Mumbai Tribunal rules buyback transaction taxable as capital gains, exempt under India-Mauritius Tax Treaty; even if considered as dividend, tax withholding does not apply

Executive summary

This Tax Alert summarizes a recent ruling of the Mumbai Income Tax Appellate Tribunal (Tribunal) in the case of Goldman Sachs (India) Securities Pvt. Ltd. (Taxpayer)\(^1\). The Taxpayer is a wholly-owned Indian subsidiary of a Mauritian parent. The Taxpayer had undertaken a buyback transaction and remitted the proceeds to its only shareholder in Mauritius.

The Tax Authority regarded such buyback as capital reduction and the amount remitted as distribution of accumulated profit. This was taxed as dividend in the hands of the recipient Mauritian shareholder. As the Taxpayer had not paid Dividend Distribution Tax (DDT) or withheld any taxes on such payment\(^2\), the Taxpayer was treated as a taxpayer-in-default (TID). Furthermore, the transaction was considered as a colorable device having the objective of avoiding payment of DDT in India.

The Tribunal ruled that the amount remitted under the buyback transaction was taxable as capital gains. As the shareholder was a resident of Mauritius, such capital gains was exempt from taxation in India under Article 13 of the India-Mauritius Double Taxation Avoidance Agreement (DTAA). Even if the amounts were treated as dividend, it would have been subject to DDT in the hands of the Taxpayer under the Indian Tax Laws (ITL) and, hence, exempt in the hands of the shareholder. Thus, withholding provisions would not apply in such a case as well. The Tribunal held that the transaction of buyback is distinguishable from that of capital reduction. Furthermore, if a taxpayer enters into a transaction which does not violate any provision of the ITL, the transaction cannot be termed as a colorable device because it results in non-payment or lesser payment of taxes in that year.

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\(^{1}\) [TS-72-ITAT-2016(Mum)]

\(^{2}\) Considering that Article 10 of the India-Mauritius DTAA specifies a tax rate of 5% on gross payment on dividend payments.
Background and facts

The Taxpayer, an Indian resident company, is a wholly-owned subsidiary of a Mauritian company (Parent Co). The Taxpayer undertook a buyback on account of which shares of face value of INR10 per share were bought back at INR46.79 per share.

The Tax Authority considered the excess payment over face value value of share as distribution of accumulated profits to its only shareholder i.e., Parent Co and, hence, taxable as dividend. The Taxpayer did not pay DDT on such payment. It also did not withhold taxes on such payment. Therefore, the Tax Authority considered this buyback transaction as a colorable transaction to avoid payment of DDT. Accordingly, the Taxpayer was treated as a TID (i.e., assessed in lieu of Parent Co) and was held liable to pay tax at the rate of 5% on gross payment under Article 10 of the DTAA, plus applicable interest. Since the Taxpayer had not paid any taxes, interest was also levied for delay in withholding taxes.

Aggrieved, the Taxpayer preferred an appeal with the First Appellate Authority.

Key observations of the First Appellate Authority

It was noted that the Taxpayer had not distributed dividend in past years, despite having profits after tax. Also, the Board of Directors did not provide any justification for not recommending dividend.

By undertaking buyback, the Taxpayer had, in effect, remitted the accumulated profits to its sole shareholder, without paying DDT. A buyback transaction is normally contemplated for achieving consolidation of shareholding and change in value of holdings. Since, in this case, the Taxpayer had only a single shareholder, the buyback did not serve any commercial purpose. Accordingly, the First Appellate Authority stressed on the inclusive definition of dividend and stated that buyback transaction, in this case, should be brought under the scope of dividend and subjected to tax as deemed dividend.

The payment of dividend was given an artificial color of capital gains to enable evasion of taxes by taking the benefit of Article 13(5) of the DTAA, which provides for taxability in Mauritius and exemption in India. Basis the above, the First Appellate Authority brought the amounts remitted into the ambit of income by construing that such income arises from shareholding or participation of profits of subsidiary.

Since, on buyback, the share capital of the Taxpayer had reduced, such transaction was construed as capital reduction. Exemption from dividend on capital reduction could only be availed of on payment of DDT. Since the Taxpayer had defaulted in payment of DDT, the Taxpayer was a TID and was subject to interest on non-withholding of tax.

Being aggrieved, the Taxpayer filed further appeal to the Tribunal.

Taxpayer’s contentions

The transaction of buyback was different from that of capital reduction. As the Taxpayer had undertaken buyback in accordance with the provisions of the Companies Act, the remittance under buyback was not to be treated as dividend and, hence, should not be subjected to DDT. The Taxpayer contended non-taxability on the basis of the provisions of deemed dividend under the ITL, which was specifically amended w.e.f. 1 June 2001. This amendment specifically carved out any purchase of shares by an Indian company in accordance with the provisions of the Companies Act from being categorized...
as dividend. This was, accordingly, outside the gamut of DDT taxation.

Post amendment in the ITL, w.e.f. 1 June 2013, brought about by the Finance Act, 2013, where transaction of buyback was brought under the gamut of taxation, the burden of payment of taxes was still not shifted to the shareholders. The Tax Authority did not consider the amended provisions of the ITL, which specifically excluded the transaction of purchase of shares by a company from the definition of deemed dividend.

Thus, the amount remitted to the shareholder was not on account of reduction of capital. Hence, it should not be considered as dividend but as capital gains.

**Tribunal's ruling**

The Tribunal accepted the contentions of the Taxpayer and held as follows:

- Buyback of shares cannot be equated with capital reduction as they are two entirely different concepts. This is a finding on perusal of the provision of the Companies Act, that deals with capital reduction and buyback. This has also been discussed and so held in the Bombay High Court (HC) decision of Capgemini India Pvt. Ltd[3].

- On tax treatment of buyback of shares, the Finance Minister’s speech in 1999, that led to an amendment of the ITL and also the Circular[4] issued by the Central Board of Direct Taxes (CBDT), specifically states that shareholders would not be subjected to dividend tax but taxed under capital gains provisions.

- On account of the 2013 amendment, buyback transactions are subjected to DDT. However, as the transaction under consideration pertained to a period prior to this amendment, there is no ambiguity about the provisions that would govern taxability for buyback. Hence, the said transaction could not be regarded as deemed dividend. It should be subjected to tax as capital gains.

- Since Article 13 of the DTAA specifically exempts such transaction from tax in India, the Taxpayer is not liable to withhold tax under the ITL. Accordingly, the Taxpayer cannot be considered to be a TID. Even if the payment was considered as dividend, the requirement to pay DDT would make the payment exempt in the hands of the shareholder. Accordingly, withholding tax provisions should not apply.

- By placing reliance on the observations of the Bombay HC ruling of Capgemini (supra), the Tribunal ruled that if the Taxpayer entered into a transaction which did not violate any provision of the ITL, the transaction cannot be termed as a colorable device just because it results in non-payment or lesser payment of taxes in that particular year. The whole exercise should not lead to tax evasion. This is relevant. Non-payment of taxes by a taxpayer in certain circumstances could be a moral or an ethical issue. However, the taxpayer cannot be penalized for it.

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Comments

The Tribunal has held that the transaction of buyback is distinguishable from that of capital reduction. Furthermore, if a taxpayer enters into a transaction which does not violate any provision of the ITL, the transaction cannot be termed a colorable device just because it results in non-payment or lesser payment of taxes in that year.

Interestingly, one may recall the ruling\(^\text{(5)}\) of the Authority for Advance Rulings, which held that if the company does not distribute dividend but buys back its shares instead, it was to be regarded as dividend and subjected to withholding tax at the rate of 5% in terms of Article 10 of the DTAA.

\(^\text{(5)}\)Please click here to refer EY Tax Alert on the ruling
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