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TAX FLASH NEWS

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Even though UAE based subsidiary was a paper/shell company, its profits are not taxable in India because it did not violate any provisions of the law

Recently, the Ahmedabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Rubamin Ltd[1] (the taxpayer) dealt with the issue of taxation of profits of a subsidiary company located in UAE in the hands of the taxpayer and treating the subsidiary company as a colourable device/shell entity. The Tribunal held that even though UAE based subsidiary was treated as a paper/shell company, its profits were not taxable in India as the activities of paper/shell company cannot be treated as illegal in nature as such company did not violate any provisions of law.

The profit earned by the UAE subsidiary company was predominantly on account of the import from the downstream subsidiary based in Democratic Republic of Congo (DRC) which was sold to a party based in China. Thus, the transaction was amongst the parties based outside India. Accordingly, such profit cannot be attributed to the taxpayer merely on the reasoning that the taxpayer is the holding company. The substance of the transaction shows that the profit was belonging to such foreign subsidiary companies.

The substance of the transaction shows that the profit was either belonging to the subsidiary in DRC or subsidiary in UAE. Even if the existence of the subsidiary in UAE is denied, such profit has to be attributed to the subsidiary in DRC. No doubt was raised by the tax department on the existence of the subsidiary in DRC which implies that the subsidiary company in DRC was functioning properly. Therefore, the profit related to the subsidiary company in DRC cannot be clubbed with the taxpayer company on the reasoning that the taxpayer had diverted the profit by using the colourable device. In either situation whether the profit belongs to UAE subsidiary or DRC subsidiary, the position of the taxpayer cannot be altered.

[1] Rubamin Ltd v. DCIT (ITA No. 2929/Ahd/2014) – Taxsutra.com
Note – In this decision, the Tribunal has dealt with several issues. However, this flash news captures issues relating to determination of substance of transactions undertaken and its taxability in India.

Facts of the case

The taxpayer, an Indian company, is engaged in the business of manufacturing of various grade of Zinc Oxide, Zinc based Chemicals and moly-based Chemicals. The taxpayer held 90 per cent shares of a UAE based entity i.e., Rubamin FZC (RFZC). Similarly, RFZC has two wholly owned subsidiary companies in DRC namely Rubamin SPRL and Rubaco SPRL.

The RFZC is a trading company whereas the companies located in DRC are engaged in the business of manufacturing of cobalt concentrates from cobalt Ore and copper concentrate. The above group of companies were controlled and managed by different persons.

A search[2] was conducted in the office of the taxpayer. During the search operation, various emails revealed the communication between the directors and CFO of the taxpayer. Email communication indicates the affairs of RFZC, and its subsidiary companies located at DRC. All the payments made by RFZC shall be subject to the authorisation of the directors/CFO of the taxpayer in India. The email shows the details relating to the restructuring of loan and advances given by the taxpayer to its DRC-based companies.

In view of the above search operation, the Assessing Officer (AO) treated RFZC as a shell/paper company. It was observed that RFZC was incorporated by the taxpayer for diverting its profit using the colourable device since company based in UAE was free from the tax liability. The taxpayer was diverting its income to RFZC with the motive to avoid the tax. Thus. the entire profit of RFZC belongs to the taxpayer and was added to the total income of the taxpayer. The Dispute Resolution Panel (DRP) upheld the order of the AO.

[2] Search was conducted dated 26 April 2013 under the provisions of Section 132 of the Act

Tribunal's decision

Whether UAE based intermediary company is a colourable device/shell company for tax evasion

Whether RFZC located in UAE was a paper company

On perusal of the financial statements of the company as on 31 March 2011, it was observed that Dubai based entity was engaged in trading activity and has shown turnover INR 229 crores. It has also shown receivables, payables, loans from the banks, administrative expenses in the financial statements. On reference to the observation made by the tax department, it was observed that there was no major activity carried out by the RFZC except on papers.

Considering the facts of the present case, the kinds of emails and the documents found during the search and the other circumstantial evidence strongly suggest that the taxpayer being a holding company was not collecting the information from the subsidiary for record purposes or to keep the track in the manner of shareholders' function. The promoter and MD of taxpayer was formulating and deciding the strategies, be it financial or hedging of its subsidiary companies. Therefore, neither any effective operations were carried out at RFZC nor any decision were taken. The company RFZC was only used for the purpose of routing the transactions on papers.

Meaning of shell or paper company

The shell /paper company has not been defined under the Income-tax Act, 1961 (the Act) or in any other Act applicable for the time being in in India. However, the Organisation for Economic Co-operation and Economics Development (OECD) has defined shell company to mean a firm that does not conduct any operations in the economy (other than in a pass-through capacity), but it is formally registered, incorporated, or has legal status in the economy.

In the facts of the present case, indeed the RFZC was incorporated after due compliance of RBI as well as the local laws of UAE. However, the approval of RBI and the local laws of UAE do not decide the nature of transactions. The purpose of RBI is to approve the company within the provisions of relevant law which has no role to play with respect to the provisions of the Act. Accordingly, it has been held that RFZC was a shell or paper company which was not doing any business activity in reality and only used as vehicle to books sales and profit and the employees cost which it has shown but actually, it is working for DRC companies. Thus, it was also held that the approval given by the RBI would not help to the taxpayer insofar holding the RFZC as a paper company.

Whether it was necessary for the taxpayer to establish a company in UAE

The taxpayer contended that the Dubai based entity was incorporated for the reason that there was political and economic disturbance in DRC viz-a-viz banking facility was very poor. The Tribunal observed that these arguments appear to be correct. In order to cope up with the uncertainty prevailing in DRC and safeguard its business and financial interest the taxpayer had to rout the transaction through third party or intermediary.

Whether the paper company is engaged in any tax evasion

Any company falling within the definition of paper/shell company does not mean that it is engaged in the activity which is illegal in nature. In other words, the formation of the paper company is not prohibited. These companies can be created for multipurpose. In practical situations, in many organisation the different companies which carries out the transactions on papers only but for numerous reasons. A company in order to avoid its reputation does not deal directly with the particular company but deals indirectly through a company which is created only for the limited purpose of routing the transactions. To our understanding, such companies do not violate any provisions of law and therefore nothing adverse can be drawn against such companies until and unless the transactions of the paper companies were violating the provisions of law. Thus, the Tribunal need to see whether RFZC contravenes the provisions of law by using the dubious method in order to avoid the tax liability.

In this connection, it was observed that there was no allegation of the tax department that there was any violation of law except to hold that the taxpayer by using the colourable device was diverting profit to RFZC. The allegation of using the colourable device of the tax department was based on the reasoning that the affairs of RFZC were controlled and managed by the taxpayer. From the allegation, it was inferred that the control and the management of the affairs of RFZC was based in India. However, it has been observed that the tax department has not invoked the Place of Effective Management (PEOM) provisions[1] of Section 6 of the Act.

[3] The above provisions requires that a company can be resident in India if it is affairs are controlled and managed wholly and exclusively in India.

The Tribunal observed that there was no violation of any provisions of the law leading to draw the inference that the taxpayer has acted in a manner which was prohibited under the provisions of law. Any transaction which is within the four corners of the law cannot be termed as a colourable device merely on the reasoning that the taxpayer is able to save tax liability.

The Act has been amended by incorporating the provisions of Place of Effective Management (PoEM), General Anti-avoidance Rule (GAAR) for bringing such transactions under the net of tax. However, the provisions are not applicable to the year under consideration. Therefore, the Tribunal observed that until and unless there was any violation of the provisions of law, it cannot be alleged that the taxpayer by adopting the colourable device has diverted the profit.

Whether the profit shown by the RFZC belongs to the taxpayer

The profit earned by RFZC was predominantly on account of the import from DRC which was sold to one party based in China. Thus, the transaction was among the parties based outside India. Accordingly, the Tribunal was of the view that such profit cannot be attributed to the taxpayer merely on the reasoning that the taxpayer is the holding company as well as it was getting the benefit by way of dividend. The substance of the transaction shows that the profit was either belonging to the subsidiary in DRC or subsidiary in RFZC. Even the existence of RFZC subsidiary company is denied then such profit has to be attributed to the DRC subsidiary company.

There was no doubt raised by the tax department on the existence of the DRC subsidiary which implies that the companies in DRC were properly functioning. Therefore, the profit related to the DRC subsidiary cannot be clubbed with the taxpayer on the reasoning that the taxpayer has diverted the profit by using the colourable device. In either situation whether the profit belongs to RFZC subsidiary or the DRC subsidiary, the position of the taxpayer cannot be altered.

In view of the above, no inference can be drawn that the profit of the taxpayer got diverted.

Restriction of long-term capital loss on sale of shares

During the year[4], the taxpayer had shown purchases of the shares of a company which was classified as 'investment' in its books of accounts. These shares were purchased in the earlier years. However, the taxpayer had sold all the shares in the year under consideration. Accordingly, the taxpayer on sale of shares had claimed short-term capital loss and long-term capital loss. The AO observed that the shares have been sold after the purchases within a short span of time and that too to the same party from whom the shares were purchased. Consequently, the AO was of the view that such transaction of purchase and sale of shares is representing the colourable device in order to generate the bogus short-term/long-term losses.

The AO in the absence of value for the purchases and sales of the shares, resorted to the provisions of Rule 11UA[5] to determine the purchase and sales value of the shares. The CIT(A) held that the entire amount of loss on the purchase and sale of shares cannot be determined with reference to the valuation of the purchase and sale of the shares in the prescribed manner provided under Rule 11UA of the Rules. Consequently, the CIT(A) treated the entire amount of loss as bogus.

The Tribunal observed that once a transaction has been treated as a colourable device, then the entire amount involved in the transaction has to be treated as bogus and consequently the same should be disallowed in entirety.

A colourable device is not an instrument or a specific document but it is whole set of series of transaction which create a different impression when they are looked at their form alone or seen from result, they create, but when it is looked through and the substance of the transaction is brought into limelight then such substance of the transaction clearly indicates an intention of tax evasion.

It is the task of the Court to ascertain the legal nature of the transaction and while doing so, entire transaction has to be looked at as a whole and not in pieces. Reference was made to the decision of Banyan & Berry[6], where it was held that every Act which results in tax deduction, exemption of tax or not attracting tax authorised by law cannot be treated as a device of tax avoidance and the real question to be asked is whether the act of the taxpayer falls in the category of a colourable device, a dubious method or subterfuge which the judicial process may not accord approval.

The AO cannot treat a part of the transaction as genuine as far as sales and purchase of the shares is concerned but having a doubt on the value of the purchases and sales of the shares. In other words, the AO cannot pick and choose the value which suits to the revenue.

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[4] AY 2007-08

[5] Fair Market Value provisions

[6] Banyan & Berry v. CIT [1996] 84 Taxman 515 (Guj)

Additionally, the taxpayer has not received any consideration in cash against the sale of shares. In view of the above and after considering the facts in totality we are not convinced with the finding of the authorities that the taxpayer has adopted the colourable device for incurring the losses.

Our comments

The House of Lords[7] while addressing the issue of tax planning held that a taxpayer is entitled to manage his affairs within law, so as to pay minimum taxes. The supreme court in the case of Azadi Bachao Andolan[8] laid down that it is not correct to held that every attempt at tax planning is illegitimate and must be ignored, or that every transaction or arrangement which is perfectly permissible under law, which has the effect of reducing the tax burden of the taxpayer, must be looked upon with disfavour.

The Supreme Court in the case of Vodafone International Holdings B.V.[9] had held that while ascertaining the legal nature of the transaction one has to consider the entire transaction as a whole and not adopt a dissecting approach particularly if there is nothing contrary on records to prove about the genuineness of the transaction.

The Tribunal in the present case has observed that there was no violation of any provisions of the law leading to draw the inference that the taxpayer has acted in a manner which was prohibited under the provisions of law. Any transaction which is within the four corners of the law cannot be termed as a colourable device merely on the reasoning that the taxpayer is able to save tax liability. Accordingly, the Tribunal held that the activities of paper/shell company cannot be treated as illegal in nature and such companies do not violate any provisions of law.

It is important to note that the government has introduced various anti-avoidance measures under the Act like GAAR (w.e.f. AY 2018-19) and POEM (w.e.f. AY 2017-18). Further in last few years India has introduced 'limitation of benefit' (LOB) clause in several Indian tax treaties. India has also ratified the MLI and included in almost all of its tax treaties as Covered Tax Agreement (CTA). Thus Principal Purpose Test (PPT) which is a minimum standard will apply to all CTAs of India. Therefore, it is important to analyse all these provisions before entering into any global business structuring/transactions.

[7] Duke of Westminster's case [1936] AC 1 (HL); 19 TC 490
[8] UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)
[9] Vodafone International Holdings B.V. v. Union of India. [2012] 341 ITR 1 (SC)

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