Indian AAR recharacterizes capital gains arising on buyback of shares as dividends

India’s Authority for Advance Rulings (AAR) issued a ruling on 22 March 2012 in which it denied the benefits of the India-Mauritius tax treaty for a share buyback by a Mauritius shareholder of an Indian company. The AAR invoked the “substance-over-form” doctrine to disregard the legal form of the buyback scheme and to treat it as a distribution of accumulated reserves. In effect, capital gains arising in the hands of the shareholders on the buyback of shares were recharacterized as dividends.

The taxation of cross-border transactions involving the transfer of shares of an Indian company to a Mauritius-based shareholder and the applicability of the India-Mauritius treaty has been a controversial and divisive issue for many years. Article 13(4) of the treaty provides that capital gains derived by an entity are taxable only in the state in which the recipient is resident. Thus, gains derived by a Mauritius company from the sale of shares in an Indian company are not taxable in India under the treaty. Such gains are not taxable in Mauritius either because Mauritius does not tax capital gains under its domestic law. Many investors in India have relied on the “Mauritius route,” and the Indian tax authorities have challenged exemption claims by Mauritius companies, resulting in the denial of treaty benefits on the grounds that the companies were not the beneficial owners of the shares and, therefore, not entitled to the exemption. In certain cases, the tax authorities have sought to deny treaty benefits on the grounds that treaty shopping is not permissible. Indian courts and the AAR, however, have allowed the exemption in most cases on the basis of the beneficial circular issued by the government and a favorable Supreme Court decision.

The new ruling is particularly significant because one of the benefits of investing into India through the Mauritius route is the ability to engage in a share buyback (redemption). Distributing profits through a share buyback can mitigate the Indian dividend distribution tax (DDT) of 16.22%, a levy payable by an Indian company on the declaration and payment of dividends.

Facts

In 2012, Otis Elevator Company (India) Ltd. (“Otis India”), an Indian company, proposed a scheme to buy back its shares from existing shareholders in accordance with the relevant provisions in the Indian Companies Act. Otis India had three majority shareholders, Otis Elevators USA, Otis (Mauritius) Limited and Otis Elevator Company (S) Pte Ltd, Singapore; an insignificant amount of the shares (1.76%) were held by the general public.

Of all the shareholders, only Otis Mauritius proposed to accept the buyback offer in return for cash consideration. Otis Mauritius, a tax resident of Mauritius, was incorporated in Mauritius in 2001 and had acquired the shares of Otis India in two tranches, during the years 2001 to 2005.

In light of the contemplated transaction, Otis India approached the AAR for an advance ruling on the following issues:

- The taxability of capital gains in the hands of Otis Mauritius, a tax resident of Mauritius, pursuant to the tendering of shares of Otis India under the buyback scheme in the context of the capital gains article (article 13) of the India-Mauritius tax treaty; and
- The withholding tax obligation of Otis India in the case of remittances of the buyback proceeds to Otis Mauritius.

The Indian tax authorities challenged Otis India’s eligibility to request a ruling, arguing that the facts and circumstances preclude a ruling by the AAR, specifically because Otis India had undertaken an identical buyback scheme in 2008 and this case was pending determination by a tax officer; and in any event, the proposed buyback scheme was designed to avoid the payment of tax in India. The AAR noted that the 2008 buyback scheme and the proposed buyback were similar in nature, but they involved two separate transactions, so there was no issue pending determination before the tax officer with respect to the proposed buyback scheme. The AAR allowed the ruling application by Otis India, but qualified its decision by stating that the AAR may examine the tax avoidance aspect at a later stage if the circumstances so warrant.

Arguments of the parties

At the hearing, the tax authorities again contended that the proposed buyback scheme was a transaction designed to avoid the payment of tax in India. The authorities explained that the declaration and payment of dividends in the normal course by Otis India would have given rise to liability to DDT. However, rather than distribute dividends, the company had allowed
reserves to accumulate, and now Otis India was attempting to distribute the accumulated reserves to its shareholders without attracting DDT by camouflaging the distribution as a buyback scheme.

The tax authorities pointed out that, before the introduction of DDT in 2003, Otis India had a history of declaring and paying dividends to its shareholders. However, after the introduction of DDT, the company refrained from declaring, distributing or paying dividends and allowed its accumulated reserves to grow substantially. Thus, Otis India now was attempting by way of the proposed buyback scheme to distribute the accumulated reserves to Otis Mauritius without paying any tax in India.

In this context, the authorities emphasized that Otis Mauritius was the only one of Otis India’s major shareholders that accepted either buyback offer, and this was because capital gains derived by Otis Mauritius would not be taxable in India under article 13 of the India-Mauritius tax treaty. The buyback offer was not accepted by the other major shareholders because that would lead to capital gains being taxed in their hands. The Indian tax authorities implied that this fact cast more doubt on the credibility of the buyback scheme and the actual motives for the transaction. The public shareholding was 1.76%, which was insignificant and would not have a bearing even if someone from general public had accepted the buyback offer.

The tax authorities also tried to argue that the place of management of Otis Mauritius was where the ultimate holding company, United Technologies Corporation, was located (United Technologies is incorporated in Delaware in the U.S.). In this context, the authorities contended that the control and management of Otis Mauritius was in the U.S., so the India-U.S. tax treaty, rather than the India-Mauritius treaty, should be applicable to the proposed buyback transaction.

Relying on jurisprudence, the tax authorities contended that both it and the courts were free to disregard the legal form of the proposed buyback transaction because the scheme had been devised as a “colorable” transaction to avoid tax. In effect, the tax authorities urged the AAR to apply judicial anti-avoidance principles to ignore the legal form of the proposed buyback scheme and thereby to treat the distribution as a dividend for tax purposes.

The taxpayer, on the other hand, argued that the buyback of shares is sanctioned by law and there is no justification in going behind the transaction or questioning the motive for the transaction or its bona fides. The board of directors of Otis India was free to decide on whether a dividend is to be paid, and the board’s decision is bona fide and valid. According to the taxpayer, taking advantage of legal and permissible means to arrange one’s affairs could not be characterized as a scheme for the avoidance of tax.

AAR ruling

Based on the facts and circumstances, the AAR agreed with the tax authorities and concluded that the proposed buyback scheme was devised for tax avoidance purposes.

The declaration and payment of dividends in the normal course by Otis India would have meant that it would have had to pay DDT. Instead of distributing dividends, Otis India had allowed reserves to accumulate. In effect, the company had devised a buyback scheme to transfer the reserves to its Mauritius shareholders without attracting DDT. In the context of DDT, Otis India was unable to offer a reasonable explanation as to why it discontinued declaring dividends after the introduction of DDT even though it continued to be profit-making.

The AAR also found it significant that the other major shareholders of Otis India (i.e. Otis USA and Otis Singapore) did not accept the buyback offer because of the adverse tax implications – they both would have been liable to capital gains tax in India. Otis Mauritius, on the other hand, accepted the offer because the capital gains would not be taxable in its hands under the India-Mauritius treaty. Thus, if the buyback scheme went through, the buyback proceeds would be remitted to Mauritius without any tax having been paid in India.

In light of the above, AAR concluded that the buyback scheme was a tax avoidance mechanism. It accordingly ignored the legal form of the buyback and treated it as a distribution of dividends for tax purposes. Hence, the buyback proceeds under the proposed scheme were to be characterized as dividends in the hands of the shareholder, Otis Mauritius, which would be taxable in India under article 10 of the India-Mauritius tax treaty. Otis India, therefore, would be under an obligation to withhold tax on payments to Otis Mauritius.
Conclusion

This ruling highlights the determination of the Indian tax authorities to block attempts at treaty shopping, albeit in an indirect manner. Although India did not have a general anti-avoidance rule (GAAR) when the transaction took place, the tax authorities had argued that the transaction was an attempt at tax avoidance and should be termed “colorable.” The AAR’s recharacterization of capital gains as dividends is the first of its kind and seeks to ignore the very form of the transaction. This is a last ditch attempt to tax a transaction that otherwise would have escaped the Indian tax net due to the Mauritius tax treaty. India’s Finance Bill 2012 has proposed to introduce a GAAR to codify the substance-over-form doctrine. With a GAAR in its arsenal, the tax authorities will be fortified in their efforts to squash all attempts at tax planning.

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