Tax alert: Taxpayer eligible for India-Mauritius tax treaty benefit, for shares acquired prior to 1 April 2017

4 September 2024

The Delhi High Court, based on peculiar facts of the case, has rendered its decision that, *inter-alia*, the taxpayer was eligible for exemption under Article 13(3A) of the India-Mauritius tax treaty for the sale of shares acquired prior to 1 April 2017.

In a nutshell

Merely an entity being situated in Mauritius and of investments in Mauritius being routed through that nation, cannot result in a default adverse inference, or raise a presumption of illegality or of such an entity being a colourable device, nor are Mauritian entities required to satisfy any separate standard of legitimacy or stricter standard of proof.

The issuance of a TRC by the competent authority must be sacrosanct and due weightage must be accorded to the same as it constitutes certification of the TRC holding entity being a bona fide entity.

LOB provisions and the TRC comprehensively and adequately addresses concerns in relation to potential treaty abuse, subject to caveats of illegality, fraud and the transaction being in contravention of the underlying object and purpose of the treaty.

The concept of beneficial ownership would arise if it is established that the holder of income had no control over the income and merely holds the same till instructed to deploy that income to another entity or if the income is controlled or regulated by a third party with the holder having no real or substantive control over that income.

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Background:

- The taxpayer[1] is a private company incorporated in 2011 under the laws of Mauritius and having its principal office in that country. The taxpayer was set up with the primary objective of undertaking investment activities with the intention of earning long term capital appreciation and investment income.
- The taxpayer's immediate shareholders were also Mauritian companies whose shareholders in turn were private equity funds who had raised funds from several investors across the globe. The indirect shareholders of the taxpayer consisted of almost 500 investors residing in around 30 jurisdictions spread across the globe.
- Another company (A Co), incorporated under the laws of Delaware, USA, was the taxpayer's Investment Manager i.e. management company. The Investment Manager (A Co) had not placed any investments with the taxpayer and it was categorically claimed that neither A Co nor any of its affiliates had either invested in the taxpayer or the private equity funds that had indirectly invested with them.
- The taxpayer was granted a Category 1 Global Business License (GBL) and was also a tax resident of Mauritius having a Tax Residence Certificate (TRC) issued by the Mauritius revenue authorities. The activities of the taxpayer were regulated by the Financial Services Commission of Mauritius.
- The taxpayer had acquired shares of a Singapore based company (S Co) between October 2011 to April 2015 and thus it claimed that the investments were made prior to 1 April 2017 [the determinative date for grandfathering of certain investments under Article 13(3A) of the India-Mauritius tax treaty].
- The taxpayer filed an application with the tax authorities for grant of a 'Nil' withholding tax certificate under section 197 of the Income-tax Act, 1961 (ITA). Tax authorities held that the taxpayer would not be entitled to the benefits of the India-Mauritius tax treaty as it was not independent in decision making with regard to various capital assets held by it. Accordingly, a certificate under section 197 of the ITA was issued subject to the payer deducting tax at the rate of 10% plus surcharge and applicable cess.
- Aggrieved, the taxpayer filed an application with the Authority for Advanced Rulings (AAR). As per the taxpayer, Article 13(3A) of the India-Mauritius tax treaty had grandfathered all acquisition of shares prior to 1 April 2017 and the gains arising from their transfer would thus be exempt from taxation. Hence, it would be eligible for claiming the exemption from the levy of capital gains tax since it acquired the shares of S Co prior to 1 April 2017.
- The AAR, based on various facts of the case[2], rejected the taxpayer's application and, *inter-alia*, held as follows:
  - the taxpayer was mere conduit company and was disentitled to claim benefits of the India-Mauritius tax treaty since the transaction lacked commercial substance and the establishment of an entity in Mauritius was principally aimed at deriving undue benefits under the tax treaty.
  - the control and management of the taxpayer was not situated in Mauritius but in the USA (i.e. A Co's country)
  - the transaction in respect of which the ruling was sought was prima facie designed for the avoidance of tax and thus falling within the scope of clause (iii) of the proviso to section 245R(2) of the (ITA [relating to application being rejected by AAR in certain cases].
  - accordingly, the AAR held that it was not obliged to render any findings on the merits of the case i.e., whether the taxpayer was entitled to avail the benefits of the India-Mauritius tax treaty in respect of the sale of shares of S Co and the question of taxability of capital gains connected therewith.

[1] [2024] W.P.(C) 6764/2020 & CM APPL. 23479/2020 and others (Delhi-HC) [there were 3 writ petitions but HC for the sake of brevity has considered only one taxpayer's facts]

[2] Entire facts of the case not reproduced for sake of brevity

- Aggrieved, the taxpayer filed a writ petition before the Delhi High Court (HC) against the aforesaid order disposing the taxpayer's application.

Relevant provisions in brief:

Relevant extracts of ARTICLE 13 of the India-Mauritius tax treaty (relating to Capital Gains)

"…3A. Gains from the alienation of shares acquired on or after 1st April 2017 in a company which is resident of a Contracting State may be taxed in that State. Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs (1), (2) and (3) of this article shall be taxable only in that State.

3B. However, the tax rate on the gains referred to in paragraph 3A of this Article and arising during the period beginning on 1st April, 2017 and ending on 31st March, 2019 shall not exceed 50% of the tax rate applicable on such gains in the State of residence of the company whose shares are being alienated;]

4.Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 3A shall be taxable only in the Contracting State of which the alienator is a resident.]

5. For the purposes of this article, the term 'alienation' means the sale, exchange, transfer, or relinquishment of the property or the extinguishment of any rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States."

Decision of the HC:

The HC explained in detail the various aspects of the ruling and thereafter summarised its decision as noted below:

A Co was not investor/holding company of the taxpayer

- The AAR's finding that A Co was the holding or parent company of the taxpayer was wholly erroneous. The taxpayer contended that A Co was its investment manager and not the holding or parent company. None of the funds invested in the taxpayer originated from A Co, as no equity participation or investments was made by A Co in the taxpayer, or any evidence put forth with respect to any monies being repatriated to A Co from the taxpayer.
- Hence, the AAR erred in concluding that A Co was the parent or holding company.
- The taxpayers[3] were intended to operate as pooling vehicles for investments, held a Category 1 GBL, had aggregated funds from more than 500 investors located across 30 jurisdictions worldwide and had A Co as its investment manager.

Taxpayer was compliant of Article 27A of India-Mauritius tax treaty [relating to Limitation of Benefit (LoB)]

- The entire stockholding in S Co was acquired between October 2011 to April 2015 and such shares in S Co were transferred on 18 August 2018.
- The taxpayer had incurred expenditure amounting to ~US$ 1 million roughly translating to ~Mauritian Rupee (MUR) 36 million as against the threshold of MUR 1.5 million prescribed under Article 27A of the India-Mauritius tax treaty.
- Therefore, the taxpayer could not be said to be lacking in economic substance or that it was domiciled in Mauritius with a sole view of engaging in tax treaty abuse.

Subsidiary being a separate entity

[3] Here and in subsequent paragraphs, wherever applicable, the HC refers to all taxpayers who had filed the writ petition

- A parent or a holding company would have a legitimate right to exercise oversight and broad supervision over the affairs of its subsidiaries which could conceivably take the form of seats on the board of directors, appointment of key managerial personnel, auditing of affairs of the subsidiary and so on.
- Subsidiaries are also recognised in law to have a distinct and independent legal persona which is liable to be ignored only in the event of apparent fraud, being interposed with a view to camouflage sham transactions or of being created to perpetuate an illegality and of being a mere puppet and lacking in economic substance.
- Merely because a parent entity may exercise shareholder influence over its subsidiary that would not lead to an assumption that the subsidiary in question was operating as a mere puppet or that it was wholly subservient to the parent entity.

Mere set-up of entity in Mauritius not illegal

- The mere factum of an entity being situated in Mauritius and of investments in Mauritius being routed through that nation cannot result in a default adverse inference or raise a presumption of illegality or of such an entity being a colorable device, nor are Mauritian entities required to satisfy any separate standard of legitimacy or stricter standard of proof.
- As per data in public record it revealed that Mauritius is one of the more favorable jurisdictions for FIIs seeking to invest in India as a result of its proximity to India as well as the wide array of agreements that it had entered into with various nations across the globe.
- Liberalized exchange controls, favorable investment climates and the prevailing socio-political stability appears to have additionally favored facilitation of Mauritius as a gateway for investments flowing into the Asian and African continent and accordingly lead to Mauritius becoming the preferred destination for various investors wishing to route investments towards South East Asian economies and with India subsequent to the liberalization measures adopted in 1991 seeing almost 50% of the FDI volume in India originating from Mauritius in the year 2012.
- Accordingly, based on observations rendered in earlier Supreme Court (SC) rulings[4] and the facts and data available, it would be incorrect to presume that investments originating from Mauritius are inherently suspect or that fiscal residence of an entity in Mauritius would require viewing such entities through a tainted prism.

Entities set up in tax friendly jurisdictions

- The establishment of investment vehicles in tax friendly jurisdictions cannot be an anomaly or give rise to a presumption of being situate in those destinations for the purpose of evading tax or engaging in treaty abuse.
- The earlier SC ruling[5] acknowledged how nations seek to compete with each other by highlighting treaty benefits that could be obtained by investors from its treaty networks, because of which there was nothing inherently objectionable about treaty shopping but that any concerns surrounding the practice of treaty shopping is best left for the consideration of the executive which may examine the political and economic implications of any measures taken by it to combat treaty shopping, particularly in light of the changing world order requiring nations to adopt measures to attract capital and technological inflows.
- Similarly, the SC in another earlier ruling[6] noted that there has been a steady increase in multinational corporations seeking to invest in markets and businesses across the globe, which would thus lend credence to the position that establishment of offshore companies could be motivated by bona fide commercial purposes.

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[4] Union of India v. Azadi Bachao Andolan [(2004) 10 SCC 1 (SC)] and Vodafone International Holdings B.V. v. Union of India & Anr [(2012) 6 SCC 613 (SC)]

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- Accordingly, these SC rulings accepted the changed world order necessitating cross-border movement of capital and investments and those in turn resulting in the creation of trans-national corporations, the incorporation of entities in different jurisdictions and thus facilitating investments in diverse parts of the world which inevitably led to entities seeking to reside in jurisdictions with established treaty networks.
- The creation of new investment pathways ought not be halted by skepticism or mistrust except based on well-established parameters.
- The principle of substance over form must be the prevailing norm and the Revenue entitled to doubt the bona fides of a transaction only in those situations where it be found that the transaction involves a sham device intended to achieve illegal objectives or formulated based on illegal motives.
- In light of the aforesaid SC rulings, treaty shopping in itself cannot be rendered abhorrent unless it were categorically established that the device was incorporated with a view to evade tax and in a manner contrary to the intent of the Contracting States to the treaty.
- Therefore, it is only in those situations where no other conclusion can be drawn other than the entity being a conduit or lacking in commercial substance and intending to perpetuate fraud, that the Revenue would be justified in doubting the nature and character of that transaction.

TRC is sacrosanct

- The issuance of a TRC by the competent authority must be sacrosanct and due weightage must be accorded to the same as it constitutes certification of the TRC holding entity being a bona fide entity having beneficial ownership domiciled in a Contracting State to pursue a legitimate business purpose in a Contracting State.
- The Revenue would thus not be justified in doubting the presumption of validity attached to the TRC as it would inevitably result in an erosion of faith and trust reposed by Contracting States in each other.
- Revenue could pierce the corporate veil of a TRC holding entity in extremely narrow circumstances of tax fraud, sham transactions, camouflaging of illegal activities and the complete absence of economic substance and the establishment of those charges would have to meet stringent and onerous standards of proof and the Revenue being required to base such conclusions on cogent and convincing evidence and not suspicion alone.
- Section 90 of the ITA itself formulates the legislative intent to lend primacy to treaty enactments. Courts have accordingly taken the consistent stand that treaty benefits ought not be overridden by provisions and that the sanctity of a treaty restrains parties from attempting to subvert the same by way of unilateral amendments.

Treaty shopping

- There cannot be an assumption of treaty shopping and treaty abuse merely because a subsidiary or any related entity is established in a tax friendly jurisdiction.
- Action 6 of BEPS[7] Action Plan, which paved the way for adoption of LOB clauses and PPT[8] test in treaties as well as the principles emanating from the OECD Commentary on Article 29 reveals that treaties incorporate disentitlement provisions to deprive persons who were not intended to fall under the ambit of the treaty availing those benefits in an indirect manner.
- Based on certain foreign ruling[9], it would be erroneous to characterise legitimate business activities undertaken by entities as constituting treaty shopping, merely because it was situated in a favorable tax jurisdiction.

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[7] Base Erosion and Profit Sharing

[8] Principal Purpose Test

[9] Cadbury Schweppes Plc and another v Inland Revenue Commissioners [(2006) 3 WLR 890] and Burlington Loan Management DAC v Revenue and Customs Commissioners [(2024) UKUT 152 (TCC)]

- Therefore, both Indian and International authorities have taken the consistent position that treaty benefits may be denied only in those cases where the transaction is a sham, where fraud is sought to be committed or where entities are incorporated as mere conduits and in a manner contrary to the schema of the treaty itself.

LOB provisions under tax treaty

- The incorporation of LOB provisions in a taxation convention will result in those provisions being determinative of allegations of treaty abuse and purported illegitimate claims of treaty benefits.
- The right of the Revenue to cast aspersions on the validity or legitimacy of a transaction would be constrained by the requirements of exacting and compelling standards of proof with the onus placed squarely on Revenue to establish that a transaction in question would be disentitled to the benefits of a treaty being a sham, a colorable device and imputed with illegality and giving rise to the conclusion that Contracting States never intended for such transactions being accorded treaty benefits.
- Contracting States did not intend for domestic taxation authorities to deploy their own subjective standards in view of the enactment of LOB provisions which had also adopted ascertainable standards to defenestrate presumptions of treaty abuse. Taking any view to the contrary would amount to privileging domestic legislation over and above the enactments in the treaty provisions adopted by Contracting States and would amount to holding that jurisdiction exists in taxing authorities to question the validity of transaction on parameters alien to the negotiated terms of the treaty.
- The LOB clause in the India-Mauritius tax treaty came to be included when Chapter X-A of the ITA [on GAAR] had already come to exist and Article 27A of the India-Mauritius tax treaty accordingly chose to grandfather all transactions relating to alienation of shares acquired prior to 1 April 2017.
- Hence, the Contracting States formulated LOB provisions bearing in mind the enactments in the domestic legislation because of which the Revenue is not entitled to erect additional barriers towards the receipt of treaty benefits by parties.
- LOB provisions and the TRC comprehensively address concerns in relation to potential treaty abuse and it would be impermissible for the Revenue to manufacture additional roadblocks or standards that parties would be required to meet in order to avail of tax treaty benefits, subject to caveats of illegality, fraud and the transaction being in contravention of the underlying object and purpose of the treaty.

Grandfathering of investments made prior to 1 April 2017 under India-Mauritius tax treaty

- The provision of Article 13(3A) embodies the intent of the Contracting States to ring-fence all such transactions which had been consummated prior to 1 April 2017.
- Article 13(3B) restricted its scope to prescribing separate tax rates for the period between 1 April 2017 till 31 March 2019, but no such tax rate was prescribed for capital gains arising from sale of shares acquired prior to 1 April 2017 which categorically demonstrates the intent of the parties to the India-Mauritius tax treaty to exclude capital gains emanating from shares acquired prior to 1 April 2017 from the ambit of taxation.
- Therefore, the grandfathering clause in Article 13(3A) would exclude the transaction undertaken by the taxpayer from the ambit of capital gains tax.
- Domestic tax legislation cannot be interpreted in a manner which brings it in direct conflict with a treaty provision or with an overriding effect over the provisions contained in a tax treaty since the same would in effect amount to accepting the right of the Legislature of one of the Contracting States to unilaterally amend or override the provisions of a treaty and would result in the elevation of a domestic subordinate legislation over that of the provisions embodied in a treaty entered into between sovereign nations.

GAAR not applicable on grandfathered investments

- The Revenue's argument that the transaction undertaken by the taxpayer would not be grandfathered in light of Rule 10U[10] and the claim that Rule 10U(2) takes away from the preceding provision of Rule 10U(1)(d) of the Income-tax Rules, 1962 (Rules) was without any merit and, since the term *'without prejudice'* was intended to mean that Rule 10U(2) would operate in contingencies not contemplated by Rule 10U(1)(d) of the Rules.

Concept of beneficial ownership

- The imputation of beneficial ownership of A Co over the taxpayer was erroneous considering the principles governing attributability of beneficial ownership.
- Notwithstanding that on facts it has been established that A Co was not the parent or holding company of the taxpayer, it would be incorrect to ascribe beneficial ownership if a conduit was entitled to avail of income itself and was not contractually obligated to forward that income to any other entity.
- The concept of beneficial ownership would get attracted if was established that the holder of income had no control over the income and merely holds the same till such time it be instructed to deploy that income to another entity or if the income is controlled or regulated by a third party with the holder having no real or substantive control over that income.
- A Co cannot be said to be the beneficial owner of shares since no evidence was rendered that the taxpayer was under a contractual or legal obligation to transmit revenue to A Co or that the revenue obtained from transfer of shareholding was as a result of actions undertaken by the taxpayer at the behest of A Co. Hence, in absence of any material or evidence underlying the claims made with respect to beneficial ownership, Revenue's submissions were based on mere surmises and conjectures.

In view of the above, the HC held that the taxpayer's transaction was duly grandfathered by virtue of Article 13(3A) of the India-Mauritius tax treaty and hence not subject to capital gains tax in India.

Comments:

Eligibility to claim tax treaty benefits, especially for capital gains tax under the India-Mauritius tax treaty, including grandfathering of certain earlier investments, has been a subject of litigation.

The HC in the current case has upheld, amongst others, the following principles:

- Merely an entity being situated in Mauritius and of investments in Mauritius being routed through that nation **cannot** result in a default adverse inference or raise a presumption of illegality or of such an entity being a colorable device, **nor are Mauritian entities required to satisfy any separate standard of legitimacy or stricter standard of proof.**
- It would be incorrect to presume that investments originating from Mauritius are inherently suspect or that fiscal residence of an entity in Mauritius would require viewing such entities through a tainted prism.
- The issuance of a TRC by the competent authority must be sacrosanct and due weightage must be accorded to the same as it constitutes certification of the TRC holding entity being a bona fide entity.
- LOB provisions and the TRC comprehensively and adequately addresses concerns in relation to potential treaty abuse, subject to caveats of illegality, fraud and the transaction being in contravention of the underlying object and purpose of the treaty.

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[10] Relevant extracts of Rule 10U of the Rules:

(1) The provisions of Chapter X-A shall not apply to—

…(d) any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before the 67[1st day of April, 2017] by such person.

(2) Without prejudice to the provisions of clause (d) of sub-rule (1), the provisions of Chapter X-A shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 68[1st day of April, 2017…"

- Domestic tax legislation cannot be interpreted in a manner which brings it in direct conflict with a treaty provision or with an overriding effect over the provisions contained in a tax treaty since the same would in effect amount to accepting the right of the Legislature of one of the Contracting States to unilaterally amend or override the provisions of a treaty and would result in the elevation of a domestic subordinate legislation over that of the provisions embodied in a treaty entered into between sovereign nations.
- The Revenue's argument that the transaction undertaken by the taxpayer would not be grandfathered in light of Rule 10U of the Rules and the claim that Rule 10U(2) takes away from the preceding provision of Rule 10U(1)(d) was without any merit, since the term *'without prejudice'* was intended to mean that Rule 10U(2) would operate in contingencies not contemplated by Rule 10U(1)(d) of the Rules.
- The concept of beneficial ownership would get attracted if was established that the holder of income had no control over the income and merely holds the same till such time it be instructed to deploy that income to another entity or if the income is controlled or regulated by a third party with the holder having no real or substantive control over that income.

Taxpayers with similar facts may evaluate the impact of this ruling to the specific facts of their cases.