal sum of INR 418 Crores invested by FMO. The attempt to take shelter under the oppression and mismanagement provisions under the Companies Act, 2013 failed as the terms to which Petitioners were objecting as being oppressive were agreed to by them voluntarily with FMO in order to garner the investment.

V. Guidelines for Place of Effective Management of a company

Prior to 2015, section 6 of the Income Tax Act, 1961 (**"the Act"**), a company was said to be a resident in India in any previous year if i) it was an Indian company; or ii) during that year, the control and management of its affairs was situated wholly in India.

Due to the requirement that whole of control and management should be situated in India and that too for whole of the year, the condition was rendered to be practically inapplicable. A company could easily avoid becoming a resident by simply holding a board meeting outside India. This allowed tax avoidance opportunities for companies to artificially escape the residential status under these provisions by shifting insignificant or isolated events related with control and management outside India.

The concept of Place of Effective Management (**"POEM"**) is an internationally recognised test for determination of residence of a company incorporated in a foreign jurisdiction. Most of the tax treaties entered into by India recognises the concept of POEM for determination of residence of a company as a tie-breaker rule for avoidance of double taxation. The principle of POEM is recognized and accepted by Organisation of Economic Cooperation and Development (OECD) also.

To address such concerns and to align the provisions of the Act with the tax treaties, the provisions of section 6(3) of the Act were amended by the Finance Act, 2015 with effect from April 1, 2016 to introduce the concept of POEM for determining the tax residency of a foreign company. POEM had been defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made. These provisions were deferred by Finance Act, 2016 to be applicable from April 1, 2017 and onwards.

The Central Board of Direct Taxes (**"CBDT"**) had issued draft guidelines in December, 2015 for determination of POEM for public comments and suggestions. On January 24, 2017, the CBDT issued the final guidelines vide Circular No. 06 of 2017 for determination of POEM of a company laying down principles for determining the residential status of a company for the purpose of its taxation in India.

The CBDT circular lays down that the process of determination of POEM would be primarily based on the fact as to whether or not the company is engaged in active business outside India. The circular provides that the income of the companies with active businesses outside India will be computed for tax purposes in accordance with the laws of the country of incorporation or as per the books of account, where such computation is not required under laws of incorporation. For this purpose, the CBDT has spelt out the following criteria for a company to be said as one engaged in *"active business outside India"*:

- Passive income should not be more than 50 percent of total income, and
- Less than 50 percent of total assets should be situated in India, and
- Less than 50 percent of total employees should be resident in India, and
- Payroll expenses on such employees should be less than 50 percent of total payroll expenditure.

Further, the circular has defined *"Passive income"* as the aggregate of income from the transactions where both the purchase and sale of goods is from / to its associated enterprises and income by way of royalty, dividend, capital gains, interest or rental income. It has been further provided that the income from interest shall not be considered

as passive income in case of a company which is engaged in the business of banking or is a public financial institution, and its activities are regulated as such under the applicable laws of the country of incorporation.

Also, *"Head Office"* is defined as the place where the company's senior management and their direct support staff are located or, if they are located at more than one location, the place where they are primarily or predominantly located. A company's head office may not necessarily be the same place where the majority of its employees work or where its board typically meets. It is further clarified that senior management would mean the person or persons who are generally responsible for developing and formulating key strategies and policies for the company and for ensuring or overseeing the execution and implementation of those strategies on a regular and on-going basis.

VA View

It is pertinent to note that private equity firms having intermediary companies registered outside India in low or zero tax jurisdictions are likely to be the most affected by POEM provisions. It may be necessary for them to base some of their investment managers or committees at such jurisdictions. Also, entities which are registered in low-tax jurisdictions just as pass-through vehicles to pool capital only for the purpose of investment in India without any active decision making may now be taxable in India by virtue of the aforesaid circular.

However, the circular does emphasize that the determination of POEM would be based on all relevant facts of each case rather than being applied universally. A "snapshot" approach is not to be adopted in the application of the POEM guidelines. It is also one which is based on substance over form. The CBDT has also proposed adequate administrative safeguards from misapplication of these provisions by the department, such as the need for any proceedings to be first sanctioned by a commissioner and later approved by a collegium of senior officers.

It further clarifies that the intent is not to target Indian multinationals which are engaged in business activity outside India, which is quite reassuring. However, as the provisions of amended section 6(3) of the Act are applicable for current financial year onwards, the POEM implications will have to be quickly evaluated in light of the final guidelines issued.

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