India’s Authority for Advance Rulings denies tax exemption under India-Mauritius treaty

February 24, 2020 Asia-Pacific, Featured News, India

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In a controversial ruling released 17 February, India’s Authority for Advance Rulings, a quasi-judicial body which rules on the taxation of non-residents, denied a capital gains tax exemption under the India–Mauritius tax treaty to a Mauritian entity.

The Authority for Advance Rulings looked through the structure of the transaction and, treating the entity as a shell company, concluded that the dominant purpose of the entity was to avoid tax in India.

As per the India—Mauritius tax treaty (amended in 2016), gains on the sale of shares acquired before 1 April 2017 are taxable only in the country of residence of the seller and not the source country.

Accordingly, gains on the sale of shares of an Indian company by a Mauritian resident are taxable only in Mauritius and not in India. The treaty was amended in 2016 to remove this exemption for investments made on or after 1 April 2017.

Bid Services Division (Mauritius) Ltd

The applicant, Bid Services Division (Mauritius) Ltd., was incorporated in Mauritius in August 2005. It held a Category 1 Global Business License issued by the Financial Services Commission, Mauritius, and a valid tax residency certificate.

Bid Services Division (Mauritius) Ltd was a wholly-owned subsidiary of a South Africa company, Bid Services Division (Proprietary) Limited.

Bidvest Group Limited, incorporated in South Africa, was the ultimate holding company of the group. The parent company was engaged in the business of international services, trading, and distribution and was listed on the Johannesburg Stock Exchange of South Africa.

Pursuant to an international competitive bidding process, the Airports Authority of India (with the approval of the government of India) invited bids for development, operation, and maintenance activities at the Mumbai International Airport and ultimately selected a consortium between Bid Services Division (Mauritius) Ltd, GVK Airport Holdings Private Limited, and ACSA Global Limited from out of ten bidders based on various qualifying criteria.

A company called Mumbai International Airport Private Limited was incorporated in India to undertake the project as a joint venture between the consortium members and its ownership structure was as follows:

shareholder	% stake
Airport Authority of India	26%
GVK Airport Holdings Private Limited	37%
Bid Services Division (Mauritius) Ltd	27%
ACSA Global Limited	10%
Total	100%

Ruling request

On 1 March 2011, the applicant, Bid Services Division (Mauritius) Ltd, entered into an agreement with GVK Airport Holdings to sell its 13.5% stake in the Indian joint venture for a consideration of USD 231 million. The transaction was completed in the applicant's 2011—12 tax year.

The applicant approached India's Authority for Advance Rulings to seek a ruling on whether the gains arising on the transaction would be liable to tax in India having regard to the provisions of the India – Mauritius tax treaty.

Tax authorities' objections and conclusion

Before India's Authority for Advance Rulings, the government tax authorities described the entire bidding process and steps in detail, which involved a request for and submission of 'expression of interest' by prospective bidders; shortlisting of prospective bidders and declaration of pre-qualified bidders for stage 2 of bidding process; and the submission of final, binding bids.

The tax authorities submitted that the Mauritius-incorporated applicant was not included as a consortium member until the filing of the technical and financial bid at the end of stage 2 of the bidding process. The applicant was not even in existence for most of the bidding process and was incorporated just two weeks before the submission of a binding bid by the consortium.

The tax authorities argued that if the Bidvest group wanted a special purpose vehicle to undertake the project, business sense indicates that India or South Africa would have been the best alternatives and not some third jurisdiction like Mauritius.

As per the tax department, the only advantage Mauritius provided was tax benefits with respect to capital gains. Thus, the inclusion of a Mauritian entity in the consortium lacked commercial substance and bonafide business purpose and it was a clear design to avoid paying taxes in India.

On this basis, the tax authorities contended that the Mauritian entity should be overlooked, and the investment should be considered as having been made directly by a South African entity. Under the India – South Africa tax treaty, in absence of any exemption, the resulting gains are taxable in India.

The tax authorities also contended that, according to another anti-abuse provision under Indian tax law (section 93), income is taxable in the hands of the ultimate holding company that had the 'power to enjoy' the income arising to the applicant.

This provision applies where the transfer of an asset results in income payable to a non-resident but another person acquires a right by virtue of which it has the power to enjoy that income (at any time).

This provision seeks to address a situation where had the income been the income of the person having the power to enjoy it, it would be chargeable to tax in India but if it is earned by a non-resident, it escapes Indian taxation.

In such a case, income shall be deemed to be attributed to the person who has the power to enjoy the income. According to the tax authorities, given the group shareholding structure and the fact that two out of four of the applicant's directors were also the directors of Bidvest parent entity and the two remaining directors were nominee directors having no real powers, the parent entity should be deemed to have the power to enjoy the income arising to the applicant, which in absence of any treaty benefit under the India – South Africa tax treaty, should be taxable in India.

This is indeed an interesting interpretation and application of the provision, which deviates from the manner in which the provision has been generally understood and applied.

The Authority ruled based on other factors and did not deal with this provision in its ruling.

Ruling

The Authority for Advance Rulings, after considering all the arguments and judicial precedents, categorically ruled that the applicant was not eligible to receive the tax treaty benefits. The Authority considered several factors for the overall determination and dealt with them in detail.

First, the Authority noted that the applicant was incorporated in Mauritius just two weeks before submission of the technical and financial bid by the consortium and when the expression of interest was filed by the consortium, the applicant was not even in existence.

For most of the bidding process involving airport visits, site inspection, and discussions with government agencies, etc. the parent entity was involved as a member of the consortium, and only at stage 2 was the applicant substituted.

Substance in the applicant

It was observed that the applicant did not have any tangible assets, employees, office space, management experts, or financial advisers. The applicant did not hire any finance professionals who could arrange finance, it did not have collaterals for raising funds, it did not provide a meeting ground for having active discussions during the development process of the project or for addressing any difficulties encountered during the implementation phase, and it did not discuss critical needs of the project in its board meetings. Moreover, it had no independent sources of funds or income nor had any fiscal independence.

Choice of jurisdiction

India's Authority for Advance Rulings remarked that Mauritius, unlike London or New York, is not a known financial centre or a vibrant business hub, nor can it boast of being a seat of civil aviation experts.

Role of the applicant in the consortium

The Authority also observed that the project could not have operated without the other two consortium members, GVK being a major business group in India and ACSA having the technical expertise and experience in the field of operation and maintenance of an airport.

However, the project could have survived without the applicant, and the funding could have been provided directly by Bidvest from South Africa. The applicant served as a conduit for routing funds for its South African group entities, the Authority said.

Decision-making process

While the shares in the Indian joint venture entity were in the name of the applicant, the beneficial owners were the holding companies in South Africa.

The applicant kept on noting and endorsing decisions of the holding company in its board meetings without any contribution or discussion about the decision-making process. The applicant did not create any value for the consortium, the Authority said.

Substance over form

Accepting the commercial reality that a holding company would predominantly control all vital decisions of its subsidiary which the latter may implement, the Authority concluded that economic rationale and substance in the subsidiary must be established for claiming tax treaty benefits.

The applicant argued that even if obtaining treaty benefits is seen as the sole objective of the arrangement, in the absence of a 'limitation of benefit' provision in the India-Mauritius tax treaty, the benefit cannot be denied.

However, relying on the Apex court's decision in the case of Vodafone International Holdings BV v Union of India, the Authority concluded that since the facts point towards a tax avoidance device, it is open to the tax department to discard the device and take into consideration the real transaction between the parties.

Some thoughts

The Indian tax law has comprehensive anti-abuse rules which have codified the 'substance over form' principle. However, investments made before 1 April 2017 have been grandfathered and, therefore, are not subject to the commercial substance test under these rules.

Accordingly, the transaction which was the subject matter of the ruling was outside the purview of these rules. However, while pronouncing the ruling, the Authority has applied judicial anti-abuse rules by concluding that the entity claiming tax treaty benefits was a sham or a conduit and a tax avoidance device.

While the facts discussed in the ruling do not throw much light on the decision making, board composition and operation at the Mauritius level, the facts may not be very different from pre-2017 structures that were commonly used for investments into India.

In this case, the incorporation of the Mauritian entity just before submitting a binding bid and the parent entity participating in the process until that stage was one of the key drivers of the decision.

From a commercial perspective, it is not uncommon for ultimate parent companies to run negotiations, etc. until there is deal certainty or, like in similar cases in the infrastructure space, until final selection and submission of a binding bid for a project.

This ruling makes it clear that this type of activity must be carefully evaluated and balanced for commercial and tax risks.

The questions that arise are – if there are no anti-abuse provisions in law – neither domestic law nor the treaty, was a commercial substance and business purpose test rightly applied; and is lifting of the corporate veil and ignoring separate legal existence of an entity justified in such cases.

The law with respect to treaty shopping and double non-taxation is still evolving. The OECD's BEPS measures, especially the MLI, is gradually being implemented across jurisdictions. Notably, the India–Mauritius tax treaty is not a covered agreement yet.

The Mauritian entity had a board of directors, albeit with some common directors. The basis for concluding that the applicant was not a beneficial owner of shares that it owned in the Indian entity and that it is not fiscally independent is not clear.

As per the expression of interest filed by the consortium, Bidvest had to provide strategic input, structured finance advice, and advice on ancillary services required for the bid and to provide corporate governance oversight and cargo and logistics development expertise as well.

Seemingly, the applicant could not substantiate the role it played other than being used as a funding vehicle, how it provided the agreed services to the project and why the applicant should be treated as the beneficial owner of shares, even though this is not a condition to claim a capital gains tax benefit under the treaty.

Like in cases involving similar disputes, this ruling also clarifies how each and every aspect is closely evaluated by the tax authorities, which puts more onus on the taxpayers to prepare a defense with supporting evidence.

All in all, in this case, the tax authorities' claims of tax avoidance could not be countered by the taxpayer with evidence.

Rulings pronounced by the Authority are binding only on the applicant and the tax authorities (but can be challenged before High Courts through a writ petition).

The ruling could have a persuasive value in cases having similar facts. Thus, the tax authorities will likely rely on this ruling when evaluating similar structures and transactions.

Needless to mention, taxpayers may have a more difficult time proving entitlement to tax treaty benefits if the case falls within the purview of the domestic law anti-abuse regime.

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Ritu is a Partner in the tax practice at Khaitan & Co, a full service law firm in India. With over a decade in the profession, Ritu has advised clients in the areas of corporate and international taxation.

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