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DUST UNSETTLED? MAURITIUS SELLER UNDER TAXMAN'S SCANNER

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The Bombay High Court (Court) recently pronounced a ruling (Indostar Capital v Asst. Commissioner of Income Tax, Writ Petition No. 3296 of 2018) in favour of the Taxpayer (Indostar Capital). The Taxpayer, a Mauritian company sought relief from the Court since it was denied a 'nil' withholding certificate on the sale of shares of its Indian subsidiary, for which it was claiming the benefits of the India – Mauritius Tax Treaty (Treaty).

In the aftermath of the amendments to the Treaty in 2016, the tax position was largely settled re the Indian tax implications arising from the sale of Indian investments by Mauritian companies. This case recapitulates key tax principles and factual considerations on this issue.

Fact & Background

The Taxpayer possesses a validly issued Category 1 Global Business Licence and a Tax Residency Certificate (TRC) formed to promote Indostar Capital Finance Limited (ICFL), an Indian company. From 2011 to 2015, the Taxpayer raised offshore capital and invested in ICFL. Seeking to divest part of its shareholding in ICFL through the Initial Public Offering (IPO) (post IPO, its shareholding would be reduced to around 57% from 97.30%), an application was made for a 'nil' withholding certificate (under Section 197 of the Income Tax Act, 1961 or Act). Applying the beneficial provisions of the Treaty, in the absence of any tax liability in India, deduction of tax at source is unnecessary.

However, after a detailed inquiry, the tax officer rejected the Taxpayer's application on the grounds that the 'transaction was not genuine' and the 'entire tax structure was crafted to avoid legitimate tax liability'. Directing the Taxpayer to deduct tax @7.73% on the entire amount, he stated that the Taxpayer:

- only earned passive income and did not undertake any business transactions;
- does not maintain any establishment, employ persons or incur any administrative expenses at Mauritius; and
- failed to provide the details / TRCs of its shareholders, furnish details of the ultimate beneficiaries of the assets being transferred.

Arguments Advanced by Parties

The Taxpayer in its writ petition to the Court put forth three key points:

- It had no Indian tax liability on capital gains arising out of sale of ICFL shares. Thus, there cannot be any direction for deduction of tax at source while remitting the sale proceeds. So long as it had a valid TRC, the tax authorities could not go beyond the TRC to deny the Taxpayer's residency status.

- Such a detailed inquiry by the tax officer is not envisaged at this stage. Further, the prima facie finding (of the transactions not being genuine) was not supported by any material on record.
- The Taxpayer was constituted for the purpose of making investment in India and it acted as a pooling vehicle and received funds from various international financial institutions. The Taxpayer accessed and benefited from the Indian markets through its investment in ICFL. All the transactions were reported to the respective statutory authorities.

In response, the Revenue contended that:

- At the stage of passing the order under Section 197 of the Act, there was sufficient material to reject the Taxpayer's application. Once it was prima facie established that the transaction was not genuine (as in the present case), the Taxpayer must participate in the assessment proceedings and only if it succeeds should the amount deducted by way of tax at source be refunded.
- Necessary reliance was placed on the tests laid down in the Vodafone case (Supreme Court, 2012) (Eg: piercing the corporate veil, investigating beyond the TRC) to prove that the entire transaction was not genuine.
- The Taxpayer also has an alternate remedy against the impugned order which can be challenged before the Commissioner of Income Tax (Section 264 of the Act).

Judgment & Court's Verdict

Limiting its judgment to the correctness of the order passed by the tax officer under Section 197 of the Act, the Court clarified that its observations, especially the taxation of receipts from the sale of ICFL shares, would be prima facie in nature and would not prejudice either party.

The key pointers from the ruling have been enumerated below:

- The question of deducting tax at source would arise only if the income in the hands of the payee is taxable in India. Prima facie, the Court found that the Taxpayer's case squarely fell within the ambit of the beneficial provisions of the Treaty and the income arising out of the sale of ICFL shares was not taxable in India.
- Citing the Vodafone case, the Court concurred that in case of genuine transactions flowing out of commercial relations, certain set of principles (Eg: respecting the corporate holding structure without piercing the corporate veil) would apply in relation to taxability of a non-resident. At the same time, in case of sham or bogus transaction, no such parameters would apply.
- Ultimately, the Court noted that prima facie, there was insufficient material to demonstrate that the entire transaction from the inception was a sham, colourable device and bogus transaction to simply avoid tax.
- The business undertaken by the Taxpayer (or lack thereof), transfer of money through banking channels / source of funds, extent of administrative expenditure and the employment structure and other factors to prove that the transaction was a colourable device may be dealt with in the assessment proceedings. Albeit, some factors alone may be insufficient to support such a conclusion.

Balancing the twin objectives of Section 197 – to protect the interest of the Revenue as well as allow the entire sale proceeds to be remitted to the non-resident payee, the Court quashed the tax officer's order, directing the release of the withheld payment subject to any adjustment in the assessment proceedings. Further, the Court directed the tax officer to issue a 'nil' withholding certificate and the Taxpayer (as stated by its counsel) to maintain a minimum 50 Lakhs shares of ICFL until the date (earlier of) when the assessment order is passed or the last date for passing the order of assessment under normal circumstances.

Comment

The Court's prima facie ruling is well reasoned and demonstrates the much-required balanced approach to tax the transfer of shares in case of a Mauritian seller. The judgement reiterates the importance of provisions like Section 197 of the Act when undertaking / advising on large M&A transactions. Often, parties grapple with the uncertainty attached to this process, which has in a way been highlighted. While the Court in its previous ruling (Aditya Birla, 2011, also where a prima facie view was expressed) disregarded a 'nil' withholding certificate and denied the taxpayer benefits of the Treaty, in this case a positive view was adopted, albeit prima facie in nature. Importantly, the Taxpayer in this case offered to retain some shares in the Indian target. This requirement of the taxpayer having to retain some shareholding until the assessment proceedings are complete should not be applied to all other cases, en masse.

While the Court has explained that the Revenue shall not be precluded from reviewing facts in addition to the TRC in cases where there is fraud, façade or colourable device, it would be beneficial if a comprehensive list of factual parameters (Eg: employees, administrative set-up, etc.) is formulated for such an investigation. Since the law (Treaty and the Act) entail clear provisions on the applicable Indian tax implications, a better understanding of relevant facts would enable parties to determine whether a 'nil' withholding certificate should be applied for - a key negotiating point in M&A deals today.

However, formulating such parameters may be wishful thinking as the goalpost for tax avoidance is constantly in motion, catching up with the sophisticated ways of doing business today.

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