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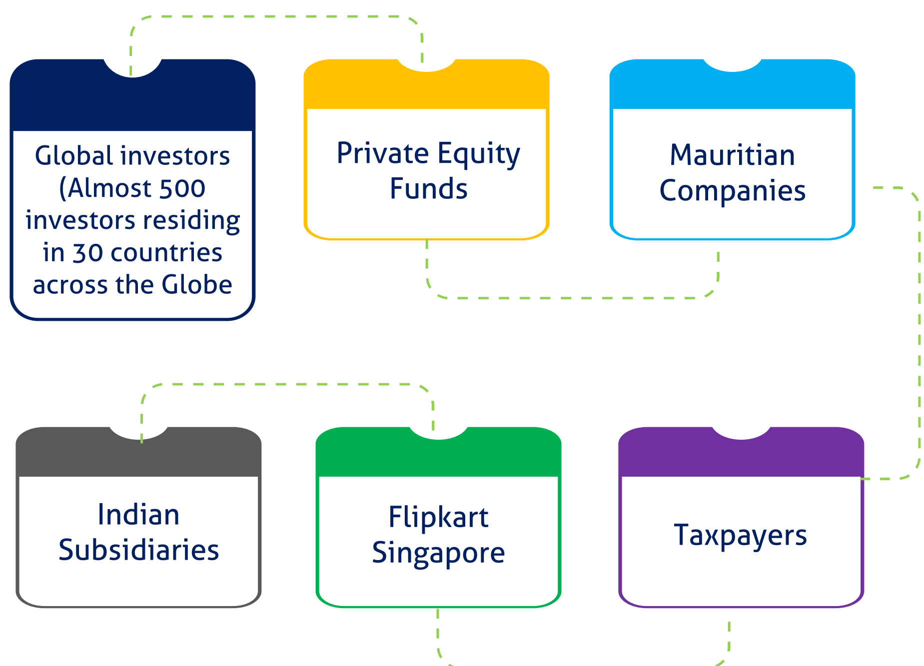
Delhi HC 'unflips' the 'Kart' flipped by AAR, emphasises on superiority of TRC & grandfathering provisions of India-Mauritius Treaty over anti-abuse provisions under domestic law

Snapshot

The Delhi High Court ruled in favour of the Taxpayers in a case where Mauritius-incorporated Taxpayers sought tax benefits under the India-Mauritius DTAA for the sale of shares of Singapore entity which had Indian subsidiaries. The court ruled that the DTAA applied to indirect transfers and the right to question the validity or character of a transaction notwithstanding duly articulated LOB provisions being met would have to meet an extremely high, exacting and compelling standard of proof with the onus lying squarely upon the Revenue to establish that the substance of the transaction clearly warranted the entity being deprived of treaty benefits. It upheld the legitimacy of Mauritius investments, noting that Taxpayers were not merely conduits and had economic substance. The Court allowed benefit of grandfathering provisions under Article 13 of India-Mauritius DTAA where shares of Singapore company were acquired before April 1, 2017, and held that GAAR provisions would not be applicable to the grandfathered shares.

Facts of the Case

Taxpayers[1] (collectively referred as Taxpayers and individually as Taxpayer) were companies incorporated in Mauritius and were set up with the primary objective of undertaking investment activities with the intention of earning long term capital appreciation and investment income. They had been granted Category 1 Global Business License (GBL) and their activities were regulated by Financial Services Commission of Mauritius. The shareholding structure of Taxpayers were as follows:



[1] Tiger Global International III Holdings [W.P.(C) 6764/2020 & CM Appl. 23479/2020], Tiger Global International II Holdings [W.P.(C) 6765/2020 & CM Appl. 23481/2020], International IV Holdings [W.P.(C) 6766/2020 & CM Appl. 23483/2020]

Tiger Global Management LLC (TGM LLC), incorporated in Delaware USA was the investment manager of the Taxpayers. Taxpayers acquired shares of Flipkart Private Limited (Flipkart Singapore) between October 2011 to April 2015. Board of Directors (BOD) of Taxpayers approved the sale of shares of Flipkart Singapore in their board meeting dated May 4, 2018, and approached the Indian tax authorities for a 'nil' withholding certificate under section 197 of the Act since Flipkart Singapore derived its value substantially from the Indian subsidiaries. The authorities rejected the application of the Taxpayers and held that it would not be entitled to benefit of India-Mauritius Double Taxation Avoidance Agreement (DTAA) since the real control of the Taxpayers was outside Mauritius. The Taxpayers transferred their shares in Flipkart Singapore to a Luxembourg entity in August 2018 and filed an application with Authority for Advance Rulings (AAR) for determining the taxability of the transaction. The Taxpayers contended that grandfathering provisions of DTAA were applicable since the shares of Flipkart Singapore were acquired before April 1, 2017. The AAR ruled in favour of the revenue pursuant to which Taxpayers filed a writ petition with Delhi HC.

AAR and Revenue's Arguments

Admissibility of Writ Petition

The revenue argued that since AAR had only formed a preliminary opinion on the issue and left the ultimate decision with respect to exigibility to tax open to be examined in any assessment that may be undertaken, the HC should not exercise its power of judicial review in the said matter.

Ownership and Control

Flipkart Online Services Pvt Ltd (Flipkart Online) was incorporated in India in 2008 and investment was made in Flipkart Online by Tiger Global Five FK Holdings through FDI route. Taxpayers were incorporated in 2011, and they admitted Tiger Global Five FK Holdings as associate. Taxpayers then incorporated Flipkart Singapore and Flipkart Singapore created a wholly owned subsidiary in India called Flipkart India Private Limited (Flipkart India). Flipkart Online in a slump sale sold the business to Flipkart India in December 2011.

Based on the above, Revenue argued that Taxpayers were interposed only as conduit companies for investment of a US based entity through a web of other conduit companies based out of Mauritius and Cayman Islands. Though the holding subsidiary structure might not be a conclusive proof for tax avoidance, the purpose for which the subsidiaries were set up do indicate the real intention behind the structure. The Taxpayers were setup to obtain benefit of India-Mauritius DTAA to avoid capital gains eventually arising at the time of their exit.

Beneficial Ownership

The Revenue observed that authority to operate the bank accounts for transactions above US$ 2,50,000 was with Mr. Charles P. Coleman who was not a director of the Taxpayer but was a director of the ultimate holding company of the Taxpayer. Mr. Coleman was partner of TGM LLC. Mr. Coleman was also disclosed as the beneficial owner by the Taxpayers in the application form for GBL filed with Mauritius Financial Services Commission. It was alleged that he took decisions of BOD through Mr. Steven Boyd who was a non-resident director on the board of the Taxpayer and was accountable to Mr. Coleman. Hence, the management and control of the affairs of the Taxpayers was situated in USA (TGM LLC) and not Mauritius. The Taxpayers were only a "***see through entity***" to avail the benefits of the DTAA.

Treaty Benefit and GAAR interplay

The Taxpayers were not entitled to capital gains tax exemption on sale of shares of a Singapore company under Article 13 of India-Mauritius DTAA since the said exemption applied only to sale of shares of Indian companies held by Mauritian resident.

The Revenue also argued that provisions of indirect transfer were introduced by Finance Act 2012 and hence were applicable to the Taxpayers. Further, sub-section 2A was introduced in section 90 by Finance Act 2013 to provide that General Anti-Avoidance Rules (GAAR) provisions shall have an overriding effect on section 90. Revenue contended that as per Rule 10U, even though an arrangement may have been entered prior to 01 April 2017, any benefit obtained from that arrangement on or after 01 April 2017 would be subjected to the GAAR provisions contained in Chapter X-A.

Revenue further relied on Hon'ble Supreme Court judgement in the case of Vodafone[2] to hold that DTAA and Circular No. 789 dated 13.4.2000 would not preclude the Income Tax Department from denying the tax treaty benefits in suitable cases. The entire investment by Taxpayers was only in Flipkart Singapore and was made with the intention to avail benefit of India-Mauritius DTAA. The entire arrangement was an arrangement for avoidance of tax in India and hence application was rejected under clause (iii) of proviso to section 245R(2) which provides that AAR shall not allow application which relates to a transaction designed prima facie for avoidance of income tax.

Taxpayer's Arguments

Beneficial Ownership

The Taxpayers argued that the Investment Manager, TGM LLC had not placed any investments with them and neither TGM LLC nor any of its affiliates had either invested in the Taxpayers or the Private Equity funds that had indirectly invested with them. Regarding Mr. Coleman being the ultimate controlling authority, Taxpayers submitted that Mr. Coleman did not even have a controlling equity interest in the taxpayers or any of its shareholders. The BOD of the Taxpayers exercised the authority, control, and management over the affairs of the Taxpayers.

The funds invested by the Taxpayers in Singapore Company as well as the sale proceeds received from the transfer were legally and beneficially owned by the Taxpayers in their sole, independent and exclusive capacity. They beneficially held the shares of Singapore Co and were not contractually, legally, or economically obliged or accountable to any other third party with respect to the consideration received for the Transfer.

The Taxpayer further argued that AAR incorrectly applied the concept of beneficial ownership, which is not included in Article 13 of the DTAA but finds place in Articles 10, 11, and 12A of the DTAA.

Treaty Benefit and GAAR interplay

Taxpayers argued that unilateral amendments in section 9 pertaining to taxation of indirect transfer should not be interpreted to override existing tax treaties. It further relied on speech of Hon'ble Finance Minister wherein it was clarified that the indirect transfer provisions would not override provisions of DTAA and would impact cases where transactions were routed through low tax or no tax jurisdictions with which India did not have any DTAA.

[2] Vodafone International Holdings B.V. [2012] 17 taxmann.com 202 (SC)

India-Mauritius DTAA does not embody an enabling provision which authorize Indian Tax authorities to tax an indirect transfer of assets. Taxpayers highlighted treaties with Colombia, Fiji and Indonesia which specifically provide for levy of capital gains from indirect transfer of shares which principally derive their value from immovable property situated in a country. In absence of similar clause in India-Mauritius DTAA, indirect transfer of shares should not be taxable in India. Furthermore, even when treaty was amended in 2016 (specifically capital gains provisions), the indirect transfer provisions were already enacted in the domestic act but the same were not incorporated in the treaty.

The Taxpayer further argued that though the shares held in Flipkart Singapore derived their value substantially from assets in India, however since those shares were acquired prior to April 1, 2017, they would not be taxable or subjected to a capital gains tax in India pursuant to the grandfathering provisions of Article 13 of DTAA. Taxpayers relied on circular no. 682 dated 30 March 1994 which provided that capital gains arising to a Mauritius resident on sale of shares of Indian company would be liable to capital gains tax only in Mauritius.

The Taxpayers submitted that they had incurred commensurate expenditure in Mauritius to satisfy the conditions prescribed in Paragraph 4 of Article 27A of DTAA (Limitation of Benefits) and hence should not be treated as shell or conduit companies.

A transaction could be considered 'designed' for the avoidance of tax only if the transaction was not based on sound commercial or business rationale but was entered for the purpose of avoidance of tax by 'illegal or improper means' without any real and genuine business purpose which was not the case of the Taxpayers.

Tax Residency Certificate (TRC) once issued by the Mauritian authorities would constitute sufficient evidence of the status of residence as well as the issue of beneficial ownership for the purposes of applying the DTAA as per circular no. 789 dated 13-4-2000. The Taxpayers relied on various judgements to substantiate that TRC would be conclusive evidence to claim benefit under the India-Mauritius DTAA. The perceived motives underlying the incorporation or establishment of an entity in Mauritius would be wholly irrelevant. They relied on the Supreme Court judgement in the case of Azadi Bachao Andolan[3].

Taxpayer further argued that only if the transaction itself (and not the structure of the entity undertaking the transaction) is designed for the avoidance of income-tax, clause (iii) of proviso to section 245R(2) could be invoked to reject the AAR application.

Decision of Delhi High Court

Admissibility of Writ Petition

Delhi HC noted that based on the tone and tenor of the findings and observations rendered by AAR, the view expressed neither appeared to be tentative nor one formed on a preliminary examination. It further observed that considering the evident element of resolute decisiveness, it would be difficult for subordinate authorities to ignore the conclusions reached by CIT and AAR. Accordingly, the Delhi HC accepted the writ.

Ownership and Control

HC observed that based on ownership structure of Taxpayers, TGM LLC was merely the investment manager with no equity participation. TGM LLC had neither been conferred the right to contract on their behalf nor was it entitled to take any decision without the approval of the BOD of the Taxpayers. The premise that TGM LLC was the parent company was held to be erroneous and unsustainable.

[3] Azadi Bachao Andolan [2003] 132 Taxman 373 (SC)]

Economic Substance and Beneficial Ownership

Taxpayers had been incorporated to act as pooling investment vehicles to access new markets and opportunities. The Taxpayers came to be domiciled in Mauritius principally on account of the investor friendly environment prevalent in that nation and the bouquet of bilateral trade agreements to which it was a party. It was on that basis that the Taxpayers also obtained Category 1 GBLs under the Financial Services Act, 2007. The transfer of holding took place in 2018 as part of a larger takeover scheme spearheaded by Walmart Inc. The Taxpayers were entrusted with funds provided by as many as 500 individual investor entities situated in 30 jurisdictions across the globe.

The extent and quantum of investments made by the Taxpayers; the expenditure incurred in Mauritius when considered cumulatively substantiated the economic substance of the Taxpayers. Taxpayers declared a significant dividend to shareholders following the Board's decision to sell Flipkart Singapore. Merely because a parent entity may exercise shareholder influence over its subsidiary 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.

The claim that Taxpayers were reduced to mere puppets due to two members' connections with large conglomerate was held to be unfounded. The minutes of the board meetings, when read in full context evidenced that decisions were made collectively by the Board rather than solely influenced by connected members. Further, the authority to operate bank accounts for transactions exceeding US$ 250,000 rested with Mr. Charles P. Coleman but the same required countersignature of one of the directors based in Mauritius. Regarding the appointment of non-resident members to the BOD, the High Court held that the AAR should not have concerned itself with the commercial decisions or the practicality of appointing specific individuals to the board.

Regarding the issue of beneficial ownership, the High Court referred to the commentaries of various authors and concluded that, for the concept of beneficial ownership to apply, it must be demonstrated that the recipient or holder of the income lacks any right or control over it and merely holds it to be deployed according to another's instructions. If it could be established that the conduit entity could use the income for itself and was not contractually required to pass it on to another party, it would be incorrect to apply the principles of beneficial ownership in such circumstances. The essence of these principles revolves around the aspects of ownership and control over the income, a right of disposal or a contractual obligation to pass on the same to another. Accordingly, rejecting the Revenue's contentions, HC held that TGM LLC could not be said to be the beneficial owner of shares since Taxpayers were under no contractual or legal obligation to transmit revenue to TGM LLC.

Treaty Benefit and GAAR interplay

The Delhi High Court held that the interpretation suggesting Article 13(3A) of the India-Mauritius DTAA would not apply to the sale of shares of a Singapore company was unsustainable. This was because the shares derived their value from underlying assets located in India. Excluding them from the scope of Article 13 would effectively make the transaction non-taxable in India.

The Delhi HC held that entities domiciled in Mauritius, as well as Mauritius itself, should not be viewed negatively or required to meet a separate standard of legitimacy. The criteria for legitimate investment are already incorporated in the DTAA and the various protocols that have been introduced over

time, which aim to exclude those not meant to benefit from the Convention. The adoption of the Limitation of Benefits (LOB) provisions was clearly intended to support these objectives. Unless it can be proven that such structuring is designed to achieve illegitimate or illegal gains or abuse the treaty's underlying purpose, it would be erroneous to place such entities under an initial or negative burden of proof.

The High Court further clarified that the circumstances under which tax authorities could pierce the corporate veil of a TRC holding entity are limited to cases involving tax fraud, sham transactions, the disguise of illegal activities, and the complete absence of economic substance. Proving such allegations would require a stringent and high standard of proof, and the Revenue must rely on clear and convincing evidence, rather than mere suspicion. Seeking a more favorable tax position would lead to disqualification from treaty benefits only if it were shown that granting such benefits would be contrary to the treaty's fundamental spirit and objectives.

The Delhi High Court thoroughly examined various decisions of High Courts and Supreme Court. Delhi HC also relied on the decision by Court of Justice of the European Communities in the case of Cadbury Schweppes Plc[4] wherein it was observed that mere establishment of a subsidiary in a favourable tax location does not automatically constitute treaty shopping. The court emphasized that a general presumption of tax evasion or avoidance should be avoided.

The High Court also found that Chapter X-A of the Income Tax Act would not apply in light of Article 13(3A) of the India-Mauritius DTAA, which grandfathers all acquisitions made before April 1, 2017. This intent of the Contracting States to shield these transactions is evident not only from the language of Article 13(3A) but also from Rule 10U(1)(d). Furthermore, Rule 10U(2) does not override or eclipse the protection accorded by clause (d) of Rule 10U(1).

The intent of the Contracting States was to prevent domestic tax authorities from using subjective standards, as the LOB provisions with clear criteria were designed to counter treaty abuse. Accepting otherwise would unfairly prioritize domestic laws over treaty agreements and allow taxing authorities to challenge transactions beyond the treaty's negotiated terms. The inclusion of the LOB clause in the India-Mauritius DTAA, even when Chapter X-A already existed, indicates that the LOB provisions were crafted with existing domestic legislation in mind. HC thus held that the Revenue could impose additional barriers to treaty benefits beyond those specified in the treaty.

The High Court further stated that once the conditions specified in Article 27A were met, an entity should not be considered a conduit or a sham. In the present case, the taxpayers had maintained their investment in Singapore for over ten years. Additionally, they incurred expenditures amounting to USD 1,063,709, which translated roughly to MUR 36,436,182, well above the prescribed threshold of MUR 1,500,000 as set out in Article 27A.

Furthermore, Article 13(3B) of the DTAA only prescribed separate tax rate for capital gains arising during the period from April 1, 2017, to March 31, 2019, but did not prescribe tax rates for capital gains arising from the sale of shares acquired before April 1, 2017. This clearly demonstrated the intention of the parties to the India-Mauritius DTAA to exclude capital gains from shares acquired before this date from being subject to taxation in India. As a result, the grandfathering clause in Article 13(3A) would exclude the transactions undertaken by the Taxpayers from the scope of capital gains tax.

[4] Cadbury Schweppes Plc and another v Inland Revenue Commissioners [(2006) 3 WLR 890]

KCM Comments

Readers may refer to KCM flash dated June 6, 2020, for referring to the analysis of AAR judgement.

The Delhi High Court has reaffirmed that investments from so-called "tax haven" jurisdictions should not be viewed with suspicion or prejudice. Instead, such investments should be assessed in the same way as investments from any other contracting jurisdiction.

The High Court did not address whether domestic GAAR provisions could override treaty provisions. In this case, the issue was limited to whether GAAR would apply, given the grandfathering clause available in the India-Mauritius DTAA. However, the question remains whether Section 90(2A), which allows for a treaty override to establish that the intent of an arrangement was not solely to obtain a tax benefit in the absence of Principal Purpose Test (PPT) or LOB clauses in the treaty, would lead to the unjust denial of treaty benefits through unilateral changes in domestic law. Such an outcome would conflict with the fundamental principles of fairness and mutual agreement between contracting jurisdictions. The HC has also not commented on whether principle of 'beneficial ownership' would be applicable for capital gains article but Hon'ble Court has evaluated the principle of 'beneficial ownership' in detail.

The judgment reinforced several key principles, including the acceptance of a TRC as conclusive evidence of residency. It also supported the legitimacy of treaty shopping, provided that the interposed entity is not a mere conduit or facade. The court again rejected the logic that an investment from Mauritius would only be considered legitimate if it "originates" from Mauritius, rather than from third countries.

The amendments proposed in the Finance Bill of 2013, which sought to modify section 90 by stipulating that while a TRC would be necessary to claim treaty benefits, it would not be sufficient on its own, were of significant importance. These proposed amendments were ultimately withdrawn following strong opposition and widespread negative reactions. HC has considered this aspect same while delivering the judgement.

India and Mauritius have signed a Protocol to amend the DTAA, aimed at preventing tax evasion and avoidance, which is yet to be notified and enforced by the government. The Protocol intends to introduce a PPT and revise the preamble of the DTAA. The language of the Protocol indicates that it may have retroactive effect once it becomes effective. How investments that are already grandfathered under the existing DTAA will be protected following the implementation of the Protocol remains to be seen. For further details, readers may refer to the KCM Flash on this topic dated April 24, 2024.

Additionally, the Hon'ble Supreme Court has recently admitted a Special Leave Petition (SLP) against the Delhi High Court's decision in the case of Blackstone Capital Partners (Singapore) VI FDI Three Pte. Ltd [2024] 158 taxmann.com 261 (SC), where the High Court had ruled that a TRC was sufficient evidence to establish treaty eligibility. The stance of the Indian judiciary on this long-standing and unresolved issue remains to be determined.

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