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Direct Tax Alert

June 05, 2020

Authority for Advance Ruling – Denial of benefit under India-Mauritius tax treaty on capital gains on indirect transfer

AAR denies beneficial treaty provisions to a Mauritian tax resident in respect of capital gains arising from sale of shares of a Singapore Company which derives its value substantially from shares of Indian Company

Recently, the Authority for Advance Rulings (AAR) has denied the applicability of beneficial treaty provisions available to Tiger Global International Holdings (i.e. the Applicant)[1], a tax resident of Mauritius, under the provisions of Article 13(4) of the India-Mauritius Double Taxation Avoidance Agreement (India-Mauritius tax treaty) in respect of capital gains arising to the Mauritius shareholder on sale of shares of a Singapore company which derived its value substantially from shares of an Indian company.

Background and decision of AAR

- The Applicants were private limited companies incorporated under the laws of Mauritius, were being regulated by the Financial Services Commission in Mauritius and were granted a Category 1 Global Business License. They were set up with the primary objective of undertaking investment activities and earning long-term capital appreciation and investment income.

- The Applicants were tax resident under the laws of Mauritius and as per the India-Mauritius tax treaty.

- Applicants (in all 3) held shares of a private company limited by shares incorporated under the laws of Singapore ('Singapore Co'), which in turn had invested into multiple companies in India. The value of the Singapore Co was derived substantially from assets located in India. The Applicants had acquired shares of the Singapore Company at various dates between October 2011 to April 2015. All the acquisitions were made before the grandfathering date of April 01, 2017.

[1] AAR No. 4 of 2019, AAR No. 5 of 2019 and AAR No. 7 of 2019

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- During FY 2018-19, the Applicants transferred certain shares of Singapore Co. to a company incorporated under the laws of Luxembourg on which capital gains was earned.

Application for Nil withholding tax certificate under section 197 of the Act

- Applicants approached the Indian tax authorities under section 197 of the Income tax Act, 1961 ("the Act") for seeking certification of nil withholding before consummation of the transfer.
- The Indian tax authorities denied the benefit under the India-Mauritius Tax Treaty on the basis that the Applicants were not independent in their decision making, and the control over the decision making of the purchase and sale of the shares did not lie with them.
- The Indian tax authorities issued a certificate under 197 of the Act mentioning the rate of withholding in the range of 6.05% to 8.47%. The Applicants thereafter approached the Authority of Advance Ruling ("AAR").

Application before the AAR

- Question raised in the application: Were the gains earned by the Applicants chargeable to tax in India under the India-Mauritius tax treaty?
- The Department contended that the application ought to be rejected on account of all three limbs of the proviso to section 245R (2) of the Act, i.e. the question raised is:
  - pending before the income tax authority on account of the continued validity of the certificate issued under section 197 of the Act and filing a return of income from AY 2019-20.
  - involves determination of the fair market value of any property on account of valuation of sale consideration for purposes of computation of capital gains.
  - relates to a transaction or issue, which is designed prima facie for the avoidance of income tax.
- The AAR rejected the applicability of the first and second limb of the proviso to section 245R(2) by holding that:
  - there is no pendency of proceedings as was accepted by the Commissioner of Income tax (IT)-4, Mumbai and once a transaction is concluded the certificate issued under section 197 ceases to be in force in line with Circular No. 774 of 1999.
  - the issue of evaluating India-Mauritius tax treaty eligibility does not involve valuation following the decision in the case of Worldwide Wickets[2].

On the third limb of the proviso to section 245R(2), the AAR held that at the stage of admission, the requirement for trigger was limited to prima facie avoidance of income tax and that there was no requirement to conclusively establish that there was tax avoidance. In light of the above, summarized below are the various arguments of the Department, the Applicant and the observations of the AAR on the third limb of tax avoidance, which was evaluated based

[2] 303 CTR 107 (AAR)

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on the arguments made on (a) Ownership Structure and Control (b) Decision making (c) Financial control at the time of investment and divestment, and (d) Beneficial ownership.

(a) Ownership Structure and Control
Department's Arguments • Applicants set up in Mauritius were not acting independently but only as a conduit for the beneficial owners based out of USA. **Reliance was placed on the following points:** • Notes to the Financial Statement stated that Applicants were held by a USA-based investment entity that invested in public and private markets across the world. • The structure chart indicated that the real control of the Applicants did not lie with Mauritius. On adopting a look through approach it was stated that GPs were involved in the day to day affairs of shareholders of the Applicants. In the case of one Applicant, Mr. X, the founding partner of the main Fund, was managing the affairs of the immediate parent companies/Funds which have invested in the one of the Applicant, as a GP. • As per the business plan of the Applicants, they were set up for making the investment in India and the funds for making investments were provided by the promoter.
Applicants' Arguments • A transaction cannot be held to be designed for prima facie avoidance of tax if there is a business rationale surrounding the transaction. • The Board minutes extract relied upon by the Department specifically notes that Mauritius's comprehensive tax treaty network with various countries (and not just India) facilitated efficient asset management and achieved a competitive return for the Applicant's investors. • The mere fact that the Applicants applied for a TRC in order to avail the tax treaty benefits does not mean that it was a colourable device for tax avoidance. • Mere claim for tax treaty eligibility is not in any manner tantamount to tax avoidance for the purposes of the Act. • The holding structure of the applicants was of no relevance and the transaction was not *prima facie* found to be designed for the avoidance of tax • It must be proven that the transaction itself and not the structure of the entity undertaking the transaction was designed for the avoidance of income tax.
Held • Capital gain is not dependent on the mere sale of shares. The entire transaction has to be looked at, including the purchase of shares, and not only the sale of shares as suggested by the applicants. • Notes to Financial Statement stated that the principal objective of the Applicant companies was to act as an investment holding company. The prime objective **from** investment in Singapore Co with Indian subsidiary, was to obtain benefits under the India-Mauritius tax treaty and Mauritius-Singapore tax treaty.

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(a) Ownership Structure and Control

- From their financial statements filed with the application, none of the three Applicants had made any investment other than in the shares of Flipkart. Thus, the real intention of the applicants was to utilize the benefit of India-Mauritius tax treaty, whatever the stated objective, was an inescapable conclusion.

- Though the holding subsidiary structure might not be conclusive proof for tax avoidance, the purpose for which the subsidiaries were set up does indicate the real intention behind the structure.

- The holding structure, coupled with prima facie management and control of the holding structure, including the management and control of the Applicants, would be relevant factors for determining the design for avoidance of tax.

- The Supreme Court in the case of Vodafone[3] stated that there is nothing wrong if the funds for making FDI by Mauritius companies/individuals originates from investors of third countries. In view of this judgement, the Department's submission that funds had not come from the Applicants but from the promoters in USA, so as to treat the arrangement as tax avoidance, was rejected.

(b) Decision Making

Department's Arguments

- Minutes of the Meeting - Mr. A, non-resident USA director (who was also General Counsel of main Fund) had attended all the Board meetings in which crucial decisions such as investing in shares, participating in buy-back, divestment, appointing investment manager, etc. were taken. Mr. A or one of the representatives was always present to advise the Board of the Applicants.

- Mauritius Directors were in effect mere spectators or took advice from Mr. A.

Applicants' Arguments

- Applicants submitted that they were managed and controlled by their Board in Mauritius in accordance with its constitution.

- The decision to invest into and ultimately sell the shares of Singapore Co was taken by the Directors of the Applicants in Mauritius after proper discussions and deliberations.

Held

- What is relevant to consider here is the control and management of the applicant companies.

- The control and management of applicants does not mean the day-to-day affairs of their business but would mean the head and brain of the companies.

(c) Financial Control

Department's Arguments

[3] [2012] *341 ITR 1* (SC)

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(c) Financial Control

At the time of investment

- Authority to operate the bank account transaction above USD 2,50,000 was with Mr. X, founder of the main Fund, along with a Mauritius-based director.

  It was stated that Mr. X was NOT on the Board of the Applicants and his presence was NOT noted in any of the minutes of the Board meeting where crucial decisions relating to investments were taken.

- Other authorization - The other non-Mauritius based signatories included all senior management personnel of the main Fund, along with Mauritius based director. Out of all the non-Mauritius based signatories, Mr. A was the only one on the Board of the Applicants.

Post November 2014

- Applicant's bank signatory group included Mr. X, founding partner of the main Fund, along with Mr. Y, COO of the main Fund. Neither of them was on Board of the Applicants. Both were key personnel of the main fund. Any transactions above USD 2,50,000 required either two signatories from Group A or one each from Group A and Group B (Mauritius Resident Directors form part of Group C).

- Thus, the ultimate control over the funds of the Applicants' company was with them. There were no changes to Group A signatories subsequently until the transfer of shares of the Singapore Co.

- It was stated that Mr. X was also the authorized signatory for the immediate parent companies of the Applicants. He was also the sole director of the ultimate holding company until July 2019. Hence, the funds were controlled by Mr. X.

Applicants' Arguments

- The mere fact that the Board of the Applicants have given a limited authorization to certain persons to operate the Applicant's bank account does not ipso facto mean that the Applicants did not have control over its funds.

- Not a single fact has been adduced to disprove the Applicant's submission that the funds invested as well as the sale proceeds received from the transaction were not legally and beneficially owned by the Applicants in its sole, independent and exclusive capacity.

Held

- The principal bank account of the Applicants had to be maintained in Mauritius. Authority to operate the bank accounts for transaction above US$ 2,50,000 was with Mr. X and other non-resident personnel.

- As the principal bank account of the Applicants was maintained in Mauritius, it would have made sense if a local person based in Mauritius was appointed to sign the cheques on behalf of the directors. The Applicants have not explained why Mr. X, who was not based in Mauritius was appointed to sign the cheques of the Mauritius bank account.
- Mr. X was the beneficial owner, as disclosed in the application form for the Global Business License. Mr. X was also the authorized signatory for the immediate parent company and ultimate holding company.

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(c) Financial Control

- The appointment of Mr. X as authorized signatory of bank cheques above a limit cannot be considered to be a mere coincidence.
- Authorization to operate the bank account was not to a certain person but to Mr. X, the founding partner of the main Fund. Mr. X and another authorized signatory Mr. Y, although being not on the Board of Applicants, were the key personnel of the Group and were managing and controlling the affairs of the entire organization structure.
- From the evidence brought on record by the Department, it is clear that the funds of the Applicants were ultimately controlled by Mr. X and the Applicants had only limited control over their fund.
- The decision for investment or sale was taken by the Board but the real control over the decision of any transaction over USD 2,50,000 was exercised by Mr. X. Thus, the head and brain of the Applicants were not situated in Mauritius but in the USA.

(d) Beneficial ownership

<u>Department's Arguments</u>

- On bare perusal of the documents submitted by one of the Applicant with Mauritius Financial Services Commission for obtaining Category 1 Global Business License, the Applicant had mentioned that its beneficial owner was Mr. X.
- On the basis of the material on record, it was evident that the decisions of the Applicants were not taken independently by the companies in Mauritius but by the people located with the main Fund.
- It was submitted that the applicant companies were see-through entities, which was designed prima facie for the avoidance of tax.

<u>Applicants' Arguments</u>

- The Applicants had beneficially held shares of Singapore Co and were not accountable to any third party.
- The mere fact that certain disclosures were made and maintained for Mauritius corporate law purposes does not ipso facto mean that the legal owner does not enjoy the benefits of the shares in his independent capacity for income tax purposes, unless clear facts are brought on record to demonstrate otherwise.
- Applying the logic adopted by the Department would result in an absurd and legally unintended situation, whereby no Indian company with foreign shareholders would ever be able to claim tax treaty benefits in India.
- The allegation also goes against the Department's own argument that the applicants have multiple owners or limited partners.

<u>Held</u>

- Based on the group structure, approval matrix, disclosures made with Mauritius authorities etc., the AAR observed that Mr. X, was the beneficial owner of the entire group structure.

(d) Beneficial ownership

- The Supreme Court in the case of Vodafone *(supra)* held that Tax Treaty and Circular No. 789 dated 13 April 2000 would not preclude the Income Tax Department from denying the tax treaty benefits in suitable cases.

Application of India-Mauritius tax treaty to Indirect Transfers

The AAR observed that Circular No. 682 dated 30 March 1994 clarified that any resident of Mauritius deriving income on alienation of shares of Indian companies will be liable to capital gains tax only in Mauritius. They further observed that the amended tax treaty between India and Mauritius also provided for grandfathering only in respect of shares of an Indian company from a capital gains perspective. In the present case, the capital gains had arisen on alienation of shares of a Singapore company and not an Indian company. The AAR thus concluded that object of the India-Mauritius Tax Treaty to grant exemption in respect of shares of an Indian Company only and exemption on transfer of shares of the company not resident in India, was never intended by the legislator.

The AAR further concluded that applicants failed miserably if the yardsticks as laid down by the Supreme Court in the case of Vodafone (supra) are applied viz. the period of business operation in India, the generation of tax revenue in India, timing of exit and continuity of business on such exit, etc. as investments were made in a Singapore company and thus the immediate investment destination was Singapore and not India.

Dhruva Comments

Availability of tax treaty benefits has always been a vexed issue in the Indian context with judicial precedents all over the place. Grant of treaty benefits, to a large extent, also depends on the facts and circumstances of each case. In this ruling, the AAR has asserted that in order to claim Treaty benefits in respect of capital gains, the Mauritius company must demonstrate that its head and brain lies in Mauritius (i.e. it was acting on its own behalf) as also that it was the 'beneficial owner' of the capital asset alienated by it.

Interestingly, in the past, the AAR in the case of AB Holdings, Mauritius II (AAR No 1129 of 2011) while upholding treaty benefit had stated that the mere involvement of the Parent company of the Mauritius company in important decision making areas should not undermine the legitimacy of the Mauritius company or its investments. However a similar fact pattern in this ruling has been treated as a negative factor resulting in denial of treaty benefit.

Further, the observation of the AAR that tax treaties never intended to exempt indirect transfers could lead to potential litigation in the future. In this regard, several judicial pronouncements in the past have upheld the eligibility to claim tax treaty exemption in respect of indirect transfers including the AAR's decision in the case of Banca Sella (AAR No. 1130 of 2011) and Gea Refrigeration Technologies GMBH, In Re (AAR No. 1232 of 2012).

This ruling yet again highlights the importance of documentation and conduct in successfully availing treaty benefits. Specifically, in addition to obtaining a Tax Residency Certificate, it is necessary to demonstrate independent decision making and commercial substance through appropriate documentation.

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The availability of treaty benefits will assume significant importance in the days to come given that the Multilateral Instrument (which encompasses the Principal Purpose Test, Beneficial ownership test, etc.) is already in force. Whilst the tax law continues to evolve and the saga of availability of treaty benefit continues, businesses will need to constantly reassess their holding structures in order to assess impact, identify risks, explore planning opportunities, and meet their obligations.

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