EY Tax Alert

AAR treats buyback of shares as tax avoidance scheme taxable as dividend under Mauritius DTAA
Executive summary

This Tax Alert summarizes a recent ruling of the Authority for Advance Rulings (AAR) in the case of A Mauritius\(^{[1]}\)(Applicant) on the issue of taxability of gains arising to a Mauritius company on buy-back of shares of the Applicant. The AAR held that the transaction was a tax avoidance device in view of the fact that the buy-back by the Applicant was in lieu of distribution of dividends. The transaction of buy-back was disregarded and treated as distribution of dividend chargeable to dividend distribution tax (DDT) in India under the Indian Tax Laws (ITL) as well as the India-Mauritius Double Taxation Avoidance Agreement (Mauritius DTAA).

Background

- The Applicant is a public limited company incorporated in India. The shareholders of the Applicant are three foreign companies incorporated in US (US Co), in Mauritius (Mau Co) and in Singapore (Sing Co) along with the residual shares being held by the general public.

- Mau Co was incorporated in Mauritius in the year 2001. Mau Co was initially held by a Hong Kong company but later its ownership was transferred to Sing Co which was ultimately held by a US based parent company. Mau Co had acquired shares of the Applicant during the year 2001 to 2005.

- The Applicant had declared dividends to its shareholders till 2003 and had thereafter accumulated reserves on year on year basis. The Applicant had offered to buy back its shares from shareholders twice (in 2008 and 2010). Only Mau Co agreed to transfer its shares under the buy-back offer to the Applicant. In respect of the first buy-back in 2008, Mau Co had filed its return of income claiming nil liability and the issue was pending before the Tax Authority.

The above arrangement is depicted in a schematic diagram below:

\([1]\) [2012-TII-15-ARA-INTL]
As per the ITL, any amount declared, distributed or paid by a domestic company by way of dividends (interim or otherwise) on or after 1 April 2003 shall be charged to additional income tax on distributed profits (i.e. DDT).

The Applicant sought an advance ruling on the taxability of the gains arising to Mau Co on the second buy-back of its shares under the Mauritius DTAA and on the tax withholding obligation in terms of the ITL.

Before the AAR, the Tax Authority contended that:

- The application was not maintainable before the AAR. It was barred by the provisions of the ITL as an identical issue in relation to taxability of the earlier buy-back (of 2008) was pending adjudication before the Tax Authority.
- The transaction was colorable, designed to avoid tax in India. The Tax Authority as well as courts are free not to accept them.
- After the introduction of DDT, the Applicant had not declared or paid dividend to any of its shareholders. Such a scheme of buy back was undertaken to avoid payment of DDT and to take the benefit of the Mauritius DTAA.
- The offers for buy back (in 2008 and 2010) were not accepted by US Co as well as Sing Co as the same could have triggered taxability in India under the respective DTAs.
- The ultimate parent of Mau Co is a US company and, accordingly, US DTAA should apply.

On the other hand, the Applicant urged that:

- Buy-back of shares was sanctioned by law and there was no justification in going behind the transaction or to question its motive or bonafides.
- It was for the Board of Directors of the company to decide whether dividend was to be paid or not and the decision taken was a bona fide and valid decision.
- Taking advantage of legal and permissible means to arrange one’s affairs cannot be characterized as a scheme of avoidance of tax.

Ruling of the AAR

- Though an identical issue was pending adjudication before the Tax Authority, the present application was maintainable since it related to a different transaction.
- Just because the ultimate parent is a US company it would not ipso facto label the transaction to be prima facie designed for avoidance of tax. One needs to identify if there exists a device or scheme for avoidance of tax.
- The transaction was designed primarily to avoid payment of tax in India as:
  - The Applicant had not declared or paid any dividend to its shareholders after introduction of DDT in the ITL in 2003. Instead of distributing the dividend on the basis of profits that accrued, the Applicant allowed the reserves to accumulate.
  - There was no proper explanation on the part of the Applicant as to why dividends were not declared subsequent to year 2003 when they were regularly making profits, where dividends were being distributed before the introduction of DDT.
  - The offer of buy-back was accepted only by Mau Co. It is significant to note that US Co did not accept the buy-back as it would have been taxable in India as capital gains under the US DTAA and Sing Co also did not accept the offer as its taxability would have depended on certain conditions being fulfilled under the Singapore DTAA.
- Therefore, the scheme of buy-back is a colorable device to avoid tax on distributed profits under the ITL and to take the benefit under the Mauritius DTAA.
- The definition of dividend under the ITL includes any distribution by a company of accumulated profits to its shareholders. The availability of exemption from tax under the Mauritius DTAA is only in respect of genuine buy-back of its shares. When the transaction is found to be colorable, it is not a transaction in the eyes of law. Once the transaction is ignored, the arrangement can only be treated as distribution of profits from the Applicant to Mau Co which would be taxable in India as ‘dividend’ under the ITL as well as Mauritius DTAA, subject to tax withholding in India.

Comments

In the present ruling, AAR has denied to give benefits of the Mauritius DTAA by regarding buy-back as a colorable device and treating it as distribution of dividends by Indian company subject to tax. The SC, in the case of Vodafone International Holdings BV[2], observed that the corporate business purpose of the transaction would be proof that the impugned transaction is not a colorable/artificial device and a business purpose must exist to overcome evidence of there being a tax device. Importance of demonstrating

[2] [341 ITR 1]
business purpose of a transaction is going to be a key test under the proposed General Anti-Avoidance rules to be enacted in the ITL.

A ruling by the AAR is binding only on the Applicant, in respect of transaction in relation to which the ruling is sought and on the Tax Authority, in respect of the Applicant and the said transaction. However, it does have persuasive value and the Courts in India, the Tax Authority and the appellate authorities do recognize the principles and ratio laid down by the AAR, in deciding comparable cases.
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