

TAX FLASH NEWS

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Cypriot company is treated as a 'beneficial owner' of interest received on CCDs from an Indian entity and hence it is eligible for India-Cyprus tax treaty benefits

Background

Recently, the Mumbai Bench of Income-tax Appellate Tribunal (the Tribunal) in the case of Golden Bella¹ (the taxpayer) held that the India-Cyprus tax treaty (tax treaty) benefit is available to the taxpayer since it was a 'beneficial owner' of interest income received on Compulsory Convertible Debentures (CCDs) from an Indian entity. Mere fact that the investment was funded using a portion of an interest-free shareholder loan does not affect the taxpayer's status as the 'beneficial owner' of interest income.

Facts of the case

The taxpayer is a Cyprus based company and it was incorporated on 1 August 2011. It is formed with the objective of undertaking business activities of an investment holding company. The taxpayer has been issued a Tax Residency Certificate (TRC) by the tax authorities in Cyprus. The taxpayer applied for 5000 CCDs in Indian entity each having face value of INR10 at a premium of INR 1,99,990 per CCD and carrying coupon of 15 per cent on the face value for an aggregate consideration of INR1000 million. The premium at which the taxpayer proposed to apply for such CCDs was determined based on a valuation report obtained by Indian entity valuing its equity shares at INR1,17,717 per share using Discounted Cash Flow (DCF) method. The taxpayer applied for such CCDs on its own account, using a portion of the share capital and the interest-free shareholder loan raised from its immediate shareholder.

During the Assessment Year (AY) 2013-14, the taxpayer filed its return of income showing a total income of INR151.64 million from interest on CCDs in Indian entity and such interest was duly offered to tax at the rate of 10 per cent in accordance with the beneficial provisions of Article 11 of the tax treaty. The Assessing Officer

(AO) denied the benefit of the tax treaty on the basis that the taxpayer was not the beneficial owner of interest income and brought to tax the interest income earned at the rates in force (i.e. approximately 42 per cent).

The AO observed that the investment made by the taxpayer in Indian entity is back-to-back loan, on the basis that it had used a shareholder loan raised from its immediate shareholder to invest in Indian entity. The taxpayer was acting as a mere conduit for the passage of funds between the taxpayer's immediate shareholder and Indian entity. The taxpayer had outsourced its corporate secretariat and management function to an institutional service provider and it did not carry out any business activities in Cyprus. It was merely a 'name plate' company. It did not exercise dominion and control over the CCDs as 'most of the companies' incorporated in Cyprus and other 'tax havens' did not have any independent office or qualified employees to carry out any business or investment activities. The taxpayer was not the 'beneficial owner' of the interest income on CCDs. Subsequently, the Dispute Resolution Panel (DRP) upheld the order of the AO.

Tribunal's decision

The Tribunal observed that the taxpayer invested in CCDs and received interest income thereon for its own exclusive benefit, and not for or on behalf of any other entity. The mere fact that the investment was funded using a portion of an interest-free shareholder loan and share capital does not affect the taxpayer's status as the 'beneficial owner' of interest income, as the entire interest income was the sole property of the taxpayer.

The Tribunal referred OECD Commentary [2017] on Article 11 (Interest) which provides the meaning of 'beneficial owner'. The Tribunal observed that mere fact that the CCDs were funded using monies received by the taxpayer from its immediate shareholder does not

¹ Golden Bella v. DCIT - [ITA No. 6958/MUM/2017] – Taxsutra.com

make the arrangement a back-to-back transaction. The taxpayer had the absolute control over the funds received from its immediate shareholder. Further, in the instant case the taxpayer wholly assumed and maintained the foreign exchange risk on the CCDs (as they were INR denominated), and the counter party risk on interest payments arising on the CCDs.

In the present case, the lower authorities have failed to prove that the taxpayer did not have exclusive possession and control over the interest income received, the taxpayer was required to seek approval or obtain consent from any entity to invest in ABPL, or to utilise the interest income received at its own discretion and the taxpayer was not free to utilise the interest income received at its sole and absolute discretion, unconstrained by any contractual, legal, or economic arrangements with any other third party. Accordingly, the transaction between the taxpayer and Indian entity cannot be considered a mere back-to-back transaction lacking economic substance. Therefore, the Tribunal accepted the appeals filed by the taxpayer.

Our comments

The issue with respect to the beneficial ownership vis-à-vis denial of the tax treaty benefit has been a subject matter of debate before the Courts/Tribunal.

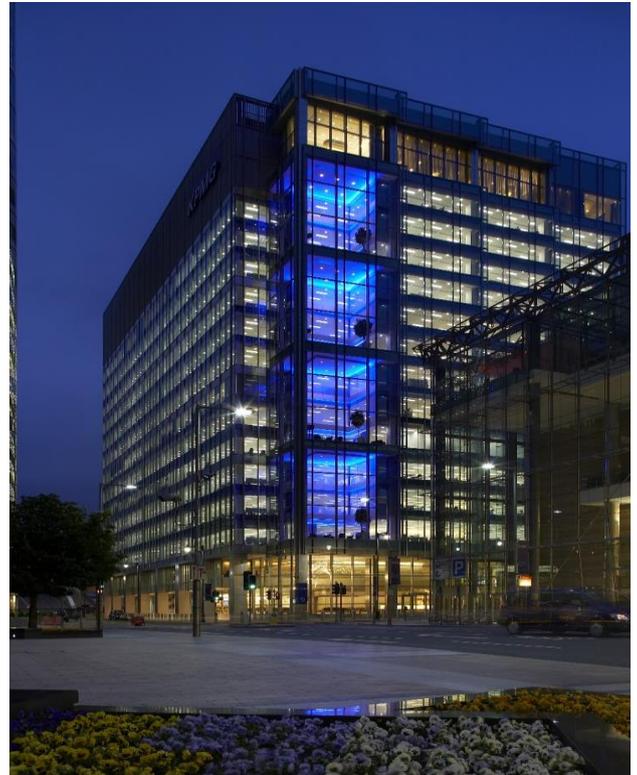
The Supreme Court in the case of *Azadi Bachao Andolan*² upheld the applicability Tax Residency Certificate (TRC) which confirms the residential status and beneficial ownership of the taxpayer.

Various Courts/Tribunal³ have held that the taxpayer was a beneficial owner of income received from the Indian Company and therefore, income would be taxed at a beneficial tax rate under the tax treaty. However, in few cases⁴, Courts/Tribunal have denied the tax treaty benefits for non-satisfaction of beneficial ownership conditions.

The Mumbai Tribunal in the instant case observed that the mere fact that the investment was funded using a portion of an interest-free shareholder loan does not affect the taxpayer's status as the 'beneficial owner' of interest income. The entire interest income was the sole property of the taxpayer. The tax authorities have failed to prove that the taxpayer did not have exclusive possession and control over the interest income received.

The MLI has introduced Principal Purpose Test (PPT) as a minimum standard. Such provisions deny the tax treaty benefit if one of the principle purposes is to take benefits of the tax treaty. Further, the GAAR provisions

are already applicable with effect from AY 2018-19 under the Income-tax Act, 1961. Thus it would be interesting to see how tax authorities will deal with the beneficial ownership criteria while applying the provisions of GAAR/PPT.



² *UOI v. Azadi Bachao Andolan* [2003] 132 Taxman 373 (SC)

³ *ADIT v. Universal International Music BV*[2011] 45 SOT 219 (Mum), *Imerys Asia Pacific Pvt Ltd v.* [2016] 69 taxmann.com 454 (Pune)

⁴ *NatWest Markets* (AAR No. 232 & 233 of 1995)

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