Surana & Surana National Corporate Law
Moot Court Competition
JSS Law College, Mysore
13 – 15 February 2015

BEFORE THE AUTHORITY FOR ADVANCE RULINGS

(INCOME TAX)

NEW DELHI

February 2015

AAR No. 100 of 2015

Name of the Applicant: Intaxicate India Pvt. Ltd., Bangalore

Name of the Respondent: Commissioner of Income-tax, Bangalore

1. Intaxicate India Pvt. Ltd. (IIPL or the Company or the taxpayer) is a private limited company incorporated as per the Indian Companies Act, 1956 in the year April 2000 having its registered office in Bangalore, India. The company, among other activities, is into financial services business such as investment in the securities of various information technology, real estate and other lucrative sector companies.

2. IIPL is a 100% subsidiary of a Mauritian company (barring one nominee member/ director situated in India as required under the Companies Act, 1956), namely, Intaxicate Mauritius Ltd. (IML) which is a Category 1 Global Business License holding company with Tax Residency Certificate (TRC) issued by the Mauritian Tax Authorities. IML acts as a pooling vehicle where it attracts investors from across the globe to invest in its securities. The predominant investors in IML are from United States. IML in turn invests in the securities (shares and debentures) of IIPL which in turn invests in various sectors (especially through stock exchanges) as mentioned above which also includes, of late, infrastructure and related companies, funds, etc. given the various sops especially tax sops provided by the Government of India for investors in infrastructure and related activities.

3. IIPL was a successful company with huge profits every year due to its calculated and well informed investment strategy. IIPL was a prompt taxpayer on its income earned. In the initial years, IIPL used to declare huge cash dividends to its sole shareholder i.e. IML. Cash dividends were declared from 2000 to March 2003. IIPL promptly withheld appropriate taxes on all the dividends it paid as per India – Mauritius tax treaty. However, as a strategy, IIPL stopped declaring any cash dividends post March 2003. The company issued millions of equity shares to IML being its sole shareholder at a meager face value, and then bought them back at a very high

premium. Such huge premiums were paid out of the current and accumulated profits the company had through its operations in India. It so happened that by paying huge premiums in the process of buyback, IIPL was able to repatriate excess profits it had to its parent company i.e. IML by way of huge capital gains to IML on the sale of shares to IIPL. IIPL also needed fresh investments year on year for investments in the securities of the Indian companies as the Indian markets just started doing well in 2003 and was catching up in a big way.

4. Every year IIPL was issuing several million shares to its parent company and then bought back at huge premiums which resulted in profit repatriation in a very tax efficient manner. Such arrangement continued till May 2013 i.e. buying back of shares at huge premiums. However, again, as a commercial strategy, IIPL stopped issuing equity shares and buying them back at premiums. Instead, the company started to issue compulsorily convertible debentures (CCDs) to IML. These CCDs were issued with lock-in period, say, five years. Post completion of the lock-in period, the parent company i.e. IML had the option of converting them into equity shares. CCDs were issued keeping in mind certain corporate aspects also, such as, the parent company, IML, had the option to sell these CCDs to third parties (Joint Venture partners-to-be, if they may be called so) in order to expand the Indian company's operations by JV participation and to open up for larger gamut of investments. The third parties will be interested to buy the CCDs as they will get equity stake in IIPL post the lock-in period by exercising their rights for issuance of equity shares for every CCD they hold. As far as IML was concerned, it had 100% control over IIPL until such third parties entered.

5. *Among other things*, the relevant terms of issuance of the CCDs were:

   - Both IIPL and IML had the right *to buy* and *to sell*, respectively, the CCDs anytime during or after the lock-in period;
   - IIPL may or may not pay fixed rate of returns to the CCD holders during the lock-in period. If IIPL does not pay the interests periodically, then such returns may be paid as accumulated rate of returns;
   - If IIPL intends to buyback these CCDs, one of the ways to arrive at the sale consideration will be the payment of accumulated fixed rate of returns on the CCDs and may include premiums. In the sense, the sale consideration to be paid by IIPL to purchase such CCDs could be accumulated interests over the years and such premiums as may be determined by IIPL; and
   - If IIPL is to redeem the debentures at a much early period i.e. less than a year's time from the date of issue of CCDs, then IIPL in addition to the principal payment, accumulated interests and premiums, is also required to pay huge additional sum *by whatever named called* such as compensation, penalty, additional premiums, additional sale consideration, etc.

6. In March 2014, IIPL bought back much of the CCDs issued to IML and paid the principal amount (i.e. the initial investment amount by IML), accumulated interests and premiums. Further, because the redemption of the debentures happened within a year's time, IIPL in addition to paying the above amounts paid a huge one time premium/ sale consideration/ compensation to IML since such money could have been invested elsewhere by IML in a more profitable manner and for a longer duration. Just to understand the total amount paid by IIPL to IML in March 2014, IIPL ended up paying the same amount in the name of accumulated interests, premiums, etc. on redemption of debentures as it was paying as premiums for buyback of equity shares in the past 10 years.

7. Meanwhile, IIPL filed its return of income (ROI) for Assessment Year (AY) 2014-15 with the Indian income-tax department (ITD or Revenue) within the due date. The ITD randomly scrutinized the company's ROI and was surprised to know that IIPL had not withheld tax on any interest payments made to its parent company in Mauritius. The ITD immediately issued a show cause notice (SCN) under section 201 of the Income-tax Act, 1961 (the Act) to IIPL to have failed to withhold tax under section 195 of the Act on the interest payments made to IML. In short, the SCN alleged that the entire payment made (other than the principal repayment) by IIPL to IML on the redemption of the CCDs is nothing but interest payments and therefore, taxes should have been withheld by IIPL as per the Act since there is no beneficial tax treatment on interest payments as per the India-Mauritius Double Tax Avoidance Agreement (DTAA). The SCN also alleged that the buyback of shares for the past 10 years at huge premiums was nothing but repatriation of profits which is dividends in the name of capital gains to IML and therefore, dividend distribution tax (DDT) should have been paid by the Indian company. Hence, the Indian company was called for to pay the withholding taxes (WHT), interest and 100% penalty on the interest payments made in March 2014 and to pay DDT from April 2003 to May 2013 with interests and penalties, again at, 100%. The total amount to be paid by the Indian company as per the notice ran into several hundred crores.

8. IIPL instead of replying to the said notice filed an application with the Authority for Advanced Ruling (AAR) requesting for a ruling on the transactions undertaken and to be undertaken (i.e. buyback of shares and redemption of CCDs) that they were only sale of capital assets (equity shares and CCDs) by IML and therefore, should be taxable only as per India-Mauritius DTAA. Further, IIPL alternatively argued that payments made for redemption of CCDs should be treated as capital receipts in the hands of IML. Further, the additional payments made were more like a compensation rather than interest payment. Since the compensation substitutes the source of income itself for IML, it is to be treated as capital receipt and therefore, not liable to tax in the hands of the recipient and consequently, not liable to any WHT under the Act or any DTAA.

IIPL also argued before AAR that merely because the sale consideration makes a reference to fixed rate of return as an index for arriving at the sale consideration, the payments cannot be treated as interest payments. IIPL also stated that there is tax neutrality even if such payments are treated as interest as it can claim deduction on them against its business income. It also argued that treating the sale consideration on buyback of shares as dividends is against the basic principle of corporate laws and relied on the definition of 'dividends'. Further, SCN cannot be issued for failure of payment of DDT and that any proceeding in this regard is time barred. It further stressed that in all the transactions since its inception, there were some corporate strategies involved as well.

9. The Revenue or ITD on the other hand argued that the application before the AAR was *ab initio* not maintainable as the Assessee-in-Default (AID) proceedings have already been initiated by issuing SCN and that no remedy lies before this forum. Further, the taxpayer (IIPL) is a resident and that AAR should maintain applications filed only by nonresidents as per the Act. On merits, the revenue argued that the entire transaction of the taxpayer from the beginning was sham as it was changing its nature of transactions as and when the Indian income-tax laws were changing only to avoid Indian taxes. In the sense, in the beginning it paid cash dividends as the rate of WHT as per the India-Mauritius DTAA was less. Since DDT was introduced in 2003, the taxpayer stopped declaring cash dividends rather resorted to buyback of shares. Once when buyback distribution tax (BBDT) was introduced in 2013, the taxpayer has now resorted to other tax evasion methods like issue of CCDs and then buys them back at extraordinary redemption premiums under various names to avoid WHT. The payments made by the taxpayer are primarily interest in nature as far as CCDs are concerned as the consideration is determinant on the fixed rate of returns which is nothing but interest payments. Also, the definition of 'interest' is very wide both under the Act and under the India-Mauritius DTAA to include 'premiums'. The compensation is nothing but a tax evasion tool and the entire redemption of CCDs before the maturity date/ lock-in period was to unnecessarily pay these huge compensations and to avoid Indian WHT liabilities. The revenue stated that there is no tax neutrality as claimed by the taxpayer as much of its income was tax exempt. As far as buyback of shares is concerned, the revenue argued it was to avoid DDT and the capital gains on buyback should be treated as dividends and subject to DDT. On the other hand, IIPL argued that the revenue cannot interfere with the commercial expediencies of the taxpayers and the issue of equity shares/ CCDs was for commercial reasons.

10. The matter is now pending before the AAR for final hearing on all aspects. The AAR gave liberty to the parties to frame such issues as per the facts and circumstances of the case.