The Pitfall of the Double Tax Avoidance Agreement between India and Mauritius due to AAR

written by Abhishek Bagga | July 22, 2020

India Mauritius Double Tax Avoidance Agreement - The Unforeseen Risk

The Authority of Advanced Ruling (AAR), New Delhi dismissed the petition in the case of *Tiger Global International II Holdings, Mauritius & Ors*[1] (Petitioner), for the tax exemption on the capital gains, arouse due to the sale of its Mauritius shares of Flipkart to Walmart on the ground of the arrangements done on behalf of the petitioner just to avoid tax under the Double Tax Avoidance Agreement(DTAA).

Background

Tiger Global Management LLC is a U.S based private equity firm incorporated in Mauritius. The company was incorporated with the primary objective of undertaking investment activities with the intention of earning long-term capital appreciation and investment. The applicant invested in shares of Flipkart Private Limited (Singapore) between the period of October 2011 to April 2015. In 2018, the company sold its 16,243,010 shares of Flipkart (Singapore) to the Luxembourg entity.

So, in the matter of the aforesaid transfer of shares, the petitioners, under Section 197 of the Income Tax, 1961("IT Act"), applied for the nil withholding certificate. The request was rejected by the tax authority on the ground that the control and actual ownership of the company does not lie with the directors in Mauritius.

Therefore, the present application was filed by the company before the AAR under section 245Q (1) of the IT Act to decide as to whether the capital gain due to the transfer of Flipkart shares will be taxable in India or not.

Arguments by tax authorities

Now, as per Section 9 of the IT Act, the capital gain arouse due to such transfer of shares is liable to be taxed in India. In this regard, it is crucial to note that as per section 90 of the IT Act Indian government can sign DTAA with other countries for exemption of such types of taxes. So accordingly, India and Mauritius signed a DTAA due to which capital gain arose as a result of the transfer of shares of an Indian company in Mauritius will liable to be taxed only in Mauritius and not in India.

Tiger Global, after calculating all aftermath, applied for the exemption of tax on the capital gains under Article 13(4) of India-Mauritius DTAA as the Flipkart (Singapore) derives the value of its shares from the assets in India. Firstly, tax authorities contended that the company is not entitled to

benefit under the DTAA as the petitioner transferred the shares of the Singapore company and not of an Indian company and the objective of such treaty was to deliver benefit to Indian companies only.
Secondly, it was observed that the actual ownership of the company is not in the hands of Mauritius but with the owner situated in the USA.
Thirdly, relying on the Minutes of the Meetings, tax authorities observed that all major decisions of the Mauritius company were taken in the presence of non-resident USA directors and the Mauritius directors were mere spectators. Fourthly, it was also observed that the financial control of the company was not with the Mauritius directors but with the USA-based directors of the company as the board of directors was given limited authority towards the bank accounts.
Submission by the Petitioner
The petitioner submitted that the transaction was not *prima facie* found to be made for the avoidance of tax. It is not the holding structure of the company but that particular transaction defines whether there was any intention to avoid tax or not, which the authorities have failed to prove. It was also submitted that all the decision-making and board meetings were done and conducted on behalf of the Mauritius company and its directors. It was further argued that limited access to the company's bank accounts does not show that the Mauritius-based director had no financial control over the company.
AAR Ruling
AAR ruled in the favour of tax authorities and rejected the contentions of the petitioner. It was decided that the arrangement made by Tiger Global is to avoid tax. The following reasons were stated by the AAR for its conclusion-

- Tax avoidance should be scrutinized through the arrangement in the larger context, not only the transfer of shares but the whole arrangement considering buying of shares will also be taken into consideration.
- AAR held that the 'head and brain' of the company is not in Mauritius but with Mr. Charles P. Coleman, owner of the entire structure. The same was backed by the fact that Mr. Charles was a signatory to the bank accounts of the petitioner company and the Mauritius directors were given a limited control on such bank accounts.
- The control and holding structure of the petitioner led AAR to conclude that Tiger Global is just a 'see-through' entity and was set up to gain the benefits of the India- Mauritius treaty.
- Further, AAR observed that the petitioner has not made any investment other than the investment in Flipkart which indicated that the petitioner intended to avail the benefit of the treaty.

Impact on the Economy
In the present situation, where there is economic instability in the market, this is a huge setback for the investors, where every country is looking to create a friendly market for the investment and the rulings like AAR will retreat the investors from the country. Firstly, the impact of such an order is expected to be colossal.
The investors were in a frame that they are protected under the blanket rule of the grandfathering rule, i.e. investment before April 1st 2017, won't be liable to taxes, but after the amendment of the rules of the convention between the government of the republic of India and the government of

Mauritius for the avoidance of double taxation the exit plans have been tightened[2]. The impact would also be seen in the litigation process as there is a lot of uncertainty about the exits of the private equity firms and the DTAA signed by India with Mauritius.

This is not the first time AAR had ruled against the normal course of the treaty. On a couple of occasions, it has been held that the investors and companies are sinking their money through Mauritius and Singapore to primarily avail the benefit of DTAA between India & Mauritius.

Secondly, after this judgment, the tax authorities will have a broad area on which they will now be assessing the deals which will give them the immense power to find loopholes in treaties such as DTAA. One such example is the "Principal Purpose Test". This test is used to prevent treaty abuse by the investors by reckoning out the principal purpose of the arrangement done by the companies.

In the current situation, AAR believed that the *prima facie* intention of the arrangement done by Tiger Global is to avoid tax and relying on the test, the company was denied any tax exemption under the treaty but such test was never included explicitly in these treaties and thus signifies the arbitrariness of power by the AAR. If AAR will constrict the scrutiny on the Mauritius based entities than it will create various stumbling blocks in the future planning of the companies and start-ups regarding their "exit plan".

The investors who were in perception for an easy exit without paying the tax on capital gains under the treaty would now be looking at their management structure, ownership structure and financial control as the same parameters can be applied for other companies too. The tightening of rules and criteria for exemption of tax under such treaties will make investors look for alternate investment destinations other than India which can turn out to be a backlash in the times when the country is about to go in a recession.

Conclusion

The AAR ruling has created a sense of uncertainty and panic in the mind of the investor, who invested through the Mauritius route. The ruling has surfaced the wide interpretation of the treaties signed by India & Mauritius for the avoidance of the tax.

Now the concern for the investors will also be to look for the possible ownership and management aspects of an arrangement to exempt tax under the treaty. There is a lack of clarity on the direct and the indirect transfer of shares of the assets situated in India. It will also be interesting to see how the tax authorities examine the indirect transfer of shares under the purview of India-Mauritius treaty as the standard perception under the tax regime was that indirect transfer of shares was exempted from capital gain tax under the treaty and also various judicial pronouncements had held the same in various cases.

However, AAR in this ruling has held that the exemption under the treaty is not applicable to the "indirect transfers". Further, AAR has surpassed the concept of grandfathering rule and also somewhere kept aside the judgment passed by the Hon'ble Supreme Court in the Vodafone case[3] where such debatable rulings of AAR was set aside. It will be interesting to see how the treaty, grandfathering rule and General Anti- Avoidance Rule provisions will be interpreted when Tiger Global set off for higher appeal.

- [1] AAR/04/2019, AAR/05/2019 & AAR/07/2019
- [2] India-Mauritius DTAA Article 13(4), Notification No. S.O. 2680(E)

(NO.68/2016 (F.NO.500/3/2012-FTD-II)), Dated 10-8-2016

- [3] Civil Appeal No. 733 of 2012, Vodafone International Holdings B.V. vs. Union of India (UOI) and Ors.

Contributed by - Abhishek Bagga & Mrinal Sharma
King Stubb & Kasiva,
Advocates & Attorneys
Click Here to Get in Touch
New Delhi | Mumbai | Bangalore | Chennai | Hyderabad | Kochi
Tel: +91 11 41032969 | Email: info@ksandk.com