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TAX FLASH NEWS

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The tax officer has been directed to enquire into the applicability of deemed dividend provisions to buy-back of shares prior to the introduction of buy-back related specific provisions

Background

Recently, the Karnataka High Court in the case of Fidelity Business Services India Pvt Ltd [1] (the taxpayer) dealt with an issue of taxability of buy-back of shares undertaken prior to the introduction of buy-back related specific provisions[2] under the Income-tax Act, 1961 (the Act). The High Court held that even though the buy-back of shares at an abnormally high price was not subject to Dividend Distribution Tax (DDT)[3] or specific buy-back related provisions[4] or provisions dealing with deemed dividend[5], the Tribunal was justified in directing an enquiry by the Assessing Officer (AO) into the aspects of Fair Market Value (FMV) of shares bought back by the taxpayer from its holding company vis-a-vis applicability of 'deemed dividend' provisions under Section 2(22)(e) of the Act.

Facts of the case

- During the Financial Year 2010-11, the taxpayer, an Indian company, bought back its own shares (shares having a face value of INR10 per share) from its Mauritian holding company at a price of INR2,85,108 per share. The Mauritius company was holding 99.99 per cent of the entire share capital of the taxpayer and the buy-back of shares was paid out of the 'reserves and surplus' of the taxpayer.

- The AO taxed the consideration of INR836.19 million[6] as dividend income under Section 115-O of the Act.

- The Tribunal held that after insertion of Section 115-QA of the Act with effect from 1 June 2013, the purchase of its own shares by the company in accordance with the provisions of Section 77-A of the Companies Act, 1956 was liable to additional tax.

- Since the transaction in the present case was undertaken prior to 1 June 2013, such buy-back of shares would be taxable as 'capital gains' under Section 46A of the Act and not as a dividend in view of exclusion provided under Section 2(22)(iv)[7] of the Act.

- The Tribunal observed that the buy-back of shares was at an abnormally high price of INR2,85,108 per share having a face value of only INR10 per share. Therefore, the payment made by the taxpayer over and above the FMV of the shares would not be treated as part of the purchase price because the transaction was between the two closely related parties and not at an Arm's Length Price (ALP). Accordingly, the payment for buy-back in excess of the FMV of shares would fall within the ambit of Section 2(22)(e) of the Act and could be taxed as dividends in the hands of the taxpayer.

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[1] Fidelity Business Services India Pvt Ltd v. ACIT (ITA No. 512/2017, dated 23 July 2018) – Taxsutra.com

[2] Section 115QA of the Act – With effect from 1 June 2013 in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount of distributed income by the company on buy-back of shares (not being shares listed on a recognised stock exchange) from a shareholder shall be charged to tax and such company shall be liable to pay additional income-tax at the rate of twenty per cent on the distributed income.

[3] Section 115-O of the Act - In addition to the income-tax chargeable in respect of the total income of a domestic company, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1 April 2003, whether out of current or accumulated profits shall be charged to additional income-tax (hereafter referred to as tax on distributed profits) at the rate of fifteen per cent

[4] Section 115-QA of the Act

[5] Section 2(22)(d) of the Act – Dividend includes any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1 April 1933, whether such accumulated profits have been capitalized or not

[6] [2,933 shares X (INR 2,85,108 - INR10) = INR 836.19 million]

[7] The term dividend does not include any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of Section 77A of the Companies Act, 1956

- The Tribunal held that since the above aspect was not examined by the lower authorities, it could be treated as a device for transfer of substantial 'reserves and surplus' by the Indian company to the holding company resulting into Base Erosion and Profit Shifting (BEPS). It could be a colourable device and a dubious method of avoiding tax in the garb of buy-back of shares at a highly inflated price, therefore, the matter needs to be examined by the AO on the issue of FMV of shares, vis-à-vis buy-back price of the shares by the taxpayer.

- Aggrieved, the taxpayer filed an appeal before the High Court.

High Court's decision

Buy-back of shares

- Since the shares were not listed on the stock exchange, FMV of the shares on a particular date of the transaction was not ascertainable and the said aspect of the matter was not admittedly looked into by the lower authorities before the appeal was decided by the Tribunal.

- Even though some findings were given by the Tribunal in favour of the taxpayer that the said payout for buy-back of the shares at an abnormally high price was not taxable under Section 115-O or Section 115-QA read with its Explanation thereto and Section 2(22)(d) of the Act, the Tribunal was justified in directing an enquiry into the FMV of the shares of the taxpayer which could have an implication of taxability under Section 2(22)(e) of the Act or otherwise.

- The High Court did not decide on the question of taxability in the present case since the factual foundation for the same was not present. Therefore, this question was left open.

Legality of the provisions and case laws

- On a perusal of the provisions of the Act and various decisions[8], it has been observed that the directions by the Tribunal for conducting an inquiry into the matter by the AO were not beyond the jurisdiction of the Tribunal.

- The direction of the Tribunal to hold such an inquiry falls within the ambit of the 'subject matter' of the appeal filed by the taxpayer. The said directions cannot amount to taxability of the said pay-out by the taxpayer as 'dividend' but the same would depend upon the nature of inquiry to be conducted by the AO.

- The power to remand for conducting an inquiry in the aspect of the matter which was not earlier adjudicated upon by the lower authorities, cannot be questioned by the taxpayer or the tax department.

- The emphasis while analysing the powers of the Tribunal should be on the words 'as it thinks fit' rather than on the word 'thereon'. The word 'thereon' only relates to the 'subject matter' of the appeal in first part of Section 254(1) of the Act and therefore while the Tribunal was dealing with the subject matter of the appeal, it can pass any such relevant order as it thinks fit, which would be rational, germane, reasonable, appropriate, necessary and expedient in the opinion of the Tribunal subject to the requirement that it gives an opportunity of hearing to both the parties to the appeal.

- None of the powers of the Tribunal including the power to allow fresh and new ground were restricted. Further, the powers to enhance an assessment or tax liability or reduce the tax especially enumerated in the Proviso to Section 254(2) of the Act also was not restricted.

- Section 254 of the Act does not have any narrower scope to put fetters on the powers of the Tribunal. The Tribunal was not bound to decide the appeal in a particular or narrower manner or limited to the grounds raised in the appeal before it. The confines or boundary limit is only 'subject matter' of the appeal.

Tax avoidance

- The Mauritius route of tax avoidance and evasion was a hugely suffered phenomenon in India. It also resulted in a huge tax controversy in the case of Vodafone[9] even after the decision of the Supreme Court which is in favour of the taxpayer. In that case, there was a retrospective amendment of law and the said matter is still being debated in international arbitration between India and Vodafone.

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[8] Kapurchand Shrimal v. CIT [1981] 131 ITR 451 (SC), CIT v. Indian Express (Madurai) (P.) Ltd. [1983] 140 ITR 705 (Mad), National Thermal Power Co. Ltd. v. CIT [1998] 229 ITR 383 (SC), Jute Corporation of India Ltd. v. CIT [1991] 187 ITR 688 (SC), Hukumchand Mills Ltd. v. CIT [1967] 63 ITR 232 (SC), CIT v. Cellulose Products of India Ltd.[1985] 151 ITR 499 (Guj) (FB), Khaitan Paper and Industries Ltd. v. CIT [2005] 273 ITR 234 (Cal), MCORP Global P. Ltd. v. CIT[2009] 309 ITR 434 (SC), etc.

[9] Vodafone International Holdings BV v. UOI [2012] 341 ITR 1 (SC)

- India-Mauritius tax treaty has been amended by inserting a Protocol with effect from 1 April 2017 seeking to plug the loopholes for the tax evasion through misuse of the erstwhile tax treaty (1983) between India and Mauritius, since it has been a route of tax evasion and money laundering in the past. Accordingly, the present appeal filed by the taxpayer was liable to be dismissed.

  The Tribunal has the power to give directions for fresh enquiry into the aspects of the subject matter of appeal filed before it either *suo motu* or on any grounds raised by either party to the appeal which has not been investigated or enquired into by the lower authorities earlier and which may result in enhancement of tax liability of the taxpayer.

  The Tribunal was right and within its jurisdiction in directing the examination of the FMV of the shares bought back by it during the previous year relevant to the AY 2011-12 in question.

Our comments

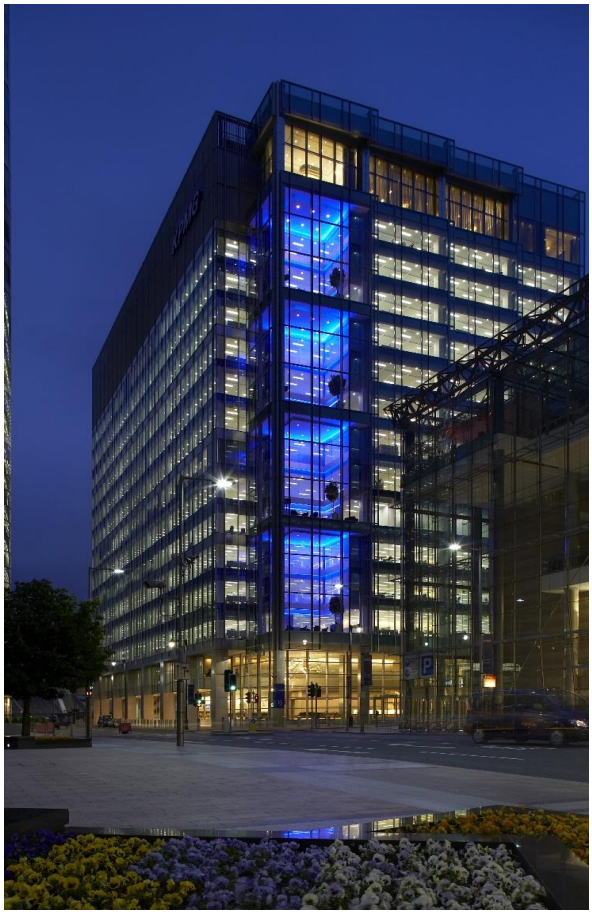
Prior to the introduction of Section 115QA of the Act the AAR in the case of A Ltd[10], based on the facts of the case held that the buy-back scheme resulting in buying back of the shares held by a Mauritian shareholder is as a 'colourable device' for avoiding payment of DDT. The AAR held that the scheme could only be treated as a distribution of profits (i.e. dividends) by a company to its shareholders which will attract DDT.

Subsequent to the introduction of Section 115QA of the Act, relying on the AAR ruling in the case of A Ltd, the tax authorities, in some of the cases have sought to re-characterise the purchase consideration received on account of buy-back of shares, undertaken prior to 1 June 2013, as dividend liable to DDT.

In this context, CBDT issued a Circular[11] and clarified that consideration received on buy-back of shares between the period 1 April 2000 to 31 May 2013 would be taxed as capital gains in the hands of the recipient in accordance with Section 46A of the Act and no such amount should be treated as a dividend. It was also clarified that no fresh notice for assessment/reassessment/non-deduction of tax at source shall be issued where buy-back of shares has taken place prior to 1 June 2013 and the case was covered under Section 46A of the Act read with Section 2(22)(iv) of the Act. It was also clarified that pending cases shall be completed by applying the above principle.

The Mumbai Tribunal in the case Goldman Sachs (India) Securities[12] while dealing with taxability of buy-back of shares prior to introduction of Section 115QA of the Act observed that there was no ambiguity about the provisions that would govern the buy-back of shares. Section 2(22)(iv) read with Section 46A of the Act would be applicable to the buy-back scheme. Accordingly, the transaction cannot be treated deemed dividend under Section 2(22)(d) of the Act.

The High Court in the present case has held that the Tribunal was justified in directing an enquiry by the AO into the aspects of FMV of shares bought back by the taxpayer from its holding company vis-a-vis applicability of 'deemed dividend' under Section 2(22)(e) of the Act.



[10] A Ltd (AAR No. P of 2010, dated 22 March 2012)
[11] CBDT Circular No. 3/2016, dated 26 February 2016

[12] Goldman Sachs (India) Securities (ITA No. 3726/Mum/2015, dated 12 February 2016)

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