TAX FLASH NEWS

7 May 2019

The Bombay High Court quashes tax officer’s order denying nil withholding tax certificate in respect of capital gains under the India-Mauritius tax treaty

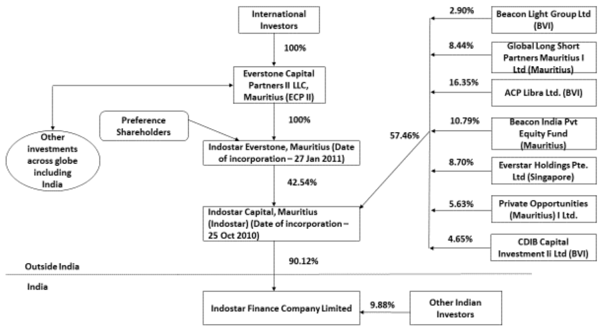
Recently, the Bombay High Court in the case of Indostar Capital[1] (the taxpayer) quashed the tax officer’s order denying nil withholding tax certificate in respect of capital gain on the sale of shares of Indian company by a Mauritian company. The High Court directed to release the tax already deducted and paid in favour of the taxpayer with interest subject to certain conditions.

Facts of the case

The taxpayer was incorporated in October 2010 as a private limited company in Mauritius with an intent to promote an Indian Non-banking Financial Company (NBFC) named Indostar Capital Finance Limited (ICFL). The taxpayer holds a Category 1 Global Business Licence issued by the Financial Services Commission of Mauritius to act as an investment holding company. The taxpayer has been issued a Tax Residency Certificate (TRC) by Mauritius Revenue Authority.

In order to acquire shares of ICFL, the taxpayer raised capital from various groups of international institutional investors located across the world. In a span of over four years between 31 March 2011 to 17 August 2015, the taxpayer acquired 7.13 crores (rounded off) shares of ICFL which corresponds to 97.30 per cent of its share capital.

The holding structure (before the IPO) of the taxpayer is depicted as follows:



The taxpayer offloaded 1.85 crores of its shares of IFCL through Initial Public Offer (IPO). The taxpayer applied to the Assessing Officer (AO) for grant of the certificate under Section 197 of the Act. The taxpayer contended that capital gain arising out of the sale of such shares was not taxable in India under the India-Mauritius tax treaty (tax treaty). The taxpayer contended that in the absence of any tax liability in India, tax was not required to be deducted and therefore, the certificate as required may be granted.

The Assessing Officer (AO) rejected the application of the taxpayer under Section 197 of the Act and held that the entire transaction was not genuine. The AO held that the entire tax structure was created to avoid legitimate tax liability.

On 13 June 2018, the AO passed the consequential order authorising the payer of the sale proceeds of

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[1] Indostar Capital v. ACIT (Writ Petition No. 3296 of 2018) – Taxsutra.com

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the shares to make the payment after deducting tax at 10 per cent on the entire amount of receipt. On 20 June 2018, he passed further order directing the payer to deduct tax at 7.73 per cent on the entire amount and release the rest in favour of the payee.

The taxpayer filed a writ petition before the High Court challenging the order dated 20 June 2018.

High Court decision

Certificate issued under Section 197 of the Act provides immunity to the payer from being declared a deemed defaulter. However, the proceedings under Section 197 of the Act would not decide the taxability of receipts in the hands of the payee. In other words, even if a certificate under the said Section is issued, the tax department can always in normal assessment bring the income to tax if otherwise permissible in law. Conversely, even if there is no certificate either asked for or granted, the taxpayer can always contest the taxability of the income in the assessment.

The High Court referred the decision of the Supreme Court in the case of GE India Technology Cen P Ltd[2] wherein it was held that that mere remittances to non-resident do not give rise to the duty to deduct tax at source under Section 195 of the Act. The question of deducting tax at source would arise only if the income in the hands of the payee is taxable. This well-settled principle would need no reference to any authority.

As per Article 13(4) of the tax treaty, as it stood at the relevant time, the gain arising on the sale of shares acquired on or before 31 March 2017, in a company which is resident of India, could not be taxed in an Indian territory. Therefore, the taxpayer had moved before the AO for issuance of the nil deduction certificate under Section 197 of the Act.

The High Court referred to various decisions[3] and observed that where the taxpayer had relied on the provisions of the tax treaty, reference to the provisions of the Act would not be relevant. The High Court observed that Circular[4] issued by CBDT states that certificate of residence issued by the Mauritius Authorities shall constitute sufficient evidence for accepting the status of the residence as well as beneficial ownership for applying the tax treaty. Further, relying on the decision of the Supreme Court in the case of Azadi Bachao Andolan[5], the High Court observed that circular issued by CBDT under Section 119(2) of the Act would bind the revenue authorities is undisputable.

Despite the existence of the tax treaty and TRC issued by the Mauritius Authorities, the High Court, based on the law laid down by the Supreme Court through series of judgments observed the tax department's case cannot be shut down totally when it comes to a fraudulent or fictitious transaction. The High Court relied on various decisions[6].

Relying on the observation of the Supreme Court in the case of Vodafone International Holdings B. V., the High Court observed that in case the AO had sufficient prima facie material to demonstrate that the entire transaction from the inception was a sham and colourable device to avoid tax, it was still open for him to express his opinion accordingly and refuse to grant a certificate under Section 197 of the Act. In the instant case, the material available on the part of AO fell short of this requirement.

The mere fact that the taxpayer has not transacted any other business by itself may not be conclusive. The reference to the fact that the taxpayer unable to produce TRC of the companies which hold shares in the taxpayer is erroneous. The observation that mere transfer of money through the banking channel would not be conclusive, may be quite correct but the same cannot be a ground against the taxpayer unless there is adverse material. The extent of administrative expenditure and the employment structure may be some of the factors which eventually would go to establish whether the transaction was sham and the existence of the taxpayer was fraudulent, however by themselves may not be sufficient. All these aspects can and need to be gone into in the assessment proceedings.

The High Court also agreed with the concern of the tax department that without adequate protection of recovery, the possible tax component should not be released in favour of the taxpayer. Accordingly, the High Court disposed of the writ petition quashing the order passed by the AO under Section 197 of the Act and directed the tax department to release the withheld amount subject to the following conditions:

- The taxpayer shall maintain a minimum 5 million shares of ICFL at the current value of INR402.55 per share which would come to the valuation of INR200 crores. This would provide security of over 200 per cent of the disputed tax amount

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[2] GE India Technology Cen P Ltd v. CIT [2010] 327 ITR 456 (SC)
[3] CIT v. JSH (Mauritius) Ltd. [2017] 84 taxmann.com 37 (Bom), Serco BPO (P) Ltd v. AAR [2015] 379 ITR 256 (Punjab & Haryana)
[4] CBDT Circular No. 789, dated 13 April 2000
[5] UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)

[6] McDowell & Co Ltd v. CTO [1985] 154 ITR 148 (SC), Vodafone International Holdings B.V. v. Union of India [2012] 341 ITR 1 (SC)

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- If the total value of these 5 million shares goes below 125 per cent of TDS being released in favour of the taxpayer by virtue of these directions, the taxpayer shall immediately inform the AO about the same and shall to the extent of shortfall of 200 per cent of the amount of TDS provide security to the satisfaction of the AO. In case of any difficulty, it would be open to the either side to approach the Court.
- The taxpayer shall maintain such minimum number of shares till 31 March 2021 which is the last date for passing the assessment order under normal circumstances, unless assessment order is passed earlier, in which case the entire issue will be governed by such assessment order subject to the right of appeal.
- Additionally, the taxpayer shall maintain such shares upto 31 December 2021 which would enable the AO to complete the assessment even after invoking extended period of limitation. If the tax department needs any further extension beyond 31 December 2021, it would be open for it to apply.
- The taxpayer shall file a return of income before the due date of filing of the return. A responsible officer of the taxpayer shall file an undertaking before this Court latest by 15 May 2019 that the taxpayer shall abide by all statements made above.

Our comments

Investment through the Mauritius route and tax litigation surrounding the same have always been in the limelight. The Indian judiciary on several occasions have dealt with the business purpose test and evaluated the ‘substance over form’ test with respect to Mauritius transactions.

The Supreme Court in the case of Vodafone International Holdings B. V. held that it is important for both the tax department and the courts to look at the legal nature of the transaction in its entirety and holistically; a dissecting approach should not be adopted. The 'look-through' approach is permissible only in instances where it can be established on the basis of facts and circumstances that the transaction is a sham or is for the purposes of tax avoidance.

The Courts/Tribunal[7] in some of the cases, based on the facts of each case, held that the intermediate holding company was having enough substance. Accordingly, the benefit of respective tax treaty was allowed to the taxpayer. However, Courts/Tribunal[8] in a few cases have disregarded the intermediary holding company and treated the parent company as a beneficial owner of a particular income.

In the instant case, the shares were acquired prior to 1 April 2017. However, the India-Mauritius tax treaty has been amended where India gets the right to tax the transfer of shares acquired on or after 1 April 2017. It is important to note that the amended India-Mauritius tax treaty provides relaxation (@ 50 per cent of domestic tax rate in India) in respect of capital gains arising to Mauritius residents from alienation of shares between 1 April 2017 and 31 March 2019. However, the taxpayer shall not be entitled to the benefits if it its affairs were arranged with the primary purpose of taking advantage of such benefits. Further, such benefits shall not be available to a Mauritius resident who is a shell/conduit company and does not satisfy business purpose test. Similar kind of provisions have also been introduced in India-Singapore tax treaty.

It would be interesting to see how GAAR provisions will apply to such type of transactions.

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[7] Satellite Television Asia Region Advertising Sales B.V. [2010-TII-58-ITAT-MUM-INTL], KSPG Netherlands Holding B.V. [2010] 322 ITR 696 (AAR), E*Trade Mauritius Limited [2010] 324 ITR 1 (AAR)
[8] Adiya Birla Nuvo v. DDIT [2011] 342 ITR 308 (Bom), Z Mauritius (A.A.R. No. 1048 of 2011)

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