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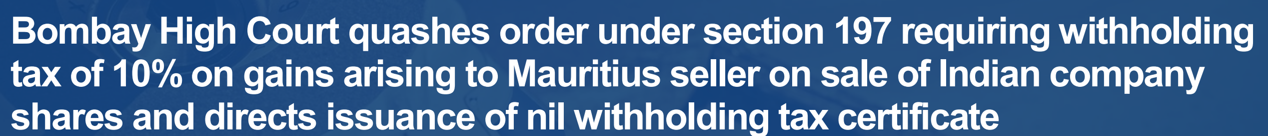

Bombay High Court quashes order under section 197 requiring withholding tax of 10% on gains arising to Mauritius seller on sale of Indian company shares and directs issuance of nil withholding tax certificate

Summary

The assessee, Indostar Capital, a company incorporated in Mauritius and holding a Tax Residency Certificate ('TRC') of Mauritius had proposed to sell shares held in an Indian company. It applied for a Nil withholding tax certificate under section 197 of the Income-Tax Act, 1961 ('the Act') on the basis that capital gains arising on the aforesaid sale would not be taxable in India as per the India Mauritius Tax Treaty. The Assessing Officer denied such exemption and directed the payer to withhold and deposit taxes @ 10% on the capital gains amount before making any remittance outside India. Accordingly, the payer withheld and deposited the aforesaid taxes with the Government.

The assessee challenged the aforesaid order by filing a writ before the Bombay High Court[1] ('the High Court'). On hearing the writ, the High Court ruled in favour of the assessee by quashing order passed under section 197 of the Act and directed issuance of a Nil withholding tax certificate. Further, it also directed the income-tax authorities to refund the withholding taxes deposited along with applicable interest, directly to the Mauritius assessee.

Background

- The assessee, a private limited company incorporated in Mauritius, held a Category 1 Global Business Licence issued by the Financial Services Commission, Mauritius to act as an investment holding company. Further, the assessee had also been issued a TRC by the Mauritius Revenue Authority.

- The assessee was formed to promote an Indian Non-banking Financial Company, Indostar Capital Finance Limited ('India Co'). The assessee had raised capital from various groups of international institutional investors located across the world to invest in

[1] Writ Petition No. 3296 of 2018 (Bom.)

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the India Co. In a span of 4 years from 31 March 2011 to 17 August 2015, the assessee acquired shares in India Co in various tranches.

- The assessee decided to sell a portion of its shareholding in India Co at the time of India Co's IPO which resulted in capital gains. Accordingly, since the assessee was a tax resident of Mauritius, it filed an application under section 197 of the Act for grant of 'Nil' withholding tax certificate on the basis that capital gains arising on the said transfer of India Co's shares was not taxable in India under Article 13(4A) of the India Mauritius Tax Treaty. For this purpose, the assessee submitted several documents such as its corporate structure, source of funding for acquisition of India Co's shares, TRC etc.

- The Assessing Officer rejected the application of the assessee stating that the entire structure was created to avoid legitimate tax liability and passed an order under section 197 directing the payer to withhold taxes @ 10% on capital gains before remitting sales consideration to the assessee. The Assessing Officer's allegations for rejection of the section 197 application were as under:

    - The assessee was not engaged in any other business or commercial activities, apart from investing in India Co and advancing loan to another company.
    - The assessee neither maintained any establishment nor incurred any administrative expenses in Mauritius.
    - The exercise of directorship functions by the assessee was not clear.
    - The assessee had no employees in Mauritius.
    - The assessee failed to furnish TRCs of its shareholders and details of its ultimate beneficiaries

- Aggrieved by the section 197 order ('impugned order') passed by the Assessing Officer, the assessee filed a writ petition before the High Court challenging such impugned order.

Assessee's arguments

The key arguments advanced by the assessee against the impugned order were as follows:

- The assessee, being a Mauritius based company, in terms of the India Mauritius Tax Treaty, it had no tax liability on capital gains arising out of sale of shares in question. Once this is established, there cannot be any direction for deduction of tax at source while remitting the sale proceeds of such shares.

- It was a duly incorporated company under the laws of Mauritius and held a valid TRC issued by Mauritian Authority. It would be contrary to the settled principles of law as well as circulars issued by Central Board and Direct Taxes ('CBDT') to go beyond the TRC and deny the tax residency status of the assessee in Mauritius.

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- The Assessing Officer carried out a detailed inquiry which is not envisaged at the stage of deciding an application for issuance of certificate under section 197 of the Act. The assessment can always be carried out with full investigation. However, at the stage of deciding whether the certificate under section 197 of the Act should be issued, the Assessing Officer cannot conduct a full-fledged investigation. To withhold a substantial portion out of the sales proceeds till the assessment is complete would be wholly unjust.

- The prima facie finding of the transactions not being genuine was not supported by any material on record. All the transactions were reported to respective statutory authorities and there is no evidence to establish the allegation of sham or bogus transaction.

Revenue's arguments

The key arguments advanced by the Revenue were as follows:

- Once it is prima facie shown that the transaction is not genuine, the assessee must participate in the assessment proceedings and only if the assessee succeeds in such assessment, the amount deducted by way of tax at source can be refunded. At the stage of passing the order under section 197 of the Act, there was sufficient material to enable the Assessing Officer to reject the application.

- The assessee is not a genuine Mauritius based company and as recorded by the Assessing Officer in the impugned order, various factors emerging from the record would establish that the entire transaction is non-genuine.

- The Assessing Officer has applied the tests laid down by the Supreme Court in case of *Vodafone International Holdings B.V.* v. *Union of India*[2] to come to such conclusion which is fully supported by the evidence on record.

- The assessee also has an alternate remedy against the impugned order which can be challenged under section 264 of the Act. In the alternative, the Assessee can also file return of income and claim refund if it succeeds in establishing that it has no tax liability.

Ruling of the High Court

The High Court ruled in favour of the assessee by quashing the impugned order under section 197 of the Act. It also directed the Assessing Officer to issue a nil withholding tax certificate and refund the taxes already deducted by the payer along with interest in accordance with the law subject to certain caveats like provision of security for the tax amount so refunded until completion of assessment.

The key observations of the High Court in arriving at this conclusion were as follows:

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[2] [2012] 341 ITR 1

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- The Hight Court relied upon the decisions in the case of Serco BPO (P) Ltd[3] and Vodafone International Holdings B.V. (supra) as well as the CBDT circular[4] dated 13 April 2000 to hold that if a TRC is available, it would prima facie appear that the capital gains arising out of sale of shares shall not be taxable in India as per the India Mauritius Tax Treaty. However, it observed that, despite existence of the TRC and CBDT Circular, the income-tax authorities might still have a case to make when it comes to a fraudulent or fictitious transaction.

- If the Assessing Officer has sufficient prima facie evidence to demonstrate that the entire transaction from inception was sham/ colourable device/ bogus transaction meant to avoid tax, the Assessing Officer could refuse to issue a certificate under section 197 of the Act. However, in the instant case, the material at disposal of the Assessing Officer fell short of this requirement.

- The High Court also summarized its position on the principle factors which formed the basis for the Assessing Officer to deny Treaty benefits in his order:

  - The mere fact that the assessee has not transacted any other business by itself may not be conclusive.
  - The reference to the assessee being unable to produce TRC of the companies which hold shares in the assessee is erroneous, were in fact were produced before the Assessing Officer.
  - While it is correct that mere transfer of money though banking channels would not be conclusive, the same cannot be a ground against the assessee unless there is adverse material available.
  - The extent of administrative expenditure and the employment structure may be some of the factors which eventually would go to establish whether the transaction was sham and the very existence of the assessee was fraudulent. However, these factors by themselves may not be sufficient.

- All the aforesaid aspects can and need to be gone into in the assessment proceedings.

Further, as a preamble to its above analysis, the High Court also stated that its observations would be prima facie in nature and as such would not prejudice the assessee or the Revenue in the course of assessment proceedings.

Dhruva Comments

In transactions involving sale of shares, where capital gain is claimed to be exempt pursuant to a tax treaty (for e.g. Mauritius or Singapore), the buyers/ sellers, including Private Equity players often explore the option of obtaining a Nil withholding tax certificate under section

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[3] *Serco BPO (P) Ltd* v. *Authority for Advance Rulings* [2015] 379 ITR 256 (Punjab & Haryana)
[4] Circular No. 789 dated 13-4-2000

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197 of the Act. This is because obtaining such a certificate provides certainty to both the buyer and seller vis-à-vis withholding tax obligations.

However, the Indian tax authorities have been increasingly scrutinizing claims involving grant of Treaty benefits under the 197 route.

The High Court decision is a welcome development since it has made an important observation that at the 197 application stage, in a genuine transaction, if the TRC is available, the Assessing Officer could not deny granting of a Nil withholding tax certificate under section 197 of the Act. The Assessing Officer can get into a detailed evaluation at the time of assessment which is not warranted at the 197 application stage.

Further, this is also the first case, wherein the High Court has directed the income-tax authorities to refund the amount of taxes which was already deducted and deposited with the Government along with interest to the assessee.

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