Tax Flash News

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The Delhi High Court upholds Mauritius treaty benefit to PE Fund, quashes AAR ruling

Executive summary

The Authority for Advance Ruling (The AAR) in the case of *Tiger Global International III Holdings*, *In re*[1] had rejected the application for advance ruling on the ground that the transaction was designed *prima facie* for the avoidance of tax. The AAR also held that the objective of India-Mauritius tax treaty (The Treaty) was to allow exemption of capital gains on transfer of shares in Indian company and such exemption on transfer of shares in the company not resident in India was never intended.

The applicant challenged the said order by way of a Writ petition before the Delhi High Court. The Delhi High Court[2] in a detailed judgement analysed various aspects related to claim of Mauritius treaty exemption and quashed the AAR's ruling holding that the transaction is grandfathered by virtue of Article 13(3A) of the treaty and is not designed for the avoidance of tax.

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[1] Reported in [2020] 116 taxmann.com 878 (AAR - New Delhi)

[2] *Tiger Global* International *III Holdings* v. *AAR [2024] 165 taxmann.com 850 (Delhi)*

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Facts of the case

Tiger Global International III Holdings (The taxpayer) was a tax resident of Mauritius. It had a Category 1 Global Business License and a TRC issued by the Mauritian authorities. The immediate shareholders of the taxpayer were also Mauritian companies which, in turn, were part of a foreign private equity fund ('The PE Fund). The PE Fund had raised funds from several investors across the globe. A US-based group company was the investment manager of the fund (with no investment in the taxpayer).

The taxpayer had acquired shares of a Singapore based company before 1 April 2017. The Singapore company had investment in the shares of the Indian companies. In 2018, the taxpayer sold shares of the Singapore company which derived their value substantially from the assets in India.

The taxpayer filed an application before the AAR to determine the tax implications in India, if any, arising from the sale. The taxpayer argued that the gains arising from the sale of shares are not taxable in India as per the treaty. The AAR held that the transaction was designed for the avoidance of tax and the application was rejected.

The taxpayer filed Writ petition against the advance ruling before the Delhi High Court. The High Court quashed the AAR order and held that the gains from the transfer of shares acquired prior to 1 April 2017 are grandfathered under the treaty.

High Court's decision

The Mauritius route

The Court noted that Mauritius is one of the preferred destinations for investors wishing to invest in the South-East Asian economies and in India subsequent to the liberalization measures adopted in 1991. This is because of its proximity to India, the wide array of agreements with various nations across the globe, the liberalised exchange controls, a favourable investment climate and the socio-political stability.

It is always open for the multinational to expand their activities and presence in various markets by choosing a tax neutral and investor friendly jurisdiction.[3]

The law does not raise a presumption of tax evasion, treaty abuse, illegality, or disreputability to the foreign investments made through entities domiciled in Mauritius. Nor such entities are obliged to satisfy a separate/stricter standard of legitimacy.

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[3] *Vodafone International Holdings B.V* v. *UOI* [2012] 341 ITR 1 (SC).

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Taxability of indirect transfer under the treaty

The AAR was not correct to hold that sale of shares of a Singapore company (i.e., indirect transfer) by a Mauritius shareholder was not covered by Article 13(3A) as that article is applicable to the sale of shares of a company resident in India. If the reasoning of the AAR were to be accepted, the transaction itself would be outside the scope of taxation in India.

Commercial substance of the taxpayer

The Court held that it is difficult to hold that the taxpayer lacked economic substance or was domiciled in Mauritius solely for taking the tax treaty benefit.

It had a valid TRC, Category 1 GBL license. The taxpayer had made substantial investment, incurred substantial expenditure, disclosed the transaction in its financial statement. The transfer of shares was part of a broader transaction. The taxpayer was intended to operate as pooling vehicles with funds provided by more than 500 investors situated in 30 jurisdictions across the globe.

The Revenue had questioned the independence and authority of the directors of the taxpayer. However, the board resolutions reveal that the key decisions with respect to investments were taken by the directors of the taxpayer. No payments were authorised without the approval of the directors. The dividend declared by the taxpayer in favour of their shareholders was by virtue of a decision taken in the board meeting. The board of directors cannot be said to be deprived of decision-making powers or reduced to a subservient status.

A holding company could legitimately claim the right to exercise oversight and retain a broad supervisory role over the affairs of its subsidiary by selecting key managerial personnel, regular audit of affairs. Mere exercise of such shareholder influence would not lead to an inference of subsidiary being a puppet.

Tax residency certificate

The High Court referred to CBDT Circular No. 789[4] which provided that the TRC is sufficient evidence of the status of residence as well as of beneficial ownership for availing the treaty benefit.

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[4] CBDT Circular No. 789, dated 13 April 2000 and *UO*I v. *Azadi Bachao Andolan* [2003] 263 ITR 706 (SC)

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The proposed amendment by the Finance Bill, 2013, (which provides that the TRC is not a sufficient condition for claiming the treaty benefit) never got enacted. The Finance Ministry[5] also clarified that the TRC will be accepted as sufficient evidence for the treaty benefit and the Revenue will not question or go behind the TRC.

The issuance of TRC constitutes a mechanism adopted by the treaty countries to dispel any speculation with respect to the fiscal residence of an entity. It can neither be cursorily ignored nor the Revenue be justified in doubting the presumption of validity. Taking any other view would result in erosion of faith and the trust reposed by the parties to the treaty in each other.

Treaty shopping should not be frowned upon unless there is tax evasion and is contrary to the underlying and stated objectives of the treaty countries. The Indian government appears to have accepted the legal position as enunciated in *Azadi Bachao* and *Vodafone* that the invocation of the substance over form principle should be confined to extreme cases.

LOB clause

In the instant case, the taxpayer qualified the expenditure test stipulated in the LOB clause.

The incorporation of LOB provisions in the treaty will result in those provisions being determinative of allegations of treaty abuse and purported illegitimate claims of treaty benefits.

The right to question the validity of a transaction, notwithstanding a LOB clause, would have to meet a compelling standard of proof, with the onus lying on the Revenue, to establish that the substance of the transaction warrants the entity being denied the treaty benefit. These would be confined to the cases of fraud or sham, transactions tainted with illegality and where the circumstances unerringly prove that the treaty countries never intended it to be covered by the beneficial treaty provisions or the transaction be contrary to the underlying objective and purpose of the treaty itself.

The treaty countries did not intend its respective tax authorities to deploy their own standards of probity. This is evidenced from the verifiable and certifiable standards of the LOB provisions. Taking any other view would result in the tax authorities of the respective countries to question the validity of a transaction based on the parameters wholly alien to the treaty and contrary to the negotiated terms.

[5] Vide press release dated 1 March 2013

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The treaties are formulated by the nations based on political and economic considerations and it is for the treaty countries to delineate the qualifying conditions. It would be incorrect for the courts to conjure or create disqualifications over and above those adopted by the treaty countries.

The LOB provisions comprised in the treaty comprehensively address treaty abuse and it would be wholly impermissible for the Revenue to construct additional barriers or qualification standards for the purposes of extending treaty benefits to the taxpayer.

GAAR provisions

When the treaty was renegotiated, and the LOB provisions were incorporated in the treaty, in 2016, the GAAR and indirect transfer provisions had already come to exist in the Act. India and Mauritius were aware of the GAAR provisions and indirect transfer provisions, but still chose to grandfather the gains from the shares acquired prior to 1 April 2017. The LOB clause was restricted to shares acquired after that date. This is also evident from the grandfathering provisions in the domestic GAAR (Rule 10U(1)(d)).

The Revenue argued that the GAAR provision will apply to the transaction irrespective of the taxpayer's reliance on the grandfathering clause of the treaty. Even though an arrangement was entered into prior to 1 April 2017, any tax benefit from an arrangement on or after 1 April 2017 would be subject to the GAAR provisions as per Rule 10U(2) which overrides Rule 10U(1)(d).

The High Court rejected the Revenue’s argument and held that it would result in sub-rule (2) taking away what stood saved in sub-rule (1)(d) of Rule 10U. The term ‘without prejudice’ is intended to mean that sub-rule (2) would operate in contingencies not contemplated by sub-rule (1)(d) of Rule 10U.

The 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 treaty provisions as it would amount to accepting the right of one country to unilaterally amend the treaty provisions.

Beneficial ownership

The beneficial ownership test requires the determination as to whether the recipient of income holds the income in the capacity of an administrator/trustee or has no right or control over the income or merely holds the income to be deployed on the instruction of another.

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The Revenue failed to substantiate that the taxpayer was under a contractual or legal obligation to remit its revenue to the US company. The High Court concluded that the allegation that the taxpayer was not a beneficial owner was thoroughly misconceived and untenable.

The entire case against the taxpayer was based on the erroneous and factually unsustainable premise that the US company was the holding company of the taxpayer and controlled major decisions taken by the taxpayer. The Revenue alleged that the US company was the beneficial owner of investments made by the taxpayer.

Neither the Revenue nor the AAR was able to prove the same with valid evidence. The US company did not have any equity participation or investment in the taxpayer. It was just a management company.

Our comments

The claim of India-Mauritius tax treaty exemption on capital gains arising from sale of Indian investments has been a subject matter of litigation. The Indian tax authorities have been denying the capital gains exemption under the treaty on the ground of treaty abuse by the foreign multinational groups by establishing an intermediary holding company for the purposes of making investment in India.

The High Court has made several significant observations in the context of claim of the treaty benefit on capital gains. The High Court's observation on GAAR non-applicability for treaty can have significant implications. However, it is important to keep in mind that the High Court has specifically stated that its observations should not be construed as a broad principle but are in the context of GAAR applicability in the facts and circumstances of the present case.

On 7 March 2024, India and Mauritius have signed a protocol to amend their treaty by replacing the existing treaty preamble and introducing the principal purpose test (PPT) in the treaty. The protocol is yet to enter into force and is not yet effective. Impact of this decision on PPT applicability (once the protocol becomes effective) would assume significance.

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It is interesting to note that the taxpayer has argued that the indirect transfer should not be taxable in India by virtue of Article 13(4) of the tax treaty, whereas the AAR has held that the treaty is not applicable to the transfer of shares in a Singapore company by a Mauritius tax resident. However, the High Court held this transaction was to be grandfathered under Article 13(3A) of the tax treaty[6].

Further, the High Court noted that LOB article enumerates the circumstances in which an entity may be denied the benefits of Article 13(3B) or where it would be deemed to be a mere shell/conduit company. The High Court applied the LOB clause [Article 27A dealing with a situation of Article 13(3B)] to the instant case.

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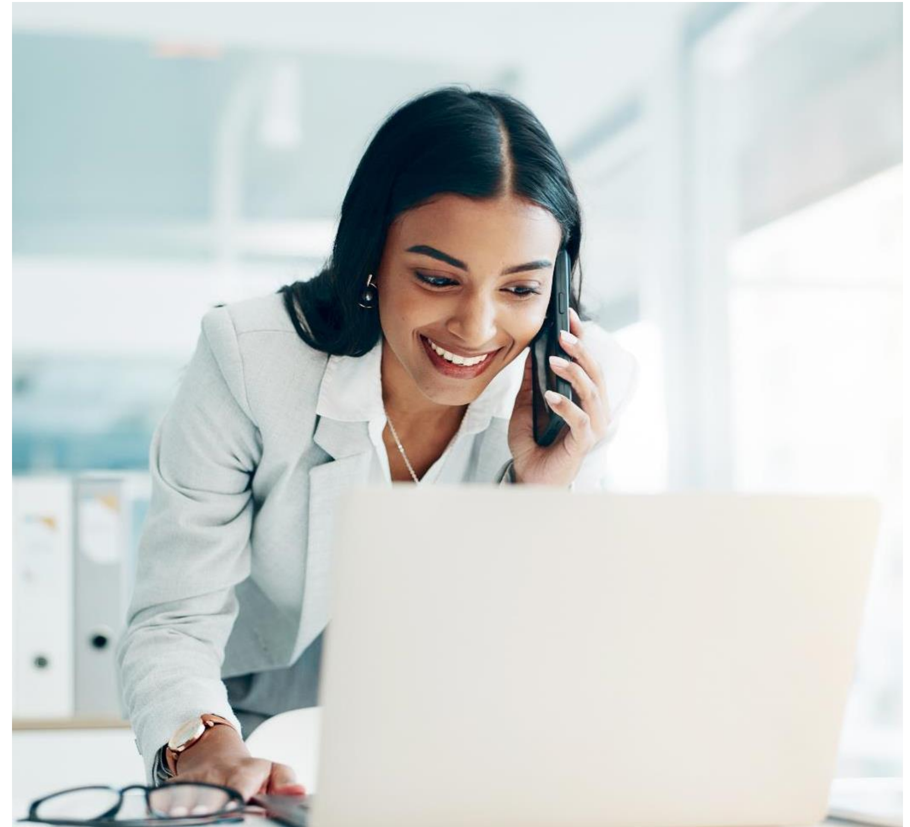

[6] Article 13(3A) of the treaty provides that gains arising to a Mauritian resident on the alienation of shares in an Indian company acquired on or after 1 April 2017 may be taxed in India. Article 13(4) provides that gains arising to a Mauritian resident from the alienation of other properties shall be taxable only in Mauritius

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