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EY Tax Alert

Recent developments relating to the India-Mauritius Tax Treaty



Executive summary

Mauritius is a preferred jurisdiction for structuring investments into India in view of the liberal business environment offered by Mauritius and the benefits available under the India-Mauritius Tax Treaty (Tax Treaty). A Circular issued by the Central Board of Direct Taxes (CBDT) which permits the Tax Treaty benefits based on the existence of a valid Tax Residency Certificate (TRC) of Mauritius and the Supreme Court (SC) ruling upholding the validity of the above Circular have generally provided certainty to taxpayers regarding the use of the Tax Treaty. However, recent developments indicate a renewed focus by the Tax Authority to challenge the use of Mauritius structures. The approach of the Tax Authority has been to make a detailed inquiry into the facts, documentation and conduct of the parties to question the legal/beneficial ownership of the shares by the Mauritius company and, thereafter, try to deny the benefits of the Tax Treaty. While the Authority for Advance Rulings (AAR) and the Income Tax Appellate Tribunal (ITAT) have ruled in favor of taxpayers in a couple of instances, a more recent ruling of the Bombay High Court (Bombay HC), which upheld the action of the Tax Authority, may cause some uncertainty. The often-published media reports on the possible renegotiation of the Tax Treaty and the possibility of the introduction of a General Anti-Avoidance Rule (GAAR) in the Indian Tax Laws (ITL) have further increased the challenges and risks. In light of recent developments as well as expected future developments, it is important for taxpayers to review the impact of these developments on their existing and future structures that involve the use of

beneficial tax treaties and assess possible steps for managing the risks that may arise.

Background

Mauritius is a preferred jurisdiction for locating a holding company for making investments into India in view of the liberal business and economic environment available in Mauritius as well as on account of the potential benefits under the Tax Treaty. While under the ITL, capital gains arising to a non-resident on transfer of shares of an Indian company are generally taxable in India, under the Tax Treaty, such gains arising to a tax resident of Mauritius are taxable only in Mauritius. It is estimated that 42% of the foreign direct investments (FDI) in India are made from Mauritius^[1].

The use of the Tax Treaty, however, has not been without controversy. The advance rulings, decided in the years 1995-1997 in the cases of P No-9 of 1995, In re^[2] (commonly referred to as the Natwest Ruling), P No-10 of 1996, In re^[3] (commonly referred to as the AIG Ruling) and DLJMB Mauritius Investment Company^[4], have generally recognized the need for an

investor to demonstrate a larger business purpose for using a Mauritius investment or holding company to be eligible for benefits under the Tax Treaty. In response to the action by the Tax Authority to deny treaty benefits on alleged grounds of 'treaty shopping', the CBDT, in the year 2000, issued a Circular^[5] stating that treaty benefits should be granted based on a TRC issued by the Mauritius Revenue Authority (MRA). A circular issued by the CBDT is generally binding on the Tax Authority.

When the validity of the above Circular was challenged in a court, the SC, in the case of Azadi Bachao Andolan^[6], while upholding the validity of the Circular, ruled that a taxpayer has the right to arrange its affairs in any legitimate manner within the framework of law so as to mitigate tax and, in the absence of specific anti-treaty shopping provisions in a tax treaty, the benefits of the tax treaty cannot be denied to persons qualifying as residents of the other contracting state. A number of Mauritius resident taxpayers have sought to rely on this decision and have claimed that as long as they possess a valid TRC, they should be entitled for benefits under the Tax Treaty although the Indian Tax Authority, in recent times, has attempted to tax such transactions by denying benefits of the Tax Treaty.

[1] Source: FDI statistics by the Department of Industrial Policy and Promotion (http://dipp.nic.in/fdi_statistics/india_FDI_April2011.pdf)

[2] [220 ITR 377]

[3] [224 ITR 473]

[4] [228 ITR 268]

[5] Circular No. 789 dated 13 April 2000

[6] [263 ITR 706]

Recent developments

Cross-border transactions involving the use of beneficial tax treaties, have been under close scrutiny by the Tax Authority over the last 2-3 years. The recent trends suggest a possible reluctance on the part of the Tax Authority to grant benefits under the Tax Treaty. The approach of the Tax Authority has been to make a detailed inquiry into the structure of investments, agreements (investments/joint collaboration/share transfer etc.), nature of transactions, conduct of parties, mode and manner of payments, benefits received by the ultimate parent etc. Based on the above, the Tax Authority has taken a view, in a few instances, that a foreign parent company of the Mauritius holding company is the legal/beneficial owner of the shares in the Indian company and, accordingly, as the foreign (non-Mauritius resident) parent was the taxpayer, the Tax Treaty is not applicable.

Advance Ruling in the case of E*Trade Mauritius Ltd.^[7]

In this case, the Applicant, a company registered in Mauritius and holder of a valid TRC issued by the MRA, was denied a nil withholding tax certificate by the Tax Authority for payment of capital gains arising from transfer of shares of an Indian company. The Tax Authority, after a detailed inquiry, was of the view

^[7] [324 ITR 1]. Please also refer EY Tax Alert dated 23 March 2010 on 'AAR rules sale of Indian shares by Mauritius company not taxable in India'.

that, at the stage of withholding tax proceedings (which are summary or tentative proceedings), it cannot be determined that the gains have arisen only to the Mauritius company and not to its US parent. The Applicant, thereafter, approached the AAR seeking a ruling on the taxability of the gains. The AAR relied on the principles emerging from the SC decision in the Azadi Bacaho Andolan case and upheld that the TRC issued by the MRA is a presumptive evidence for residency in Mauritius and that the capital gains on sale of the Indian company shares had arisen to the Mauritius company which was the legal owner of such shares. The AAR also observed that the legal structure of the Mauritius company cannot be disregarded and legitimate tax planning within the framework of law was permissible.

In addition to the advance ruling in the case of E*Trade, a few other recent rulings by the AAR/ITAT^[8] also provide some degree of comfort on the eligibility of a Mauritius company to claim benefits under the Tax Treaty based on a TRC of Mauritius. It has, however, been reported that the Tax Authority has filed a special leave petition (SLP) before the SC against the AAR ruling in the case of E*Trade.

^[8] Saraswati Holding Corporation [2009-TIOL-529-ITAT-DEL], DB Zwirn Mauritius Trading [A.A.R. 878 of 2010], Praxair Pacific Limited [326 ITR 276]. Please also refer EY Tax Alerts on 'Delhi ITAT sustains non-taxability of capital gains arising to a Mauritian company' dated 26 August 2009 and 'AAR rules on taxability of sale of Indian shares' dated 4 April 2011.

Bombay HC in the case of Aditya Birla Nuvo and others^[9]

In a more recent development, in the case of Aditya Birla Nuvo, having regard to the facts and circumstances of the transaction, the Bombay HC held that the Tax Authority had a prime facie case for considering capital gains arising from transfer of shares of an Indian company as taxable in the hands of the US parent company of a Mauritius company, in whose name the Indian shares were registered. In its order, the Bombay HC has made observations which suggest that even though the Mauritius entity was the registered owner of the shares, having regard to the facts and circumstances, it could not be regarded as legal/beneficial owner of the gains arising on transfer of the shares. The gains may have, therefore, accrued to the US parent company and, accordingly, the gains may not be eligible for protection under the Tax Treaty. This was despite the fact that the Mauritius company was holding a valid TRC issued by the MRA. The HC also observed that neither the CBDT Circular nor the SC ruling in the Azadi Bachao Andolan case is applicable to the facts as the gains may not have arisen to a Mauritius taxpayer.

The Bombay HC decision was based on a detailed review of the documents on record and conduct of the parties which, apparently, led to an inference by the Bombay HC that the Mauritius company was not the legal/beneficial owner but was merely a nominee

^[9] [2011-TII-26-HC-MUM-INTL]. Please also refer EY Tax Alert dated 16 July 2011 on 'Bombay HC rules on taxation of cross-border transactions and indirect transfer of shares'.

holder of the shares of the Indian company. Although the Bombay HC decision is largely based on the specific facts and circumstances, it does seem to raise a number of questions which are likely to result in a fair bit of uncertainty for taxpayers.

Possible renegotiation of the Tax Treaty

Over the last few years, it has often been reported in the media that the Government of India (GOI) has sought to review the Tax Treaty. Media reports in the year 2010 suggested that a team of Indian officials was scheduled to visit Mauritius for the renegotiation talks and that the GOI and Mauritius would be discussing the renegotiation of the Tax Treaty in a meeting shortly^[10]. More recent media reports suggest that India has made a fresh request for the talks and has suggested dates for holding discussions^[11]. However, these attempts have not resulted in a new or revised Tax Treaty as yet. It may be noted that most of India's recently negotiated/renegotiated tax treaties include a Limitation on Benefits (LOB) article to prevent tax treaty abuse.

Direct Taxes Code Bill, 2010 (DTC) and GAAR^[12]

The GOI tabled the DTC in Parliament in August 2010. The DTC, if approved by Parliament, is expected to be effective from 1 April 2012. The DTC proposes to introduce a GAAR in the ITL that seeks to deny tax benefits expected from an arrangement if the arrangement lacks bona fide purpose or commercial substance or results in abuse or misuse of the DTC. The GAAR would override a tax treaty. Hence, even if the Tax Treaty does not contain an LOB article, the Tax Authority could seek to deny benefits of the Tax Treaty by invoking GAAR in case the Mauritius structure is regarded as an impermissible avoidance arrangement.

What does this mean for taxpayers?

Taxpayers who may seek to rely on the Tax Treaty may be subject to detailed scrutiny by the Tax Authority to assess whether or not the gains that arise from a transaction are eligible for protection under the Tax Treaty. The inquiry by the Tax Authority may go beyond the mere existence of a TRC issued by the MRA and may require the taxpayer to demonstrate that the Mauritius company that proposes to claim the treaty benefit is the legal/beneficial owner of the gains. There may be an increased focus on facts,

documentation and conduct of the parties in such an inquiry. Taxpayers may also find it difficult to obtain nil withholding tax certificates from the Tax Authority for such transactions. Taxpayers may, therefore, be in for a period of uncertainty and would need to consider various options for managing the risk.

What should taxpayers do?

Taxpayers may need to consider the following for managing the likely challenge:

- ▶ Taxpayers may need to exercise adequate caution on their investments/holding structures that involve the use of beneficial tax treaties and recognize the importance of facts, documentation and conduct in relation to the structures. A proper focus on these factors could be helpful to manage the risk of denial of the Tax Treaty benefits on the alleged grounds that the Mauritius company is not the legal/beneficial owner of the shares.
- ▶ Taxpayers could evaluate the option of seeking an advance ruling on the taxability of a transaction that involves reliance on a beneficial tax treaty. The main benefit of an advance ruling is the upfront certainty it provides and the binding nature of the ruling.
- ▶ In light of recent trends and expected future developments, taxpayers may also need to consider the need to transition their existing

[10] Please refer EY Tax Alert dated 2 July 2010 on 'Possible renegotiation of India-Mauritius Tax Treaty'.

[11] Source: www.economicstimes.indiatimes.com (News reports dated 4 April 2011 and 21 July 2011)

[12] Please refer EY Tax Alert dated 17 September 2010 on 'Key Anti Abuse provisions of the Direct Tax Code, 2010'.

investments/holding structures to alternative structures if an alternative could help better in demonstrating business purpose and commercial substance. The timing and manner in which the transition should take place would require careful consideration.

- ▶ Taxpayers should watch developments closely and assess impact of the developments on the future of Mauritius structures for investment into India.

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