

Buy Back of Shares: bye **bye Mauritius**

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Mauritius is always a favourite among tourists across the world. However, Mauritius is also famous among worldwide investors for their tax friendly environment. As per an estimate 40% of portfolio inflows in India are coming from Mauritius. Like Mauritius, other tax havens i.e. Cyprus, Switzerland etc. allow easy parking of money either through investments or deposits. They offer a range of incentives including a nominal or NIL taxes on income and also provide complete financial secrecy of accounts held by individuals and corporates.

India is having Double Taxation Avoidance Agreement (DTAA) with 84 countries. DTAA with countries like Mauritius contains a clause that capital gains on transfer of shares shall be taxed only in the place of residence of beneficiary i.e. in Mauritius. Further those countries do not levy tax on capital gains under their domestic tax laws. Accordingly, Indian Companies are distributing the accumulated profit to its shareholders, within the ambit of law, by opting Buy back route and that too without paying a single rupee as tax.

Hon'ble Finance Minister, Mr. P Chidambaram, while presenting his 8th Budget had said 'some tax avoidance arrangements have come to notice, and I propose to plug the loopholes'. Memorandum explaining Finance Bill 2013 has given a complete background for this '**Dabaang Amendment**':

Section 115- O provides for levy of Dividend Distribution Tax (DDT) on the company at the time when company distributes, declares or pays any dividend to its shareholders. Consequent to the levy of DDT the amount of dividend received by the shareholders is not included in the total income of the shareholder. The consideration received by a shareholder on buy-back of shares by the company is not treated as dividend but is taxable as capital gains under section 46A of the Act.

A company, having distributable reserves, has two options to distribute the same to its shareholders either by declaration and payment of dividends to the shareholders, or by way of purchase of its own shares (i.e. buy back of shares) at a consideration fixed by it. In the first case, the payment by company is subject to DDT and income in the hands of shareholders is exempt. In the second case the income is taxed in the hands of shareholder as capital gains.

Unlisted Companies, as part of tax avoidance scheme, are resorting to buy back of shares instead of payment of dividends in order to avoid payment of tax by way of DDT particularly where the capital gains arising to the shareholders are either not chargeable to tax or are taxable at a lower rate.

Before moving into the intricacy of the proposed amendment, I would like to share two interesting Advance Rulings (AAR) **which will explain the so called tax avoidance scheme.**

a) Armstrong World Industries Mauritius Multi-consult Limited (252 CTR 260):

In this case the applicant, a tax resident of Mauritius, is a wholly-owned subsidiary of a UK Company. The applicant held 99.97 % share of an Indian Company and 0.03% shares held by UK Company. Indian Co. proposes to buyback a part of its shares from the applicant under Section 77A of the Companies Act, 1956. The applicant filed an application before AAR for seeking taxability of capital gains arising in their hands by considering the provisions of Income Tax Act as well as DTAA. Department raised its objection by stating that the applicant is a shell company with no business purpose and that the transactions were undertaken with the motive of tax avoidance. AAR held that capital gains in the hands of Applicant Company are exempt by virtue of article 13 of DTAA between India and Mauritius.

b) Otis Elevator Company (India) Ltd AAR/957/ 2010:

In the given case, 'Otis India', an Indian company, proposed a scheme to buy back its shares from existing shareholders in accordance with the section 77A of Companies Act. 'Otis India' had three majority shareholders, Otis Elevators USA, Otis (Mauritius) Limited and Otis Elevator Company (S) Pte Ltd, Singapore. Only 'Otis Mauritius' has accepted the proposed buy back scheme. Otis India had approached AAR for taxability of capital gains in the hands of Mauritius counterpart and also the withholding tax obligations u/s 195.

Department had raised an argument 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.

AAR held that 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. Other shareholders of 'Otis India' i.e. USA and Singapore entities did not accept the buy-back offer due to resultant capital gain taxes in India. Accordingly AAR concluded that the proposed buy back scheme is a device for tax avoidance.

The proposed amendment is likely to curb similar tax avoidance scheme in a lucid way. As per newly inserted section 115QA, in addition to existing tax liability of a **domestic unlisted** company, **any amount of distributed income** by the company, on **buy-back of shares** from a shareholder shall be charged to additional tax @20% (plus surcharge & cess). Distributed income means the consideration paid by the company on buy-back of shares as reduced by the amount which was received by the company for issue of such shares.

Accordingly, the companies, opting for buy back route, are required to pay additional tax @ 20% even if there is no liability to pay tax on their regular income. The tax is required to be paid to the government within 14 days from the date of payment of any consideration to the shareholders. For removal of cascading effect, it is also proposed that any gain arising in the hands of the shareholders will be exempt. There will be no tax credit in any manner either to the company or any other person and the tax paid on this account shall be treated as final tax payment in respect of said income. In case of failure to deposit the tax in time, the principal officer or the company shall be deemed to be assessee in default and liable to pay interest @1% for every month or part of the month for the period beginning on the date immediately after the expiry of 14th day from the payment to shareholders. **The amendment will be effective from 1st June 2013 and will override the Income Tax Act.**

Proposed amendment also affirmed the recent Advance Ruling in **A, In Re (343 ITR 455)**. In this case the applicant, an Indian company, 48.87 %, of whose shares were held by a group holding company in the U.S.A, 25.06 % by a group holding in Mauritius & 27.37% by a group holding company in Singapore. The board of directors of the applicant passed a resolution proposing a scheme of buy back of its shares from its existing share holders in accordance with section 77A of the Companies Act 1956. Mauritius Company which acquired the shares sought advance ruling on whether the capital gains that may arise were

chargeable to tax in India in terms of DTAA. **AAR held that, the proposal of buy-back in the instant case is a scheme devised for avoidance of tax. Capital gains exemption under India-Mauritius DTAA is not available.** AAR further held that the remittance is in the nature of dividend and hence tax is required to be deducted at source u/s 195.

Is the proposed amendment too harsh?

The proposed amendment will make a big impact on the taxability of resident as well as non resident shareholders. Further, there is an ambiguity in calculation of taxes. The same is explained below:

- a) A non resident shareholder will not be able to take the shelter of tax treaty for reduction of tax liability.
- b) Shareholders, being tax residents of UK, USA etc, who do not enjoy capital gain exemption under DTAA with India, are now subject to so called DDT. Non resident shareholder can explore the concept of underlying tax credit which may reduce the effective tax burden; however, it is uncertain whether taxes paid on this exercise by the Indian company can be available as tax credit in their home country.
- c) The difference between the initial issue price and buy back price will be taxed under this section. The company will most likely pass the tax burden on to the buyer. For e.g. Mr. A purchase the shares from the company for INR 500/- per share. Mr. B buys shares from Mr. A for INR 2,500. The company buys back the shares from Mr. B for a consideration of INR 3,000. The company is required to pay tax on INR 2,500 i.e. (INR 3,000 – INR 500) instead of actual gain of INR 500 in the hands of Mr. B. Accordingly; Mr. B will receive a net amount of INR 2500 only.
- d) Resident shareholders, in case of buy back for a price less than its cost, will not be able to take the benefit of resultant loss and the same will be lapsed.
- e) Resident shareholders, who otherwise could take the benefit of tax slab rates for capital gains, will lose the opportunity.

Conclusion:

Domestic unlisted companies, opting for buy back route, are now required to pay 'so called DDT' @ 20%, on the difference between the consideration paid to shareholder and initial issue price. Proposed amendment will enable the taxing authorities to collect taxes on single and earliest point of time. The newly inserted section will override the Income Tax Act and when it becomes law, will curb the tax avoidance scheme, particularly planned through so called **Mauritius Route**.

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