WHITHER "TAX TERRORISM"
FIIs and Book Profit Tax
under Indian Income Tax Act.

Creating a tax conducive environment for the foreign investors in India has been one of the agendas of the present Government of India. Assurances have been provided by it at various occassions that the "tax terrorism" would come to an end.

However, recent newsreports suggest that despite such assuraces, notices are being issued by the Tax Department to FIIs and FPIs demanding them to pay Minimum Alternate Tax (MAT) on the capital gains income derived by them in India.

Supporting this step of the Tax Department, the Hon'ble Finance Minister has indicated that they would press ahead with the said tax demand since the FIIs have lost a case on the said issue before the Authority of Advance Rulings[1].

This article aims at providing a better and detailed understanding on the said issue.

At the outset, it would be pertinent to note that an advance ruling is binding only in respect of the transaction(s) for which ruling has been sought and on the Commissioner and the Income Tax Authorities subordinate to him in respect of the applicant; and on the applicant who had sought it[2]. It does not have any precedence value whatsoever in case of other assessees. As against this, under the Indian judiciary system, the rulings of Income Tax Appellate Tribunal have a greater binding effect and precedence value. In this regard, attention is invited to the decision of the Delhi Tribunal in Bank of Tokyo Mitsubishi UFJ Ltd. (49 taxmann.com 411) (Del) wherein it has been held that the provisions of section 115JB does not apply to foreign companies. While rendering this decision, the Hon'ble Tribunal has also considered the advance ruling in Castleton Investments (supra).

Besides, even in case of Advance Authority rulings, there are both favourable as well as unfavourable rulings on the said issue. In Timken Co., In re (193 Taxman 20)(AAR) and Praxair Pacific Ltd, in re (193 Taxman 1)(AAR), the AAR has taken a favourable view and held that MAT cannot be applied to foreign companies. Hence, reliance should not be placed on an unfavourable advance ruling, which does not even have any precedence value, to justify the action of the Tax Department.

Indeed, it is true that section 115JB refers to "companies", which is defined under section 2(17) to mean even a foreign company. However, the said section 2 opens with the words "In this Act, unless the context otherwise requires..".

In CIT v. B. C. Srinivasa Shetty (128 ITR 294), the Apex Court of the country has held that the definitions in section 2 are subject to an overall restrictive clause that is

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[1] In the case of Castleton Investment Ltd., In re (24 taxmann.com 150). The Supreme Court has granted Special Leave Petition against the order of the AAR. The matter is presently pending before the Supreme Court.

[2] Section 245S of the Act.

expressed in the opening words of the section "unless the context otherwise requires" and hence, it would be necessary to enquire as to whether contextually the words defined under said section would apply to a particular provision. Accordingly, the Apex Court held that goodwill cannot be described as a "capital asset" within the meaning of section 45 and hence, any capital gains arising on the transfer of such goodwill cannot be subject to income-tax under the head 'Capital gains'.

In K.V. Muthu v. Angamuthu Ammal (AIR 1997 SC 628), the Apex Court observed that "Section 2 of the Act in which various terms have been defined open with the words 'in this Act, unless the context otherwise requires' which indicates that the definitions, as for example, that of 'Family', which are indicated to be conclusive may not be treated to be conclusive if it was otherwise required by the context. This implies that a definition, like any other word in a statute, has to be read in the light of context and scheme of the Act as also the object for which the Act was made by the Legislature. While interpreting a definition, it has to be borne in mind that the interpretation placed on it should not only be not repugnant to the context, it should also be such as would aid the achievement of the purpose which is sought to be served by the Act. A construction which would defeat or was likely to defeat the purpose of the Act has to be ignored and not accepted."

Similarly, the Delhi High Court[3] has held that it is a well-settled principle of law that although the definition would govern the statute whenever that word is used in the body thereof, but where the context makes the definition given in an interpretation clause inapplicable, a defined word may have to be given a meaning different from that contained in the interpretation clause.[4]

Thus, the definition of 'company' under section 2(17) requires evaluation of the circumstances in which the said word has been used and if the circumstances do require otherwise, then the meanings as given to those words by the said definition are not to be resorted to.

Now, the context of section 115JB can be ascertained from the documents pertaining to the Finance Bills under which the said section or its predecessor sections were inserted or amended. In this regard, attention is invited to the notes on clauses explaining the provisions of Finance Bill, 2002 that provided for some amendments to section 115JB, which reads as follows:

> *"Clause 49 seeks to amend section 115JB of the Income-tax Act relating to special provision for payment of tax by certain companies. The existing provisions of the said section provide for levy of a minimum tax on <u>domestic companies</u> of an amount equal to seven and one-half per cent of the book profit, if the tax payable*

[3] Dr. Nalini Mahajan v. DIT (122 Taxman 897)(Del)

[4] Also see K. Balakrishna Rao v. Haji Abdulla Sait [1980](1 SCC 321); Printers (Mysore) Ltd. v. Assistant Commercial Tax Officer [1994](2 SCC 434)

> *on the total income chargeable to tax as per the provisions of the Income-tax Act, 1961, is less than seven and one-half per cent of the book profit...”*

(Emphasis supplied)

Clearly, the foregoing has clarified the law that section 115JB is a levy of minimum tax on domestic companies. The Government has itself recognized that section 115JB is not applicable to foreign companies.

Besides, the relevant extracts of Circular No. 794, dated 9-8-2000, issued by the Central Board of Direct Taxes (CBDT), which explains the provisions of Finance Act, 2000 under which the provisions of section 115JB were introduced, reads as follows:

> *“The new provisions provide that all companies having book profits under the Companies Act, prepared in accordance with Part II and Part III of Schedule VI to the Companies Act, shall be liable to pay a minimum alternate tax at a lower rate of 7.5 per cent as against the existing effective rate of 10.5 per cent of the book profits.”*

As would be can be observed, in the foregoing Circular, the “existing effective rate” was specified to be 10.5 %. Now, under the predecessor section 115JA, MAT liability was computed by multiplying the corporate rate of tax to 30% of the book profit. At that time, the corporate rate of tax for domestic companies was 35%, 30% of which comes to 10.5%. As against this, the corporate rate of tax applicable to foreign companies was in those year was 48 %. Hence, in the said Circular, the effective rate of MAT has been worked out with reference to domestic companies only, which clearly indicates that even as per the CBDT, MAT applies only to domestic companies.

Further, in the Budget Speech of the then Finance Minister of India made in Parliament while introducing section 115J (a predecessor provision dealing with MAT), the rationale for MAT was explained as under:

> *"It is only fair and proper that the prosperous should pay at least some tax. The phenomenon of so-called 'zero-tax' highly profitable companies deserves attention……I now propose to introduce a provision whereby every company will have to pay a 'minimum corporate tax' on the profits declared by it in its own accounts. Under this new provision, a company will pay tax on at least 30 per cent of its book profit. In other words, a domestic widely held company will pay tax of at least 15 per cent of its book profit."*

(Emphasis supplied)

Hence, the foregoing clearly indicates that the term “companies” used in section 115JB and as intended by the Legislator as well as CBDT refers only to domestic companies.

Further, under section 115JB(2) of the Act, it has been provided that for the purposes of section 115JB, every company has to prepare its profit and loss account in accordance with the provisions of Part II and Part III of Schedule VI of the Companies Act, 1956 for the relevant previous year. Such accounts also contemplate maintaining books of account in respect of the operations of the company. Indeed, Sections 591 to 602 of the Companies Act, 1956 make provisions as to the establishment of places of business in India by companies incorporated outside India which require, inter-alia, preparation of Balance Sheet and Profit & Loss A/c by such foreign companies. However, such provisions apply to foreign companies which establish a place of business within India. Similarly, under section 381 read with section 2(42) of the Companies Act, 2013 and Rule 4 of the Companies (Registration of Foreign Companies) Rules, 2014, only foreign companies having place of business in India are required to prepare financial statements of their Indian business operations in accordance with the provisions of that Act.

Hence, in the absence of any business operations in India, a foreign company is not required to prepare such accounts nor maintain any books of accounts in India. Now, in absence of profit and loss account prepared in accordance with the Companies Act, it would not be possible to apply the provisions of sub-section (2) of section 115JB to foreign companies.

Indeed, based on this rationale it has been held by the High Courts and Tribunals in the case of banking, insurance and electricity companies, that since such companies are required to prepare their accounts as per their specific statutes and not as per the Companies Act, the provisions of section 115JB would not apply to it. See:

- Kerala State Electricity Board v. Dy. CIT (329 ITR 91)(Ker);
- Maharashtra State Electricity Board v. Joint CIT (77 TTJ 33) (Mum);
- Krung Thai Bank PCL v. Jt. DIT(IT), (133 TTJ 435)(Mum);
- ICICI Lombard General Insurance Co. Limited vs. ACIT (54 SOT 538)(Mum).

Subsequent to these decisions, a specific amendment was brought vide *Explanation* 3 to section 115JB with effect from April 1, 2012, which made section 115JB applicable even to these companies. However, even this amendment does not cover foreign companies. Hence, the provisions of section 115JB cannot be said to applicable to foreign companies/FIIs.

Indeed, if the said provisions were to be made applicable to these companies, it would lead to various absurd results, as discussed hereunder:

- If MAT provisions were to be applied to all foreign companies, irrespective of whether they have a place of business in India or not, then it would literally mean that every foreign company would be required to compile its entire

global accounts in accordance with the Companies Act, so as to make the provisions of section 115JB workable! That clearly cannot be the intention of the Government;

- As an alternate, if financial statements of foreign companies/FIIs prepared as per the foreign laws are considered, it would include not only Indian income (such as capital gains earned by FIIs), but also their entire global income. Now, under the *Explanation* below sub-section (2), for computing "book profit", net profits as per the profit and loss account is the starting point. Hence, in case of foreign companies, apart from their Indian income, the entire global profit income disclosed in their profit and loss account would be the starting point, and they may end up paying income-tax on their entire global income which may not have even accrued/arisen or received in India!

- Besides, the rationale behind inserting section 115JA (the predecessor to section 115JB levying MAT), was explained by the CBDT vide Circular No. 762 dated 18.2.1998. It states that "Studies have shown that in spite of the fact companies have earned substantial book profits and have paid handsome dividends, no tax has been paid by them to the exchequer. The Finance Act has inserted a new section 115JA of the income-tax Act, so as to levy a minimum tax on companies who are having book profits and paying dividends but are not paying any taxes."[5] Now, foreign companies do not declare any dividend in India. Hence, the rationale behind inserting MAT provisions cannot at all apply to foreign companies[6].

- Further, under section 115JAA(2), credit is available for the MAT paid by companies in the manner computed therein, if in the subsequent years, the tax payable under the normal provisions of the Act exceeds the MAT payable. However, in case of FIIs, if MAT is made applicable to the capital gains earned by them, then since such capital gains is exempt from tax under the normal provisions of the Act, a situation would arise where there would keep paying MAT on such income, and never be able to claim credit for the same!

These absurdities clearly indicate that the provisions relating to MAT as enacted were never intended to apply to foreign companies and that if there are in fact made applicable it would be unfair and baseless.

Further, even if MAT provision is held to be applicable in case of foreign companies/FIIs, they would still be able to claim the benefit of Double Taxation Avoidance Agreements (DTAAs), if any, which their country of residence may have entered into with India. MAT is leviable under section 115JB on "Book Profit", which

[5] Also see Circular No. 495 dated September 22, 1987 where the scope of section 115J was explained and the Explanatory Memorandum to the Finance (No. 2) Bill, 1996, under which section 115JA was introduced.

[6] In Process pumps (P) Limited vs. DCIT (94 TTJ 190)(Bang) it has been held that since the assessee had never declared any dividend, provisions of section 115JA were not applicable as per the circular of the CBDT.

means the net profit of the company as a whole after adjusting it with specific adjustments provided in that section. It is not leviable on any particular type of income. In case of members of an AOP, the shares of whom are determinate, section 67A of the Act deems the character of their income from the AOP to be same as that in the case of AOP. However, there is no such deeming provision under section 115JB. Hence, the character of "book profit" cannot be equated with the character of different types of income recognized under the Act. Similarly, "book profit" for the purpose of the DTAAs, cannot be regarded as being in the nature of capital gains, interest, royalty, business income, etc. which are specifically dealt with in the DTAAs. At most, it may fall in the residual category of "Other Income". Now, in many DTAAs, other income is taxable only in the country of residence. Hence, based on this rationale, it can be argued by the foreign companies/FIIs that tax on "book profit" levied under section 115JB cannot be brought to tax in India since under section 90(2), the beneficial provisions of the DTAA would override the provisions of the Act. In fact, recently, the revenue secretary, Mr. Shaktikanta Das had stated that wherever India has a double taxation avoidance agreement, FIIs will get the treaty benefit. Further, the CBDT has issued a circular to the revenue authorities asking them to dispose the cases of FIIs claiming treaty benefit within a month.

In all fairness, in order to make India attractive to FIIs, the Hon'ble FM has in the Finance Bill 2015, proposed to amend the provisions of section 115JB so as to specifically exempt the capital gains earned by FIIs from the ambit of MAT. Also, it is proposed to exempt the capital gains, interest, royalty and fees for technical services earned by foreign companies from MAT provided the rate of tax payable thereon is less that MAT rate. However, even as per the proposed amendments, the question of how the book profits of an FII or a foreign company would be computed who are not required to prepare the profit and loss account is not addressed. In the absence of any specific guidance provided for computation of book profits in such cases, it may so happen that the entire income shown in the profit and loss account of such assessees is brought to tax in India! In fact, the way the proposed amendment has been drafted, where an exemption has been provided only in respect of certain types of income of FIIs and foreign companies as against exempting the company itself from the provisions of MAT, a view could be taken by the Tax Department that the intention of legislature was always to cover such companies within its ambit. Further, the said amendment is to take effect only prospectively. Hence, the controversy in respect of applicability of MAT provisions on FIIs for earlier years still prevails. Hence, instead of bringing any clarity on the issue of applicability of MAT to FIIs and foreign companies, the proposed amendments would only create further confusion.

Having regard to the foregoing, the move of the Tax Department of issuing mass notices to all FIIs appears to be unjustified. Lastly, the observations of the Apex Court in Sirpur Paper Mill Limited vs. Commission of Wealth-tax (77 ITR 6) that the authorities invested with quasi-judicial power cannot be directed or instructed in exercise of their quasi-judicial function, must be borne in mind.

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