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Bombay HC dismissing impugned order passed under section 197 of the AO

Bombay High Court dismisses the impugned order passed by the Assessing Officer under section 197 of the Income tax Act, 1961, by holding that the Assessing Officer did not have sufficient material on record to demonstrate that the transaction was designed for avoidance of tax.

Brief facts of the case:

- Indostar Capital (Taxpayer), a Mauritius based company, had acquired 7.13 crore shares of Indostar Capital Finance Limited (ICFL), comprising 97.3 percent of its share capital during the period March 2011 to August 2015.
- The Taxpayer desired to transfer 1.85 crore shares of ICFL through an initial public offering and in this regard, made an application before the Assessing Officer (AO) for obtaining a certificate under section 197 of the Income-tax Act, 1961 (the Act), confirming non-deduction of taxes by the payer. Several documents including copy of Tax Residency Certificate (TRC) was submitted along with the application.
- Pursuant to carrying out a detailed inquiry on the subject transaction, the AO rejected the application and passed an order directing the payer to withhold taxes at a specified rate, from the sales consideration payable to the Taxpayer.
- Aggrieved, the Taxpayer preferred a writ petition before the Bombay High Court (HC) challenging the aforementioned order passed by the AO.

Key contentions of the Taxpayer:

- As per the India-Mauritius Double Taxation Avoidance Agreement (DTAA), capital gains arising from the sale of shares of ICFL would be taxable only in Mauritius and accordingly, there would be no tax liability in India. Therefore, there cannot be any direction for deduction of tax at source while remitting the sale proceeds of shares.
- Revenue authorities cannot question the tax residency status of Taxpayer, as long as TRC issued by the Mauritian Authorities is in existence. Reliance was placed on Circular No 789 dated 13 April 2000 issued by the Central Board of Direct Taxes (CBDT) wherein it was clarified that certificate of residence issued by the Mauritian authorities will constitute sufficient evidence of residence as well as beneficial ownership for applying provisions of the DTAA.
- Reliance was also placed on various judicial precedents including *Azadi Bachao Andolan*[1], *Serco BPO (P) Ltd*[2] and *JSH (Mauritius) Ltd*[3], to support the above contentions.
- The AO could conduct a full-fledged investigation during the assessment proceedings, which is not envisaged at the stage of deciding an application for issuance of certificate under Section 197 of the Act.

[1]Union of India vs Azadi Bachao Andolan (2003) (263 ITR 706) (SC)
[2]Serco BPO (P.) Ltd vs AAR [2015] 60 taxmann.com 433 (Punjab & Haryana)
[3]CIT vs JSH (Mauritius) Ltd. [2017] 84 taxmann.com37 (Bombay)

- The *prima facie* findings of the AO to conclude that the transaction is not genuine, was not supported by appropriate material on record.

Key contentions of Revenue authorities:

- Taxpayer is not a genuine Mauritius based company on account of the following:
  - It had not made any business transaction or engaged itself in any other commercial activities, apart from making investment in ICFL and advancing loan to its holding companies;
  - It did not maintain any establishment nor had it incurred any administrative expenses at Mauritius;
  - It was not clear as to where the Taxpayer would hold the director's functions; and
  - The Taxpayer had no employees at Mauritius.
- The AO applied the tests laid down by the Supreme Court in the case of *Vodafone International Holdings B.V.*[4] and came to the above conclusion based on the evidence available on record.
- The shares of the Taxpayer were held by eight companies, which did not have any office or employees and the Taxpayer failed to produce TRC of such holding companies and the ultimate beneficiaries of the assets being transferred.
- In view of the above, the transaction did not appear to be genuine and the entire structure was created to avoid legitimate tax liability. Based on these findings, there was sufficient material on record to enable the AO to reject the application filed under section 197 of the Act.

Ruling of the Bombay HC:

Key observations of the Bombay HC are outlined below:

- The mere fact that the Taxpayer has not transacted in any other business by itself may not be conclusive that the transaction structure was a colourable device.
- 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 Taxpayer was fraudulent. However, these parameters by themselves may not be sufficient to conclude that the transaction is fictitious or fraudulent.
- The reference by the AO of the inability of the Taxpayer to produce TRC of the companies which hold shares in the Taxpayer, is erroneous.
- Principle laid down by the Supreme Court in the case of *Vodafone International Holdings B.V. (supra)* was relied upon wherein the Supreme Court observed that the Revenue authorities may invoke the principle of "substance over form" or "piercing the corporate veil" test and deny the benefits of the tax treaty only after it is established that a transaction is a sham or is designed for tax avoidance.
- In view of the above, the Bombay HC noted that AO did not have *prima facie* material to demonstrate that the entire transaction was a sham and was a colourable device and a bogus transaction to simply avoid tax. Further, given that such determination could be carried out during the assessment stage, the impugned order passed by the AO under section 197 of the Act was quashed.

[4]Vodafone International Holdings B.V. vs Union of India [2012 341 ITR 1 (SC)]

- The Bombay HC also directed the AO to release the taxes withheld along with applicable interest and issue a nil withholding tax certificate to the Taxpayer, subject to the Taxpayer retaining specified number of shares in ICFL as security.

Key takeaways:

- In the context of availing the capital gains exemption under the India-Mauritius DTAA, the position that the exemption can be claimed by merely producing the TRC issued by the Mauritian authorities, is well established by the controversial CDBT Circular as well as by a series of judgements of the Supreme Court and High Courts. In this ruling, while the Bombay HC has acknowledged this principle, it has also observed that exceptions are possible in certain situations such as fraudulent or fictitious transactions.
- Though Revenue authorities are not required to conduct a full-fledged scrutiny for determining taxability of a transaction in issuing a certificate under section 197 of the Act, in the recent past, Taxpayers opting for such proceedings have been intensely scrutinised particularly where the determination involves an exemption claim under the India-Mauritius DTAA. In this judgement, the observation of the HC that the AO did not have enough material on record to prove that the transaction was a sham may prompt officers to further intensify the proceedings before disposing applications made under section 197 of the Act. This approach would discourage taxpayers from opting for this route due to the fear that transaction timelines may be delayed.
- It is also worthwhile to note that the Bombay HC has entertained the writ petition filed by the Taxpayer, despite the Taxpayer having an alternate remedy of application under section 264 of the Act for revision of order passed by the AO.