news flash

MARCH 2013

Finance Bill, 2013: Two Key Proposals - Buy-back of Shares and Tax Residency Certificate

It is that time of the year again! After a tumultuous year spent trying to allay investor sentiments and reaffirming intent to provide certainty in the Indian tax laws, the Finance Minister, Mr. P. Chidambaram, presented a modest Budget for the year 2013-14 on 28 February 2013.

Rather than provide a summary of the entire budget proposal, which are generally and widely available, we thought that we would pick up two important proposals that will significantly affect investment-structures of the future and which would be of interest to our readers. Accordingly, we have endeavoured in this newsflash, to analyse in some detail the proposals to impose a tax on buy-back of shares and the much talked about requirement of obtaining a tax residency certificate ("**TRC**") by a foreign entity who wishes to claim benefit under a Double Taxation Avoidance Agreement ("**DTAA**").

Tax on Buy-back of Shares

Since Dividend Distribution Tax ("**DDT**") was introduced by the Finance Act, 1997, companies have been using the buy-back route rather than paying dividends to its shareholders. Since gains made pursuant to a buy-back of shares is treated as capital gains in the hands of a shareholder, which when routed from a company in Mauritius is tax exempt, this route became very popular. In order to curb tax avoidance by companies resorting to buy-back of shares in the place of dividend declaration on which DDT would have been payable, the Finance Bill, 2013 has proposed to levy a tax on distributed income of domestic company for buy-back of unlisted shares.

Current Law

Under the existing provisions (section 46A) of the Income Tax Act, 1961 (the "**Act**"), the shareholders of the company are liable to pay tax on capital gains arising in their hands pursuant to buy-back of shares.

contd...

Proposed Law

Under the Finance Bill, 2013, it is proposed to amend the Act *with effect from 1 June 2013*, by insertion of a new chapter XII-DA to provide that the consideration paid by the company for purchase of its own shares (not being shares listed on a recognised stock exchange) are reduced by the sum received by the company at the time of issue of such shares ("**distributed income**") will be charged to tax and the company would be liable to pay additional income-tax @ 20% of the distributed income paid to the shareholder (Section 115QA). The income arising to the shareholders in respect of such buy back by the company would be exempt from tax where the company is liable to pay the additional income tax on the buy-back of shares [Section 10(34A)].

Our Analysis and Conclusion

The proposed amendment is not an unexpected development since the tax authorities have long been questioning buy-back transactions. While advising on such transactions in the past, at ALMT, we had always raised the possibilities of litigation by tax authorities questioning the rationale for buy-back of shares. The proposed amendment sets out clearly the intent of taxman to tax buy-back of shares. While with the tax treatment on buy-back becoming a stated position of law it is hoped that much of the future litigation on this issue would now be forestalled, the manner in which it is proposed to be done leaves a lot to be desired. It appears that not enough thought has been given to the proposed amendment of levying additional tax on buy-back. The disparity in the applicable rates (i.e. 20% in case of buy-back and 15% in case of DDT) has not been explained or rationalized. Further, the intent of the proposed amendment may have been better achieved by treating such cases of buy-back as a 'deemed dividend' and thereby subjecting it to DDT. Yet another aspect which requires consideration is the fact that although the words used are 'distributable income', the proposed levy does not clearly make a distinction between buy-back of shares made out of the distributable profits of the company vis-à-vis buy-back in a genuine case of the company having excess capital.

Tax Residency Certificate

The memorandum to the Finance Bill, 2012 stated that the Central Government enters into various DTAAs, in order to ensure that a taxpayer, who is resident of one of the contracting country to the DTAA, is entitled to claim applicability of beneficial provisions either of DTAA or of the domestic law. However, it was recognised that in many instances taxpayers who are not residents of a contracting country (including third party residents) claim unintended benefits under the DTAA entered into by the Government with that country. In order to remedy this situation, the concept of a TRC was introduced last year.

contd..

Current Law

At present, provisions of the Act stipulate that a non-resident assessee to whom a DTAA applies, is required to obtain a TRC, i.e. a certificate of his being a resident in any country outside India or specified territory outside India, from such country or territory, in order to be entitled to claim any relief under the DTAA [(Section 90(4) / 90A(4)]. These provisions were inserted by the Finance Act, 2012 *with effect from 1 April 2013*. The memorandum to the Finance Bill, 2012 stated that the aforesaid provisions made the submission of the TRC a necessary but not sufficient condition for availing benefits of a DTAA. However, this statement was not reflected in the final text of the amended section 90 pursuant to the Finance Bill, 2012, which limited the amendment only to the need for a TRC.

Proposed Law

It is now proposed to insert the following sub-section (5) to sections 90 and 90A *with retrospective effect from 1 April 2013* (assessment year 2013-14):

"The certificate of being a resident in a country outside India or specified territory outside India, as the case may be, referred to in sub-section (4), shall be a necessary but not a sufficient condition for claiming any relief under the agreement referred to therein." [Emphasis supplied]

The memorandum explaining the provision of the Finance Bill, 2013 states that this position was earlier mentioned in the memorandum to the Finance Bill, 2012 as stated above and therefore the proposed amendment merely seeks to enact and incorporate the same into the Act.

Clarification

Owing to the proposed amendment, concerns were expressed by foreign investors regarding the conclusiveness and validity of a TRC in order to claim DTAA benefits. In particular, concern was raised regarding the continuance of Circular 789 dated 13 April 2000, issued by the Finance Ministry which clarifies that a TRC issued by Mauritian authorities would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAA.

In order to address these concerns, the Finance Ministry issued a press release dated 1 March 2013. The press release clarified that Circular 789 continues to remain in force, pending ongoing discussions between India and Mauritius on the Indo-Mauritius DTAA. The press

contd...

release also states that the amendment as proposed in the Finance Bill, 2013 has merely restated the law and that nothing new is being done this year which was not already there

last year. The press release further recognised that the language of the amendment may be interpreted to mean that the TRCs could be questioned by the income tax authorities in India and therefore clarified that this is not in fact the intention of the proposed amendment. Assurance was given in the press release that tax authorities will not go behind the TRC and question the resident status of the person submitting the TRC. The press release further states that the language of the proposed section 90(5) / 90A(5) will be suitably modified.

Our Analysis and Conclusion

While the Finance Ministry has explained its intention, certainty on the issue will emerge only once the proposed amendment has been carried out and incorporated into the Act. If the language remains the same, notwithstanding clarification on Circular 789, several questions will arise, for instance:

- How will TRCs issued by authorities of contracting states other than Mauritius be treated?

- Since a TRC would not be a sufficient condition, what other documentary evidence would be called for by the authorities in order for an assessee to claim benefits under the relevant DTAA?

- Will the condition of ‘beneficial ownership’ which may be required under certain articles in some DTAAs in order to claim benefits thereunder (specifically in context of royalty and fees for technical services payments) be satisfied by the issue of a TRC or will the tax authorities insist on showing more substantial proof of beneficial ownership?

The imposition of tax on buy-back of shares and the TRC issue will certainly affect the manner in which foreign investors structure their investments in India. It will be interesting to see what new structures are devised in light of these amendments.

contd..

Disclaimer

This news flash has been written for the general interest of our clients and professional colleagues and is subject to change. It is not intended to be exhaustive or a substitute for legal advice. We cannot assume legal liability for any errors or omissions. Specific advice must be sought before taking any action pursuant to this news flash.

For further clarification, you may write to the tax team, comprising of Aliff Fazelbhoy at afazelbhoy@almtlegal.com, Statira Ranina at sranina@almtlegal.com, Astha Chandra at achandra@almtlegal.com, Kruti Desai at kdesai@almtlegal.com, Anamika Pandey at apandey@almtlegal.com and Mallika Noorani at mnoorani@almtlegal.com.

ALMT Offices

Mumbai:
4th Floor, Express Towers,
Nariman Point,
Mumbai 400-021
India
Tel: +91 22 4001 0000
Email: mumbai@almtlegal.com

Bangalore:
2 Lavelle Road,
Bangalore 560 001
India
Tel: +91 80 4016 0000
Email: bangalore@almtlegal.com

New Delhi:
506 DLF Place Mall Office,
Block District Centre,
New Delhi 110 017
India
Tel: +91 11 4944 5566
Email: delhi@almtlegal.com

London
DowGate Hill House,
14-16 DowGate Hill,
London EC4R 2SU
United Kingdom
Tel: +44 020 7332 2367
Email: london@almtlegal.com