

## Tax Hotline

May 17, 2019

### BOMBAY HIGH COURT QUASHES 197 ORDER REJECTING MAURITIUS TAX TREATY BENEFITS

- High Court sets aside section 197 order due to absence of prima facie evidence of tax avoidance
- Rejects factors such as lack of business activities and administrative expenses as conclusive of sham transactions
- Holds that a detailed inquiry can be conducted during normal assessment
- Directs refund of withheld tax subject to conditions for maintaining security

Recently, in *Indostar Capital vs. ACIT*<sup>1</sup>, the High Court of Bombay set aside an order passed by the Indian tax authorities under section 197 of the Income Tax Act, 1961 (“ITA”), which denied benefits under the India – Mauritius Double Taxation Avoidance Agreement (“Mauritius Treaty”) to a Mauritius company which was selling shares of an Indian company under an IPO, on the grounds that the concerned transaction was a sham and colorable device to avoid tax. In doing so, the Court established that for the purpose of issuing a nil or lower withholding tax certificate (under section 197 of the ITA) (“197 Certificate”), the tax authorities are not required to conduct a detailed enquiry, and if there was no prima facie evidence demonstrating that the transaction was a sham from its very inception, the tax authorities could not reject the application.

#### BACKGROUND

Indostar Capital (“the Taxpayer”) is a private limited company incorporated in Mauritius. The Taxpayer held a Category 1 Global Business License and a Tax Residency Certificate (“TRC”) issued by the Mauritian authorities. It was incorporated as an investment holding company to promote an Indian company named Indostar Capital Finance Limited (“IFCL”), and had raised capital from various investors across the globe between 2011 and 2015 to acquire approx. 97.3% of the total share capital of ICFL. In 2018, the Taxpayer proposed to dispose of approx. 1.85 crores of the IFCL shares for a total consideration of INR 1058.68 crores through an IPO.

Under section 195 of the ITA, tax is required to be withheld at source on payments made to a non-resident (such as the Taxpayer) if they are chargeable to tax in India, and section 197 of the ITA permits an AO to issue a certificate allowing for non-deduction of such tax or deduction at lower rates in appropriate cases.

Thus, the Taxpayer made an application to its jurisdictional Assessing Officer (“AO”) in India for a 197 Certificate on the basis that no tax would be payable in India on the gains derived by it from the sale of IFCL shares due to applicability of Article 13 of the Mauritius Treaty, and in the absence of any income chargeable to tax, there could be no withholding tax.

The AO rejected the application of the taxpayer for nil withholding and instead passed an order requiring the taxpayer to deduct tax at 7.73% on the entire amount, on the ground that the entire transaction was not genuine and was a colorable device created to avoid tax liability, thereby denying Mauritius Treaty benefits. The AO based his reasoning on the fact that the Taxpayer had not carried out any other business transactions or commercial activities in Mauritius, had not maintained an establishment nor had incurred administrative expenses in Mauritius, and had failed to produce TRCs of its ultimate beneficiaries.

Aggrieved by the order of the AO, the Taxpayer filed a writ petition in the Bombay High Court. The High Court accepted the Taxpayer’s contentions, quashed the order and directed the tax authorities to release the withheld payment to the Taxpayer subject to certain conditions.

#### DECISION OF THE HIGH COURT

At the outset, the High Court settled that the proceedings under section 197 of the ITA could not conclusively decide the taxability of the receipts in the hands of the payee. Despite issuing a nil withholding certificate, the tax authorities could nonetheless tax the income in the regular assessment proceedings and conversely if a 197 Certificate was not granted the taxpayer could still contest the taxability of the income in the normal assessment.

Therefore, the court accepted the Taxpayer’s contention that at the stage of deciding whether a 197 Certificate should be issued, a detailed inquiry is not required and if the Taxpayer prima facie proved its case, the tax authorities could not deny the 197 Certificate.

Thereafter, the High Court confirmed that it would prima facie appear that gains arising to the taxpayer on sale of IFCL shares was not taxable in India. The court reached this conclusion on a reading of Article 13, paragraph 4 of the treaty which states that gains arising to a Mauritius resident from the sale of shares of an Indian company acquired on or before 31.03.2017 would only be taxable in Mauritius and not in India under the Mauritius Treaty. It followed Circular 789 of 2000 (the “Circular”) issued by the Central Board of Direct Taxes, to state that the TRC would be sufficient proof of residency in Mauritius as well as for beneficial ownership of shares for obtaining treaty benefits,

## Research Papers

### Little International Guide (India) 2024

November 08, 2024

### Unmasking Deepfakes

October 25, 2024

### Are we ready for Designer Babies

October 24, 2024

## Research Articles

### The Bitcoin Effect

November 14, 2024

### Acquirers Beware: Indian Merger Control Regime Revamped!

September 15, 2024

### Navigating the Boom: Rise of M&A in Healthcare

August 23, 2024

## Audio

### Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

### Renewable Roadmap: Budget 2024 and Beyond - Part I

August 26, 2024

### Renewable Roadmap: Budget 2024 and Beyond - Part II

August 26, 2024

## NDA Connect

Connect with us at events, conferences and seminars.

## NDA Hotline

Click here to view Hotline archives.

## Video

### “Investment return is not enough” Nishith Desai with Nikunj Dalmia (ET Now) at FI8 event in Riyadh

October 31, 2024

### Analysing SEBI's Consultation Paper on Simplification of registration for FPIs

September 26, 2024

which is a position indisputably settled by the Supreme Court in *Union of India vs Azadi Bachao Andolan*<sup>2</sup> (“*Azadi Bachao Andolan*”).

On the question of genuineness of the transaction, the Court stated that the AO could reject the application under section 197 only if he could prima facie demonstrate that the entire transaction right from its inception was a sham and a colorable device created simply to avoid tax. For this it relied on the decision of the Supreme Court in *Vodafone International Holdings B.V. vs Union of India*<sup>3</sup> (“*Vodafone*”) which has settled that tax authorities cannot go behind a genuine transaction to bring out a supposed underlying substance of tax avoidance, but this did not override the power of the tax authorities to question and discard the transaction if it was fraudulent or fictitious.

However, the Court observed that merely because the Taxpayer had not transacted any other business, had no administrative expenditure or employment structure, it would not be sufficient by itself to create a prima facie case of a fraudulent transaction, although such factors may be used to establish that the transaction was a sham in the assessment proceedings. Thus, the Court quashed the order and directed the withheld tax to be returned. However, the Court recognized the difficulty to recover tax from non-residents if it was determined payable in the normal assessment and thus ruled that the withheld amount should not be released without adequate protection of recovery. To this end, the Court directed the taxpayer to (i) maintain shareholding in the Indian company equivalent to 200% of the disputed tax amount as security against potential future tax liability until 31.12.2021 (i.e., until the extended date for completion of assessment proceedings for the relevant tax year); and (ii) immediately inform the tax authorities if the value of the maintained shareholding dropped below 125% of the disputed tax amount, and provide additional security to the extent of shortfall below 200% to the satisfaction of the tax authorities.

## ANALYSIS

Importantly, the High Court's order brings greater clarity on the scope of a 197 Certificate, and the parameters that the tax authorities should keep in mind for issuing such orders. The High Court has confirmed that only a preliminary examination of the genuineness of the transaction and the taxability needs to be done for granting a 197 Certificate.

This becomes especially important since tax authorities may reject applications without sufficient basis, even where a prima facie case has been made out by the applicant. Nil withholding certificates become even more relevant in the case of M&A transactions, wherein to protect interests of the buyer (or payor), detailed tax indemnity clauses and / or insurance with high premiums are typically sought. If respected and implemented well, 197 Certificates may become more common in M&A deals, and this decision would help bring relief and clarity on how withholding tax liabilities can be addressed in cross border transactions.

On the other hand, High Court has recognized the need to secure interests of the tax department and has posed conditions on the payee. While these conditions such as the requirement for the taxpayer to maintain shareholding in the Indian company equivalent to 200% of the disputed tax amount as security against potential future tax liability may be considered somewhat onerous and commercially unfeasible, it relieves the buyer/ payor of its liability on account of non-withholding, and rightly shifts the burden back on the taxpayer (who has the primary tax liability). This is helpful from the buyer's perspective, considering that in cases such as *Vodafone*, it is the payor / buyer against whom tax demands have been raised for non-withholding, despite it not being its primary liability.

With respect to applicability of treaty relief, the decision of the High Court clarifies the current validity of the Circular by accepting that the TRC would be sufficient proof for determining the status of residence in case of Mauritius residents, which is a settled position.<sup>4</sup> However, the High Court has reiterated the caveat that a valid TRC does not prevent the tax authorities from conducting an inquiry in cases where non-genuineness of the transaction can be established. These aspects have been considered by Indian courts in the past. While in some of these cases the courts have relied on *Azadi Bachao Andolan* and upheld the applicability of treaty benefits<sup>5</sup>, there have been a couple of cases where treaty benefits have been denied.<sup>6</sup> In this backdrop, the decision of the High Court in the present case is welcome in as much as it lays down that factors such as the lack of business or commercial transactions, administrative expenses and employment structure cannot be final and conclusive to establish that a transaction is not genuine for denying treaty benefits. The High Court concludes that while these factors may assist in arriving at a conclusion during normal assessment when a detailed inquiry is made, they cannot be considered sufficient by themselves and the tax authorities would need other material to demonstrate that the entire transaction is a sham to solely avoid tax.

Another interesting question which comes up is regarding the maintainability of the writ petition itself. An argument raised by the tax authorities to challenge the writ petition was that the taxpayer had alternate remedies in the form of revision of the impugned order under section 264 of the ITA, or the filing of a return of income and claiming a refund. The Delhi High Court has dismissed a writ petition filed against a 197 Certificate on this basis by stating that an alternate remedy by way of revision was available to the taxpayer.<sup>7</sup> While this remains the established principle, there have been instances in similar situations where courts have however allowed writ petitions against 197 Certificates even where an alternate remedy in the form of revision was available, based on specific facts and circumstances of the case.<sup>8</sup> The fact that the High Court in the present case did not even address this argument and proceeded to decide the issue on merits, raises the question whether the Bombay High Court has impliedly relaxed the rule for admissibility of petitions challenging 197 Certificates. Therefore, while a challenge to the maintainability of writ petitions in such situations should be expected from the tax authorities, this decision of the High Court may potentially be used as an argument against such a challenge.

– Anuja Maniar & Shipra Padhi

You can direct your queries or comments to the authors

<sup>1</sup> WRIT PETITION NO. 3296 OF 2018, Bombay High Court

<sup>2</sup> [2003] 263 IT 707 (SC)

<sup>3</sup> [2012] 341 ITR 1 (SC)

<sup>4</sup> *Serco BPO (P) Ltd. v. AAR* [2015] 60 taxmann.com 433 (Punjab & Haryana); *DDIT v. Saraswati Holdings Corporation* [2009] 111 TTJ 334; *D.B. Zwim Mauritius Trading* [2011] 333 ITR 32 (AAR); *In Re: Ardex Investments Mauritius Ltd.* [2012] 340 ITR 272 (AAR); *In Re. Castleton Investment Ltd.* [2012] 348 ITR 537 (AAR); *In re, Mahindra BT Investment Company (Mauritius) Limited* AAR No. 991 of 2010; *In re, E\*Trade Mauritius Limited* [2010] 324 ITR 1 (AAR); *In re, Dynamic India Fund* [2012] 209 Taxman 417 (AAR – New Delhi);

<sup>5</sup> *In Re: Ardex Investments Mauritius Ltd.* [2012] 340 ITR 272 (AAR); *In re, Mahindra BT Investment Company (Mauritius) Limited* AAR No. 991 of 2010; *In re, E\*Trade Mauritius Limited* [2010] 324 ITR 1 (AAR)

<sup>6</sup> *Aditya Birla Nuovo Ltd. v. DDIT* [2011] 242 CTR 561; "*AB*" *Mauritius, In re* [2018] 90 taxmann.com 182 (AAR - NewDelhi)

<sup>7</sup> *Sis Live v. ITO* (2011) 333 ITR 13 (Del)

<sup>8</sup> *Tata Teleservices (Maharashtra) Ltd v. DCIT* [2018] 90 taxmann.com 1 (Bombay); *McKinsey & Co. Inc. v. Union of India* [2010] 193 taxman 47 (Bombay); *Serco BPO Pvt. Ltd. v. ACIT* [2012] 253 CTR (P&H) 410; *Vodafone Cellular Ltd. v. ACIT (TDS)* [2014] 42 taxmann.com 459 (Karnataka)

---

## DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.