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Tax alert: SC holds AAR application related to transaction, as designed prima facie for tax avoidance; rules capital gains is taxable

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The Supreme Court (SC) has held that the advance ruling application filed by the taxpayers related to transactions that were, *prima facie,* structured for tax avoidance and were rightly rejected. Accordingly, capital gains arising from the transfer of shares effected after 1 April 2017 are liable to tax in India.

In a nutshell

The mere holding of a Tax Residency Certificate (TRC) cannot, by itself, prevent an enquiry subsequent to the amendments brought into the statute, particularly by the introduction of section 90(2A) and Chapter X-A [(relating to General Anti-Avoidance Rules (GAAR)] to the Income-tax Act, 1961 (ITA) and the Rules, if it is established that the interposed entity was a device to avoid tax.

After the amendments to domestic tax laws and to the India-Mauritius Tax Treaty, there can be no doubt that a TRC alone is not sufficient to avail the benefits under the tax treaty, and reliance upon earlier judgments dealing with circulars issued in the pre-amendment regime, cannot *ipso facto* come to the aid of the taxpayer. Rather, the facts will have to be independently analysed to decide on the applicability of GAAR Chapter.

Though it is permissible in law for a taxpayer to plan his transaction so as to avoid the levy of tax, the mechanism must be permissible and in conformity with the parameters contemplated under the provisions of the ITA, rules, or notifications. Once the mechanism is found to be illegal or sham, it ceases to be “a permissible avoidance” and becomes “an impermissible avoidance” or “evasion”.

GAAR Chapter is made applicable to any arrangement, irrespective of the date on which it was entered into, in respect of a tax benefit obtained from such arrangement on or after 1 April 2017. Therefore, the prescription of the cut-off date of investment under the Rules stands diluted, if any tax benefit is obtained based on such arrangement. The duration of the arrangement is irrelevant.

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Background:

- The taxpayers[1] are private companies incorporated under the laws of Mauritius. They were set up with the primary objective of undertaking investment activities with the intention of earning long term capital appreciation and investment income.
- The taxpayers are regulated by the Financial Services Commission (FSC) in Mauritius and have been granted a Category I Global Business License (GBL-1) under section 72(6) of the Financial Services Act, 2007, enacted by the Parliament of Mauritius.
- As per the taxpayers, their business was wholly controlled and managed by their Board of Directors in Mauritius. It held valid Tax Residency Certificate (TRC) issued by the Mauritius Revenue Authority, certifying to be tax residents in Mauritius for income-tax purposes.
- The taxpayer had engaged A Co, a company in the USA, to provide services in relation to their investment activities.
- The taxpayer held shares of a private company (S Co), incorporated under the laws of Singapore. S Co invested in multiple companies in India, and the value of its shares was derived substantially from the assets located in India. Thereafter, it transferred shares of S Co to a company in Luxembourg.
- The taxpayer filed an application with the tax authorities for grant of a 'Nil' withholding tax certificate under section 197 of the Income-tax Act, 1961 (ITA), prior to consummation of the transfer. The tax authorities informed that the taxpayer would not be eligible to avail the benefits under the India-Mauritius tax treaty on the grounds that they were not independent in their decision-making and that control over the decision-making relating to the purchase and sale of shares, did not lie with them. Accordingly, the taxpayer was issued certificates prescribing a withholding tax rate in respect of the sale of shares by the taxpayer.
- Aggrieved, the taxpayer approached the Authority for Advance Rulings (AAR), seeking an advance ruling on, *inter alia, whether gains arising to the taxpayer from the sale of shares held by them in S Co would be chargeable to tax in India under the ITA read with the tax treaty between India and Mauritius?*
- The AAR came to the conclusion that the applications preferred by the taxpayer relate to a transaction or issue which was ***prima facie*** designed for the avoidance of income-tax and therefore, rejected as being hit by the threshold jurisdictional bar to maintainability under section 245R(2) of the ITA.
- Aggrieved, the taxpayer filed a writ petition before the Delhi High Court (HC) against the aforesaid order disposing the taxpayer's application. The HC allowed the writ petition and quashed the AAR's order, after holding that the taxpayer was entitled to treaty benefits and that their income would not be chargeable to tax in India.
- Aggrieved, the Revenue authorities filed an appeal before the Supreme Court (SC).

Relevant provisions in brief:

Article 13 Capital Gains (India-Mauritius Treaty)

"...3A. Gains from the alienation of shares acquired on or after 1st April 2017 in a company which is resident of a Contracting State may be taxed in that State. Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs (1), (2) and (3) of this article shall be taxable only in that State.

3B. However, the tax rate on the gains referred to in paragraph 3A of this Article and arising during the period beginning on 1st April, 2017 and ending on 31st March, 2019 shall not exceed 50% of the tax rate applicable on such gains in the State of residence of the company whose shares are being alienated;]

[1] Civil Appeal No. 262 of 2026 (SC) [along with 2 other appeals]

4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 3A shall be taxable only in the Contracting State of which the alienator is a resident.

5. For the purposes of this article, the term 'alienation' means the sale, exchange, transfer, or relinquishment of the property or the extinguishment of any rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States..."

Rule 10U of the Income-tax Rules 1962

(1) "The provisions of Chapter X-A shall not apply to-
(a) an arrangement where the tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed a sum of rupees three crore;
.....
(d) Any income accruing or arising to, or deemed to accrue arise to, or received or deemed to be received by, any person from transfer of investments made before the first day of April, 2017 by such person."

(2) ***Without prejudice to the provisions of clause (d) of sub-rule (1), the provisions of Chapter X-A shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1st day of April, 2017..."***

Decision of the SC

The SC noted that the core issue for consideration was "*Whether the AAR was right in rejecting the applications for Advance Ruling on the ground of maintainability, by treating the capital gains arising out of a transaction of sale of shares of S Co, which holds the shares of an Indian company, by a Mauritian company controlled by an American company,* ***to be prima facie an arrangement for tax avoidance****, and hence, whether it can be enquired into to ascertain whether the capital gains would be taxable in India under the ITA, read with the relevant provisions of the Mauritius tax treaty, or not?"*

The SC observed as follows:

Provisions of the India-Mauritius tax treaty, ITA and subsequent amendments

- For the benefit under Article 13(4) of the India-Mauritius tax treaty, the person claiming treaty protection must not only qualify as a 'resident' of the other State i.e., Mauritius, but also establish that the movable property or shares forming the subject matter of the transaction, are directly held by such resident entity. An indirect sale of shares would not, at the threshold, fall within the treaty protection contemplated under Article 13.
- The object of the tax treaty is to prevent double taxation and not to facilitate avoidance or evasion of tax. Therefore, for the treaty to be applicable, the taxpayer must prove that the transaction is taxable in its State of residence.
- The amendments to the India-Mauritius tax treaty were introduced to prevent revenue loss to the State where the gains actually arise, by abuse of the tax treaty. Hence, the taxpayer has to establish that it is a resident of the Contracting State covered by the tax treaty by producing all relevant documents.
- The amendments in the domestic tax law subsequent to earlier SC ruling in case of Vodafone[2] to Chapter IX, the insertion of Chapter XA (GAAR provisions), the amendments to Rule 10U, and the India-Mauritius tax treaty completely changed the scenario. Circulars[3] issued by the CBDT[4] earlier, though binding on the Revenue at the time of their issuance, operate only within the legal regime in which they were issued and cannot override

[2] Vodafone International Holdings B.V. vs. Union of India [2012] 17 taxmann.com 202 (SC)/[2012] 204 Taxman 408 (SC)/[2012] 341 ITR 1 (SC)/[2012] 247 CTR 1 (SC) [20-01-2012]

[3] CBDT Circular No. 682 dated 30 March 1994, Circular No. 789 dated 13 April 2000 and Circular No. 1/2003 dated 10 February 2003

[4] Central Board of Direct Taxes

subsequent statutory amendments.

After the amendment has come into effect, there can be no doubt that a TRC alone is not sufficient to avail the benefits under the tax treaty, and reliance upon earlier judgments dealing with circulars issued in the pre-amendment regime, cannot *ipso facto,* come to the aid of the taxpayer. Rather, the facts will have to be independently analysed to decide on the applicability of Chapter X-A (GAAR).

- As the provisions have undergone a sea change by amendments to Chapter IX, Chapter XA of the ITA and Rule 10U, the tax officers under the ITA are now empowered to determine where taxable entities are really resident by investigating the centre of their management, and thereafter to apply the provisions of the ITA to the global income earned by them by reason of the provisions of the ITA.

Power of AAR to reject applications of prima facie tax avoidance

- Given settled anti-avoidance principles, Parliament has statutorily empowered the AAR to reject applications at the threshold where the transaction appears **prima facie** tax-avoidant.
- The AAR rejected the applications of the non-resident applicants on the grounds that the transaction was ***prima facie*** for the avoidance of income tax by relying upon the method of operation to ascertain the effective control and management of the taxpayer to hold that the effective management was not in Mauritius and was, in fact, in the USA.
- The use of the term '*prima facie*' under the provisions of the ITA implies that it is sufficient if the AAR, on an initial examination of the documents, is satisfied that the transaction is for avoidance of income-tax and can reject the application. The provision is couched in such a way that the burden lies on the person claiming a particular fact, and such *prima facie* opinion is sufficient to reject the application.

Role of TRC and availability of treaty benefits

- Section 90(4) of the ITA only speaks of the TRC as an 'eligibility condition'. It does not state that a TRC is 'sufficient' evidence of residency, which is a slightly higher threshold. The TRC is not binding on any statutory authority or Court unless the authority or Court enquires into it and comes to its own independent conclusion. The TRC relied upon by the taxpayer is non-decisive, ambiguous and ambulatory, merely recording futuristic assertions without any independent verification. Thus, the TRC lacks the qualities of a binding order issued by an authority.
- The taxation of capital gains from the sale of shares of Indian companies by Mauritian residents has set aside the indiscriminate tax exemption granted to Mauritian residents on all incomes arising in India under Article 13 of the DTAA. The grandfathering clause under GAAR will be applied to capital gains from transfers made on or before 1 April 2017, provided the applicant satisfies the test of 'resident' as defined under its State law, particularly under section 73 of the Mauritius Income Tax Act and the provisions of the ITA.
- The mere holding of a TRC cannot, by itself, prevent an enquiry subsequent to the amendments brought into the statute, particularly by the introduction of section 90(2A) and Chapter X-A (GAAR) to the ITA and the Rules, if it is established that the interposed entity was a device to avoid tax.

Applicability of GAAR

- The application of India's anti avoidance provisions are relevant to test the applicability of the tax treaty. GAAR is applicable to the AY under consideration, empowering the Revenue to declare the subject transaction to be an impermissible arrangement, which means *'an arrangement, the main purpose of which is to obtain a tax benefit, and which, inter alia, is entered into or carried out by means or in a manner which is not ordinarily employed for bonafide purposes.'*
- Two important conditions are prescribed under the rules relating to application of GAAR [i.e. Rule 10U of the Income-tax Rules, 1962], to seek exemption from the applicability of GAAR. By the use of the words "*without prejudice to the provisions of clause (d) of sub-rule (1)*", GAAR Chapter under the ITA (i.e. Chapter X-A) is made

applicable to any arrangement, irrespective of the date on which it was entered into, in respect of a tax benefit obtained from such arrangement on or after 1 April 2017. Therefore, the prescription of the cut-off date of investment under Rule 10U(1)(d) stands diluted by Rule 10U(2), if any tax benefit is obtained based on such arrangement. The duration of the arrangement is irrelevant.

- In the alternative, even if GAAR is held to be inapplicable, the Revenue invoked the JAAR[5], grounded in the doctrine of substance over form, consistently recognised in Indian jurisprudence. The contentions put forward by the Revenue were found in force due to following reasons:
  - taxability of the transaction is established under section 9(1)(i) of the ITA;
  - the availability of treaty relief is contested by challenging the residency claim in view of the *prima facie* finding that effective management and control were not in Mauritius, the scope of Article 13, and the applicability of Circular No. 789 and *earlier* SC ruling *;*
  - GAAR and, in the alternative, JAAR are invoked to pierce the structure and deny treaty benefits where the transaction lacks genuine commercial substance.
- In the present case, the taxpayers sought exemption from the Indian Income-tax while, at the same time, contending that the transaction was also exempt under Mauritian law, which ran contrary to the spirit of the tax treaty and presented a strong case for the Revenue to deny the benefit as such an arrangement was impermissible.
- There was clear and convincing *prima facie* evidence to demonstrate that the arrangement was designed with the sole intent of evading tax, and the taxpayer failed to furnish sufficient material to rebut this presumption. Though it is permissible in law for a taxpayer to plan his transaction so as to avoid the levy of tax, the mechanism must be permissible and in conformity with the parameters contemplated under the provisions of the ITA, rules, or notifications. Once the mechanism is found to be illegal or sham, it ceases to be "a permissible avoidance" and becomes "an impermissible avoidance" or "evasion".
- Once it is factually found that the unlisted equity shares, on the sale of which the taxpayer derived capital gains, were transferred pursuant to an arrangement impermissible under law, it is not entitled to claim exemption under Article 13(4) of the India-Mauritius tax treaty.

  The application preferred by the taxpayers related to a transaction designed prima facie for tax avoidance and were rightly rejected as being hit by the threshold jurisdictional bar to AAR application maintainability. Accordingly, capital gains arising from the transfers effected after the cut-off date, i.e., 1 April 2017, were taxable in India under the ITA read with the applicable provisions of the India-Mauritius tax treaty.

Comments:

The SC has delivered a long-awaited ruling in the case of eligibility of a non-resident taxpayer for availing tax treaty benefits specially in the context of recent developments in domestic as well as global tax laws. Recent judicial trends reflect a more substance-driven approach to the application of international tax treaties and cross-border tax planning arrangements. Anti-avoidance doctrines—most notably the GAAR, the substance-over-form principle, and the prohibition on treaty shopping—to deny treaty benefits where intermediary structures lack commercial justification or economic nexus to the transaction, are invoked in certain cases.

The SC in this case has touched upon the issues such as holding TRC being sufficient condition, holding company status, or grandfathering provisions for applicability of GAAR. The historic ruling will help taxpayers and Revenue to see treaty interpretation and whether the same would overlap or supersede India's sovereign right to tax.

It is also pertinent to note that Justice Pardiwala has separately pointed out the following safeguards that India must take to protect its tax sovereignty, while entering into any international tax treaties:

[5] Jurisdictional Anti-Avoidance Rules

1. Include a LOB clause in the tax treaty
2. Include a GAAR override
3. Ensure right to tax digital economy
4. Preserve source-based taxation rights
5. Include tax credit, not exemption
6. Include exit or renegotiation clause
7. Avoid 'Most favoured nation' (MFN) clause
8. Clearly define Permanent Establishment (PE)
9. Align with India's domestic laws and constitution
10. Conduct cost-benefit analysis before signing
11. Build treaty monitoring and review mechanism
12. Consult stakeholders before signing

The SC, in this ruling has, amongst others, held and laid down the following principles:

- The mere holding of a TRC cannot, by itself, prevent an enquiry subsequent to the amendments brought into the ITA, particularly by the introduction of section 90(2A) and Chapter X-A (GAAR) to the ITA and the Rules, if it is established that the interposed entity was a device to avoid tax.
- After the amendments to domestic tax laws and India-Mauritius tax treaty, there can be no doubt that a TRC alone is not sufficient to avail the benefits under the tax treaty, and reliance upon earlier judgments dealing with circulars issued in the pre-amendment regime cannot *ipso facto* come to the aid of the taxpayer. Rather, the facts will have to be independently analysed to decide on the applicability of GAAR Chapter.
- Though it is permissible in law for a taxpayer to plan his transaction so as to avoid the levy of tax, the mechanism must be permissible and in conformity with the parameters contemplated under the provisions of the ITA, rules, or notifications. Once the mechanism is found to be illegal or sham, it ceases to be "a permissible avoidance" and becomes "an impermissible avoidance" or "evasion".
- GAAR Chapter is made applicable to any arrangement, irrespective of the date on which it was entered into, in respect of a tax benefit obtained from such arrangement on or after 1 April 2017. Therefore, the prescription of the cut-off date of investment under the Rules stands diluted, if any tax benefit is obtained based on such arrangement. The duration of the arrangement is irrelevant.

It may be noted that the AAR has been replaced with Board for Advance Rulings (BFAR).

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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