

TAX FLASH NEWS

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Income from Indian investment by UAE based settlor through a Jersey based Trust is not taxable under the India-UAE tax treaty

Recently, the Bombay High Court in the case of Abu Dhabi Investment Authority¹ (the taxpayer/ UAE based settlor) while quashing Authority for Advance Ruling's (AAR) decision held that income earned from Indian investment by UAE based settlor through Jersey-based Trust is not taxable in India by virtue of exemption provided under Article 24 of the India-UAE tax treaty (tax treaty). As per the provisions of the Income-tax Act, 1961 (the Act) read with the tax treaty, even if, the trust is based out of Jersey and the trust is settled in Jersey, the income which arises to UAE based settlor by virtue of investment in Indian Portfolio companies will be governed by the beneficial provisions of the tax treaty as UAE based entity was the settlor and sole beneficiary of the trust and resident of UAE.

Further there was no attempt to reduce the tax liability by using the trust structure. Under the provisions of the Trust Deed, UAE settlor was provided right to re-assume power over the entire income arising on the investments made by the trust in the portfolio companies. Thus the entire income arising therefrom has to be assessed in the hands of UAE based settlor considering the provisions of revocable transfer of asset² under the Act. Consequently, such income is not taxable in India under Article 24 of the tax treaty.

Even if for any reason the provisions of revocable transfer of asset are not applicable, then also the trustee can only be assessed in a representative capacity and, accordingly the provisions of representative assessee³ will be applicable. Therefore, even if the income is taxed in the hands of the trustee, it will be taxed in the 'like manner and to the same extent' as the beneficiary.

Facts of the case

Abu Dhabi Investment Authority (ADIA) is a public institution owned by and subject to the supervision of the Emirate of Abu Dhabi. ADIA does not have any Permanent Establishment (PE) in India.

Green Maiden A 2013 Trust, a foreign Trust⁴ was established by ADIA and Equity Trust (Jersey) Ltd (ETL) as a settlor and trustee, respectively. The trust is settled by ADIA in Jersey. Under the Deed of Settlement (dated 22 July 2013), the Trust was set-up by and for the benefit of ADIA who is, apart from being the settlor, also the sole beneficiary of the trust. This trust is a revocable and determinable trust.

The Trust was registered with the Securities and Exchange Board of India (SEBI) as Foreign Institutional Investor (FII) under the SEBI (Foreign Institutional Investors) Regulations, 1995 and later on as Foreign Portfolio Investor (FPI) under the SEBI (FPI) Regulations 2014.

ETL as trustee has entered into an Investment Management Agreement (dated 24 July 2013) with Kotak Mahindra (International) Ltd. (KMIL). One of the obligations cast on KMIL in terms of the agreement is that a KMIL group subsidiary will invest in each and every portfolio company alongside the Trust.

The Deed of Settlement provides that the capital contributions made or proposed to be made by ADIA to the Trust would be a revocable transfer. Pursuant to the Deed of Settlement, ADIA made a capital commitment of USD 200 million in the trust in its capacity as a settlor.

¹ Abu Dhabi Investment Authority and Others v. AAR (Writ Petition No. 770 of 2021) – Taxsutra.com

² Section 61

³ Under Section 160

⁴ Located in Jersey

ADIA set-up the trust to make investments in India and claimed the benefit of the India-UAE tax treaty. According to ADIA, the income derived from making investment and debt securities in India was not assessable to tax in India having regard to the provisions Article 24⁵ of the tax treaty.

In a view to have clarity on the position and avoid needless litigation, ADIA filed an application⁶ before the AAR to determine taxability of the income accruing on the investments made or proposed to be made in the Indian portfolio companies by the Trust. However, the AAR rejected the contentions of the taxpayer regarding the non-taxability of the income accrued on the investments made or proposed to be made by the Trust in Indian portfolio companies and passed a ruling denying ADIA and ETL the benefit of the tax treaty.

High Court's decision

Requirements of Section 61 and Section 63

Section 61 provides that any income arising to any person by virtue of revocable transfer shall be chargeable to tax as the income of the transferor. In the instant case, the Deed of Settlement indicates that there was a revocable transfer by settlor, i.e., ADIA to trustee ETL and as such any income arising to the trustee should be chargeable in the hands of ADIA. Nothing in Section 61 requires involvement of a Trust in revocable transfer.

A transfer can be revocable transfer on its own merits without reference to Section 63⁷. Clause (a) of Section 63 merely extends the provisions of Section 61 to cases which might not otherwise be covered by Section 61 by extending the meaning of word revocable. Clause (b) in Section 63 extends the meaning of the word transfer in Section 61 to cases which might not otherwise amount to transfer.

A settlement or a Trust are merely instances of what could amount to transfer for the purposes of Section 61. Section 63(b) includes in the definition of transfer, any settlement or Trust or covenant or agreement or arrangement. Moreover, Section 63 is not restricted only to Trust. It is an inclusive definition. As long as the

conditions provided in Section 63(a) were fulfilled, any transfer whether connected with the trust or not will be a revocable transfer. The case of AAR that if the transaction does not qualify as a trust, the provisions of Section 63 and/or Section 61 are not applicable, is erroneous.

Applicability of specified trust provisions of the Act to a foreign trust

In any event, under Section 63 there is no requirement that a trust covered by it must necessarily be an Indian trust falling under the Indian Trust Act. Such restriction which is not there in the Act cannot be imported into Sections 61 and 63. Wherever required like in provisions of Section 10(23FB), it is specifically provided that venture capital fund (VCF) means a fund operating under the trust deed registered under the provisions of Registration Act, 1908.

There is nothing in Sections 61 and 63 to restrict its applicability only to trust settled in India and, therefore, one cannot rule out their applicability to a Foreign Trust. Even if the definition of the trust under the Indian Trust Act can be held to say that it does not cover 'The Trust', i.e., Green Maiden A 2013 Trust, still the word trust in Section 63 covers all trust within its ambit.

Ratification of Hague Convention on the Law

Hague Trust Convention referred by the AAR does not decide the issue one way or the other. There was nothing to even suggest in the ruling of the AAR as to how the ratification of Hague Trust Convention would affect the status of Foreign Trust in India. If we accept what AAR has opined that Foreign Trust can be recognised in India only if and after India ratified the Hague Trust Convention that would imply that no Foreign Trust can be treated as trust for the purpose of the Act.

The High Court referred the decision of H.M.M. Vikramsinghjit of Gonda⁸ wherein it was held that even Foreign Trusts are recognised in Indian Tax Laws. On reference to Article 2 of the Trusts (Jersey) Laws 1984, it can be observed that the Trust created in terms of the deed of settlement is consistent with the requirements of both, the Indian Trusts Act as well as Trust (Jersey) Law, 1984 as to what constitutes a trust.

⁵ The Government of one contracting State shall be exempt from tax, including capital gains tax, in the other contracting State in respect of any income derived by such Government from that other contracting State

⁶ dated 18 March 2020

⁷ Section 63 -

(a) a transfer shall be deemed to be revocable if:

(i) it contains any provision for the re-transfer directly or indirectly of the whole or any part of the income or assets to the transferor, or

(ii) it, in any way, gives the transferor a right to re-assume power directly or indirectly over the whole or any part of the income or assets

(b) "transfer" includes any settlement, trust, covenant, agreement or arrangement.

⁸ CWT v. Estate of HMM Vikramsinhji of Gondal [2014] 45 taxmann.com 552 (SC)

Settlor as a sole beneficiary of trust

There was no provision under the Indian Trust Act which debars the settlor from being beneficiary. In the case of Bhavna Nalinkant Nanavati⁹, the settlor of the trust was also the sole beneficiary in the Deed of Settlement. Thus, it follows that the settlor cannot be the trustee and sole beneficiary. In the present instance, the settlor was not the trustee but was the sole beneficiary which is clearly permissible.

Avoidance of tax

In the present case, if ADIA had invested the amount directly, the income derived from such investment would be exempt under Article 24 of the tax treaty. ADIA had not created the trust to avoid tax and that is not AAR's case either. As per the Deed of Settlement, the trust was set up, contained specific clauses which established the revocable nature of the trust. As the ADIA has settled the trust on the terms mentioned in the Deed of Settlement, the contribution made by it to the trust would be a transfer as defined in Section 63.

Even if, the trust is based out of Jersey and the trust is settled in Jersey, ADIA being the settlor and sole beneficiary of the trust and resident of UAE as per Article 24 of the tax treaty, the income which arises to it by virtue of investment in Indian Portfolio companies will be governed by the beneficial provisions of the India-UAE tax treaty.

It has been observed that there was no attempt whatsoever to reduce the tax liability by using the trust structure. When the provisions of the Trust Deed provided that ADIA has right to re-assume power over the entire income arising on the investments made by the trust in the portfolio companies, the entire income arising therefrom has to be in terms of Section 61 to be assessed in the hands of ADIA.

Taxability as representative assessee

Even if for any reason the provisions of Section 61 are not applicable, then also the trustee can only be assessed in a representative capacity and, accordingly the provisions of representative assessee under Section 160(i)(iv) will be applicable. Therefore, even if the income is taxed in the hands of the trustee in terms of Section 161(1), it will be taxed in the 'like manner and to the same extent' as the beneficiary.

As there was no bar to the settlor and beneficiary being the same person and in view of the judgment in Bhavna Nalinkant Nanavat, it is quite clear that

⁹ Bhavna Nalinkant Nanavati v. Commissioner of Gift Tax [2002] 255 ITR 529 (Guj)

Section 61 is independent of Section 63 and a transfer can be a revocable transfer on its own merits and was not restricted only to trusts.

Applicability of Article 24 of India-UAE tax treaty

A 'settlement' or a 'trust' are instances of what amount to transfer. So long as the settlor has a right to reassume power over the assets settled, the same would amount to revocable transfer. In the facts of the case at hand, ADIA could reassume the power and hence the contribution to the trust was a revocable transfer thereby making the income arising to the trust taxable in the hands of ADIA which was exempt under Article 24 of India-UAE tax treaty.

The tax liability of a trust has to be determined by applying the provisions of the Act along with the provisions of India-UAE tax treaty and not apply the law as applicable in Jersey. In the circumstances, AAR ruling has to be quashed. The income that accrues to the trust would not be chargeable to tax in India either by virtue of application of Section 61 read with Section 63 or on an application of Section 161 of the Act conjointly with the provisions of Article 24 of the India-UAE tax treaty.

Our comments

A trust is a legal entity that holds property for the benefit of others and managed by a trustee. In the instant case, trust was formed in a different country than the country of settlor. Further such trust had made investment in India. The Bombay High Court observed that there is no provision in the Act which provides that specified Trust related provisions shall apply only to an Indian Trust. Such provisions will also apply to a foreign trust.

Further considering the tax treaty provisions, the High Court held that income earned through Jersey-based Trust is not taxable in India by virtue of Article 24 of the tax treaty as the Trust is covered under Section 61 read with Section 63 of the Act.

Emphasis was provided to the fact that even if the trust was based out and settled in Jersey, ADIA being the settlor and sole beneficiary of the trust and resident of UAE as per Article 24 of the tax treaty, the income which arises to it by virtue of investment in Indian Portfolio companies will be governed by the beneficial provisions of the tax treaty.

Further weightage was also given to a comparative reading of India's and Jersey's laws relating to trust. Jersey Trust created in terms of the deed of settlement was consistent with the requirements of being a trust under both the laws.

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