A CRITICAL APPRAISAL OF SELECTED AAR RULINGS

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Abstract

The Authority for Advance Rulings has gained significance in recent years because of its ability to quickly and efficiently resolve complex questions on income tax, particularly as a forum for non-resident investors to determine their tax liabilities in advance and avoid litigation, In recent years however several of the AAR's decisions have brought about confusion and have been inconsistent with established principles of law and commercial expediency. This short article seeks to highlight these inconsistencies and explore these recent developments in income-tax law.

I. INTRODUCTION

The Authority for Advance Rulings (AAR) came into being vide the Finance Act 1993, which introduced chapter XIXB to the Income Tax Act 1961(I-T Act). An 'advance ruling' under the Act is broadly a determination of the tax liability of an applicant either as to transactions undertaken or to be undertaken.[1] The Supreme Court has

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[1]See generally, Income Tax Act, 1961, §245N.

recently noted that the AAR is a body exercising judicial function and that it would qualify as a tribunal for the purpose of determining its character.[2]

In the last five years, the AAR has adjudicated upon several cases relating to the maintainability of applications before it and also regarding capital gains tax, buyback of shares and tax avoidance in the context of various Double Taxation Avoidance Agreements (DTAA's). This short note seeks to highlight and address three debatable issues and the varying stand of the AAR: First with respect to the maintainability of an application before the AAR once a return of income (ROI) under Section 139 of the I-T Act is filed. Second, with respect to the re-characterisation of various transactions deemed to be colourable by the AAR and third, with respect to the exemption of buy-back of shares from capital gains tax.

The recent controversy regarding Minimum Alternate Tax (MAT)[3] can be traced back to the decision of the AAR in the *Castleton Investment*[4] case, revealing how important it is for the AAR to ensure consistency and predictability in its decision making. Along the same vein, this note seeks to highlight the several important decisions the AAR has made over the past few years and examine them with a critical approach.

[2]Columbia Sportswear Company v. Director of Income Tax, Bangalore, (2012) 8 TMI 105 (SC).

[3]Deepshikha Sikarwar, *Government, Castleton Investments agree to expedite Supreme Court hearings on tax row,* ECONOMIC TIMES, https://economictimes.indiatimes.com/news/politics-and-nation/government-castleton-investments-agree-to-expedite-supreme-court-hearings-on-tax-row/articleshow/47102653.cms.

[4]In Re: Castleton Investment Limited, AAR No. 999 of 2010.

II. JURISDICTIONAL ISSUES

Many questions have been raised regarding the maintainability of an application before the AAR once a ROI has been field by the applicant. Section 245R(2)(i) of the I-T Act provides that the AAR may reject an application where the question raised in the application is already pending before any income tax authority of Appellate Tribunal.

Initially, the AAR was of the view that once an ROI had been filled by an applicant under Section 139 of the I-T Act it becomes 'pending' so as to bar an application before the AAR.[5] This position was affirmed again by the AAR in the cases of *SEPCO Electric*[6] and *NetApp BV*,[7] where it was held that once a ROI is filed by the applicant, the jurisdiction of the I-T authorities is assumed and that the AAR can no longer entertain such an application. This position in fact saw support from the Delhi High Court on appeal as well.[8]

However this position saw a dramatic shift in the case of *Hyosung Corporation*,[9] were the AAR ruled that the mere filing of a ROI will not be sufficient to claim that the matter is pending before any income tax authority. This decision was further elaborated and clarified in the case of Mitsubishi Corporation,[10] where the AAR held that a matter can be pending before an authority *only* when a notice under Section 142 or 143 of the I-T Act is issued. The Supreme Court after having taken cognisance of the above two rulings in fact remanded the case of *NetAapp BV* back to the AAR for reconsideration after setting

[5]In Re: Rotem Company, (1999) 238 ITR 189; In Re: Mustaq Ahmed, (2007) 293 ITR 530.
[6]In Re: SEPCO III Electric Power Corporation, (2012) 342 ITR 213 (AAR).
[7]In Re: NetApp B.V, (2012) 347 ITR 461 (AAR).
[8]NetApp B.V. v. Authority for Advance Rulings, (2012) 253 CTR 164.
[9]In Re: Hyosung Corporation, (2013) 261 CTR 230 (AAR).
[10]In Re: Mitsubishi Corporation, A.A.R. No.1309 of 2012.

aside the ruling of the Delhi High Court.[11] Therefore it can be inferred that this position has received the approval of the Supreme Court as well.

This position is correct and should be upheld, support for this can be found in the *Vodafone international*[12] case, where the Supreme Court noted that several forms of notice under the I-T Act only create a liability to deduct tax, the court went on to distinguish this from a procedure for "assessment" under the Act.[13] In another instance, the AAR has previously ruled that an order determining the liability of the payer to deduct tax at a particular rate will not make the matter pending before the income tax authorities.[14]

Therefore, If a notice under Section 142 after filing a ROI is issued, it is processed according to Section 143(1) which contains detailed procedure for assessment of the same and therefore would make the matter pending. For the sake of clarity, such an "assessment" can be distinguished from other Sections, for example, Section 201 *inter-alia* states that a person is an assessee in default if he fails to file his ROI, a notice under this Section should not make the matter pending for the purpose of Section 245R because it is not in the nature of an assessment.

III. ISSUES RELATING TO RE-CHARACTERISATION OF TRANSACTIONS

Two recent cases before AAR have raised important issues as to the re-characterisation of transactions for the purposes of determining the true nature of the transactions:

[11]Sin Oceanic Shipping ASA v. AAR,(2014)269 CTR 15(SC).
[12]Vodafone International Holdings B.V. v. Union of India, (2012) 6 SCC 613.
[13]*Id*.
[14]In Re: Burmah Castrol Plc., (2008) 305 ITR 375 (AAR).

A. *Re-characterisation Of Buyback Of Shares As Dividend*

The first of these cases is *Otis Ltd*.[15] where the AAR held that a proposed scheme for buyback of shares under Section 77A of the Companies Act 1956 (Act of 1956) as a colourable device for the purpose of avoiding tax and in fact re-characterised the transaction as a dividend payment. The AAR made this ruling based on the following findings: First, that the scheme for buyback of shares was undertaken only to avoid the Dividend Distribution Tax (DDT) under Section 115-O of the I-T Act which was introduced in 2003, and if the company had continued to declare dividends then they would have been liable to pay tax in India. Second, among the various shareholders of *Otis Ltd.*, only the Mauritian shareholder accepted the proposal and not the remaining shareholders, leading the court to believe that the transaction was undertaken only to avail the benefit of the DTAA.

This ruling, however, is not free of criticism and incorrect on the following grounds; Firstly, regarding the re-characterisation of shares as dividend, Section 2(22)(4) of the I-T Act specifically excludes consideration paid on buyback of shares from the definition of dividend. Secondly, Section 46A of the I-T Act also clearly states that consideration paid on buyback of shares is capital gains, the speech of the then Finance Minister also clarifies this position stating that, "*I propose to amend the law to put it beyond doubt that on buyback of shares the shareholders will not be subject to dividend tax.*" [16] Third, The AAR itself has previously ruled that taking advantage of the India-Mauritius DTAA is not objectionable treaty shopping.[17] Finally, regarding the ruling of the AAR that the purpose of the buyback

[15]In Re: Otis Ltd., AAR No. 957 of 2010.
[16]Shri Yashwant Sinha, Finance Minister, Government of India, 27th February 1999, Speech at Union Budget 1999-2000, https://www.indiabudget.gov.in/doc/bspeech/bs19992000.pdf.
[17]In Re:Ardex Investment Mauritius Ltd., (2012) 340 ITR 272 (AAR).

scheme was to avoid the DDT it is pertinent to highlight the observations of the Expert Committee on General Anti Avoidance Rules (GAAR)[18] where it was clarified that "*Whether to pay dividend to its shareholder or buyback its shares is the strategic business choice of the company.. Further at what point of time it makes these decisions cannot be questioned under the GAAR.*"[19] Admittedly, the GAAR are scheduled to be effected from 2016,[20] however this interpretation should clarify that the actions of the I-T Authorities in presuming that the transaction was for tax avoidance was incorrect.

B. Re-characterisation of compulsorily convertible debentures (CCD's) as interest

The second of these cases is that of *Z ltd.*[21] where the AAR re-characterised payments made on redemption of CCDs as interest income and not capital gains. The AAR made this ruling based on the following facts: First, relying on its prior ruling[22] the AAR found that debentures are in the nature of debt instruments and therefore any consideration made on their redemption amounts to interest taxable as per Article 11 of the India-Mauritius DTAA and under Section 2(28) of the I-T Act. Second, after lifting the corporate veil the AAR found that the relevant parties were in-fact a single economic entity and that the transactions were intended to avoid tax.

Subsequently, however, this case was reversed on appeal by the Delhi High Court in the case of *Zaheer Mauritius,*[23]where the court held

[18]Expert Committee, Final Report on General Anti Avoidance Rules in Income Tax Act 1961, Ministry of Finance (2012), www.itatonline.org/info/?dl_id=1013.
[19]*Id.* at p.71-72.
[20]Girish Vanvari & Arinjay Jain, *Tax Conundrums on buybacks*, HINDU BUSINESS LINE, http://www.thehindubusinessline.com/features/taxation-and-accounts/tax-conundrums-on-buybacks/article5079584.ece.
[21]In Re: Z Ltd., (2012) 345 ITR 11 (AAR). [This case was eventually overruled by an appeal to the Delhi High Court.]
[22]LMN India Ltd. v. CIT, (2008) 307 ITR 40 (AAR).
[23]Zaheer Mauritius v. DIT, (2014) 47 TMN 247 (Delhi).

that the gains arising from the transfer of a CCD would in fact be capital gains and not interest. The court arrived at this conclusion on the basis of the following facts: First, the existence of call and exit options meant that the returns were not fixed. Second, the relevant parties were separate entities not exercising singular management and third that CCD's were recognized instruments for the purpose of India's Foreign Direct Investment (FDI) policy and so sufficient commercial rationale exists in effecting the transaction therefore precluding the I-T authorities from deeming it a scheme for tax avoidance.

The position of the Delhi High Court is correct on the following grounds: Firstly, the AAR was incorrect in holding that CCD's can be re-characterised as interest. The definition of 'interest' under both Article 11 of the India-Mauritius DTAA and Section 2(28) of the I-T Act requires the existence of a debt. However the Reserve Bank of India (RBI) its guidelines for foreign investment in debentures has stated that "*instruments which are fully and mandatorily convertible into equity, within a specified time would be reckoned as part of equity and not as part of a company's debt.*"[24] Therefore CCD's, unlike traditional debentures, are not debt instruments. Secondly, CCD's cannot in every case be fixed return instruments, in fact the RBI in its foreign investment guidelines with respect to CCD's has stated that "*The guiding principle would be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreement and shall exit at the price prevailing at the time of exit, subject to lock-in period requirement, as applicable..*[25] Finally, It is consistent business purpose test as elaborated by the Supreme Court in *Vodafone International* were the

[24]Foreign Investment in Debentures-Revised Guidelines, RBI/2006-2007/435 A.P. (DIR Series) Circular No. 74 of 2007 (Issued on June 8, 2007).

[25]Foreign Direct Investment-Pricing Guidelines for FDI instruments with optionality clauses, RBI/2-13-2014/436 A.P. (DIR Series) Circular No. 86 of 2014 (Issued on January 9, 2014).

Supreme Court has observed that mitigating tax liability by arranging commercial affairs is not impermissible and that the existence of a commercial rationale behind a transaction prevents the I-T authorities from deeming it as colourable.[26]

C. Permissibility of re-characterisation?

It should be noted that the Supreme Court in the *Vodafone international* case had held that in the absence of any specific anti-avoidance legislation, the I-T authorities are prohibited from looking through the transaction.[27] Admittedly Section 115QA of the I-T Act or the Buyback Distribution Tax (BBDT) was introduced in 2013 with the intent to tax buy-back of shares, a transaction several persons resorted to in order to avoid the DDT,[28] however it does not permit the I-T authorities from looking through the transaction and, as long as the buy-back transactions had taken place prior to the BBDT coming into effect it is not liable to tax as only the legal position at the time of withholding taxes needs to be considered.[29]

Again, re-characterising consideration paid on buy-back of shares as interest after reaching the conclusion that the CCD's are in fact debt instruments should not only be impermissible before the GAAR comes into effect, [30] it also created uncertainty and ambiguity in India's FDI policy evidenced by the recent dispute between the I-T authorities and Shell India Pvt. Ltd.[31] The reason for this is that debt instruments are beyond the scope of the FDI policy and instead fall

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[26]See generally, Vodafone, *Supra* note 10.
[27]*Id.*
[28]Vodafone, *Supra* note 20.
[29]Channel Guide v. DCIT, (2013) TaxCorp (INTL) 6702; New Bombay Park Hotel Pvt. Ltd v. ITO, (2014) 61 SOT 105 (Mumbai).
[30]See generally, Income Tax Act 1961, Chapter X-A, as amended by Finance Act 2013, w.e.f 1-4-2016.
[31]Remya Nair & Utpal Bhaskar, *Shell India to challenge tax evasion order,* LIVEMINT, http://www.livemint.com/Companies/3cXN4BVXIDJdaoFY7LbUfL/Tax-evasion-reports-baseless-Shell-India.html.

within the purview of external commercial borrowings (EBC's) both of which require different regulatory qualifications.[32]

IV. THE DEBATE OVER EXEMPTING CAPITAL GAINS TAX FOR BUYBACK OF SHARES.

The AAR has also adopted a controversial approach in determining the application Section 47(iv) of the I-T Act. In the case of *RST Ltd*[33] and in *Armstrong World Industries*[34] the AAR refused to grant the benefit of capital gains tax exemption under Section 47(iv) on the buyback of shares by a subsidiary company from its holding company. Section 47(iv) provides for exemption of the transfer from a holding company to its 100 percent owned Indian subsidiary from capital gains tax. At this stage it is relevant to note that the Companies Act 1956 vide Section 49(3) enables a company to hold shares in the name of its nominees to ensure that the number of shareholders does not fall below the statutory mandate.[35] Therefore, it is legally impossible for a company to hold 100 percent shares in its subsidiary.

The AAR had based its ruling on the following findings: First, that both companies did not own their subsidiaries 100 percent by reason of appointing nominee shareholders to satisfy the mandate of the Companies Act and therefore do not qualify for the benefit under Section 47(iv), which uses the phrase 'the parent company or its nominees.' Second, the AAR ruled that Section 46A is special

[32]See generally, Consolidated FDI Policy, D/o IPP F.No. 5(1)/2013-FC.I (Issued on April 17, 2014).

[33]In Re: RST Ltd., AAR No. 1067 of 2010.

[34]In Re: Armstrong World Industries Mauritius Multiconsult Ltd., AAR No. 1044 of 2011.

[35]Section 12(1) of the Companies Act 1956 requires at-least two persons for the formation of a private company.

charging provision and that Section 47 only pertains to Section 45 of the I-T Act which is the charging provision for capital gains. Therefore, there are two important issues to consider:

A. *Interpretation Of Section 47(iv)*

There are naturally adverse commercial implications of the above decisions. First, it would mean that the subsidiary company either has to be held entirely by the parent company, which is impossible considering the mandate of the Companies Act 1956 or it has to be held entirely by the *nominees* of a holding company to avail the benefit of Section 47(iv) of the I-T Act. Moreover, the position of the AAR in *RST* and *Armstrong World Industries* contradicts the AAR's own prior understanding on the matter; in the case of *Praxair Pacific*[36] the AAR ruled that the provisions of Section 47(iv) will apply to a transaction where a Mauritius applicant proposed to transfer its shares in an Indian Company to its 'wholly' owned Indian subsidiary, despite the existence on nominee shareholders holding a small portion of the shares.

In light of these anomalies it is submitted that that this position of the AAR incorrect with respect to the interpretation of Section 47(iv), on the following grounds: The effect of a strict and literal interpretation by the AAR of Section 47(iv) is to nullify the working of the statute itself, which is inconsistent with the established principle that no statue should be read so as to render its working redundant.[37] Moreover, being a beneficial provision, Section 47(iv) must be read liberally so as to give it full effect,[38] and therefore the AAR should read the words 'the parent company or its nominees' as 'the parent company *and* its nominees'. Such an interpretation will be consistent

[36]In Re Praxiar Pacific Ltd., (2010) 326 ITR 276 (AAR).
[37]CIT v. Hindustan Bulk Carriers, (2003) 259 ITR 449 (SC).
[38]CIT v. J Palemar Krishna, (2012) 342 ITR 366.

with the Supreme Courts view that words can be added or read into a statue to avoid making it meaningless.[39]

B. Relationship Between Sections 46A And 47(iv)

Regarding the relationship between Section 45, 46A and 47, there is some support for the AAR's view. For example the benefit of Section 47(iv) does not apply to the provisions of Section or 46(2), which creates a separate charge as opposed to Section 45.[40] However this position should not hold true for Section 46A because, arguable, Section 46A creates no separate charge, support for this can be found in the difference in the language between Sections 46(2) which uses *"shall be chargeable to income tax under the head 'capital gains'",* and Section 46A which says *"shall be deemed to be capital gains."*

Therefore, it is arguable that Section 46A still draws its chargeability from Section 45 and that together they should be treated as an integral code,[41] a view made possible by the fact that Section 2 (24)(vi) of the I-T Act recognises only Section 45 for the purpose of capital gains.

V. CONCLUSION

Another interesting development is the question of the binding authority of an advance ruling; according to Section 245S if the I-T Act, a ruling by the AAR is only binding upon the applicant, the transaction in question and the relevant I-T authority. However, Section 245S (2) states that a ruling will be binding unless there is a change in law or facts on the basis of which it has been pronounced. However, the Bombay High Court in the case of Prudential Assurance

[39]Parshottam Nagindas v. Adwalpalkar, (1996) 218 ITR 392 (Guj).
[40]CIT v. Brahmi Investments P. Ltd., (2006) 204 CTR 319 (Guj).
[41]CWT v. Karan Singh, (1993) 1 SCR 560.

Company,[42] on a perusal of Section 245S (2), has ruled that a subsequent ruling of the AAR on a third party will not override the advance ruling obtained by an applicant.

The Delhi High Court has observed that there should be consistency and uniformity in interpretation of provisions as uncertainties can disable and harm governance of tax laws.[43] This especially stands true for the AAR which aims to be an authoritative forum to sort out complex issues of income tax.[44]

To summarize the key takeaways from the AAR's recent rulings discussed above: It is noted that the AAR's verdict in *Mitsubishi* is good in law considering the analysis of Section 142 and 143 with respect to Section 245R of the Act. Further, the *Otis Ltd.* case is incorrect in law after the Expert Committee Report clarifying that making a *prima-facie* assumption that a company's choice of transaction is designed to avoid tax should not be allowed. Moreover, the AAR must not attempt to re-characterize transaction until either the Direct Tax Code (DTC) is enacted or the GAAR comes into effect and specific provisions enable it to do so. The *Zaheer Mauritius* ruling is important as it adopt the commercial rationale test as set out in *Vodafone International* in determining the true intent of the transaction. Both the cases of *RST* and *Armstrong* deserve re-consideration in light of the AAR's own ruling in *Praxair* and the true nature of Section 46A.

[42]The Prudential Assurance Company Ltd. v. DIT, (2010) 324 ITR 381.
[43]Cairn U.K. Holdings Ltd. v. DIT, (2013) 359 ITR 268 (Del).
[44]HANDBOOK ON ADVANCE RULINGS, at 4, http://aarrulings.in/book.pdf.