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# AAR APPLIES 'LOOK THROUGH' APPROACH – DENIES TREATY RELIEF TO MAURITIAN ENTITIES ON INDIRECT TRANSFER OF INDIAN SHARES

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The Authority for Advance Rulings (AAR) recently rejected applications made by three Mauritian entities on the taxability of capital gains on indirect transfer of an Indian company's shares, under the India-Mauritius Double Taxation Avoidance Agreement (Tax Treaty). The AAR held that that the transaction was prima facie designed for tax avoidance and that even otherwise, the benefit of the Tax Treaty cannot be allowed in this case.

## Background

Tiger Global International II Holdings, Tiger Global International III Holdings and Tiger Global International IV Holdings (Applicants) are private companies incorporated in Mauritius. The Applicants each hold a Category 1 Global Business License and are tax residents of Mauritius for the purposes of the Tax Treaty. The Applicants were incorporated with the primary objective of undertaking long term investment activities and earning long term capital appreciation.

Between October 2011 to April 2015, the Applicants invested in the shares of Flipkart Private Limited, a company incorporated in Singapore (Flipkart). Flipkart had in turn invested in multiple Indian companies, thereby deriving its value substantially from assets located in India. The Applicants were desirous of transferring the shares of Flipkart to Fit Holdings SARL, an independent buyer based out of Luxembourg (Buyer), as a part of the larger transaction relating to Walmart's acquisition of a majority stake in Flipkart.

In relation to the aforesaid share transfer, the Applicants had approached the Indian tax authorities under Section 197 of the Income Tax Act, 1961 (IT Act) seeking a nil withholding certificate. The tax authorities denied this request on the premise that the Applicants were not eligible to avail benefits under the Tax Treaty as they did not exercise independence in their decision making, and because the control pertaining to the purchase and sale of the shares did not lie with them.

The Applicants thereafter filed applications before the AAR under Section 245Q(1) of the IT Act to determine whether the sale of Flipkart's shares by the Applicants to the Buyer would be chargeable to tax in India under the IT Act read with the Tax Treaty.

### Arguments advanced by the Parties

Section 245R of the IT Act, which lays down the conditions for admissibility of an AAR application, provides that an application shall not be admitted, where the question raised in the application:

- is already pending before any income tax authority or the Income Tax Appellate Tribunal or any court;
- involves determination of fair market value (FMV) of any property;
- relates to a transaction or issue which is designed prima facie for the avoidance of income tax.

The Indian tax authorities challenged the admissibility of the applications under all the three abovementioned conditions, as outlined below.

- Pending Proceedings: The tax authorities argued that the issue in question had been examined in detail during the proceedings under Section 197 of the IT Act, and the conclusion of such proceedings was a reasonable ground for rejecting the applications. Alternatively, it was argued that since the certificate issued under Section 197 of the IT Act was valid for the financial year 2018-19, there was a pending proceeding on the date when the applications were filed by the Applicants.
- Determination of FMV: The tax authorities contended that the transfer of shares necessarily involves valuation of shares. It was argued that the computation of capital gains would be dependent on the sale consideration which would be based on the value assigned to each share. Hence, the question raised by the Applicants in the applications involved determination of FMV of Flipkart's shares.

<u>Both the objections raised above were rejected by the AAR</u>.

- Transaction or issue which is designed prima facie for the avoidance of income tax.

The tax authorities argued that the Applicants were 'see-through entities' designed prima facie for avoidance of tax and therefore, clause (iii) of the second proviso to Section 245R(2) of the IT Act was squarely attracted. The Applicants vehemently denied the said allegation and argued that the transaction in question was a simpliciter sale of shares undertaken between two unrelated independent parties which could not be considered as being designed for the avoidance of tax. It was further buttressed that a transaction having a business rationale cannot be designed for prima facie avoidance of tax. The Applicants emphasised that the argument of the tax authorities that the entity undertaking the transaction should not be entitled to treaty benefits was different from saying that the transaction was entered into with a view to avoid income tax.

The submissions of the tax authorities and the Applicants on the issue of tax avoidance are discussed in detail below:

(i) <u>Ownership and Control</u>.

Arguments by tax authorities: The tax authorities argued that the Applicants had been set up as conduits for investments in India. The tax authorities noted that the Applicants were ultimately held by Tiger Global Management LLC (TGM LLC), an entity based in the USA that invests in markets across the globe through a web of entities in the Cayman Islands and Mauritius. TGM LLC was also founded by Charles P Coleman (Charles), a US tax resident, who was also a director in several intermediate entities. The tax authorities also noted from the Applicants' business plan that funds for investments were to be provided by the promoter.

Arguments by Applicants: The Applicants argued that their holding structure was not relevant in determining whether the transaction was designed for tax avoidance. It was contended that the requirement is for the tax authorities to prove that the transaction, and not the holding structure, is designed for tax avoidance.

(ii) Decision Making.

Arguments by tax authorities: The tax authorities highlighted that each of the Applicants had one US based director on their respective boards, who was also the general counsel of TGM LLC. It was argued that such US director took decisions on all important issues while the local Mauritian directors were mere spectators, and only relied on advice from the US director. In the absence of such US director, a representative of TGM LLC always attended important meetings of the board of directors of the Applicants.

Arguments by Applicants: The Applicants on the other hand argued that the entities were managed and controlled by their respective boards in Mauritius. It was also contended that the decision to invest and divest in Flipkart was also undertaken by all the members of the board of directors of the respective Applicant entities after due discussions and deliberations.

(iii) Financial Control.

Arguments by tax authorities: The tax authorities noted that Charles (the founder and partner of TGM LLC) had the authority to operate bank accounts of the Applicants for transactions exceeding USD 250,000. The tax authorities also noted that several other signatories to the bank accounts were senior members of TGM LLC, and all such signatories were not on the board of directors of the Applicant entities. Accordingly, the tax authorities concluded that the control of the funds of the Applicants was outside Mauritius, in the hands of TGM personnel in the USA.

Arguments by Applicants: The Applicants argued that a mere fact that the board of directors had given a limited authorisation to operate bank accounts did not demonstrate that the Applicants did not have control over their funds. It was contended that the tax authorities had not adduced any evidence to prove that funds invested by the Applicants, and the sale proceeds from the transaction received by the Applicants, were not independently owned and controlled by the Applicants.

(iv) Beneficial Ownership:

Arguments by tax authorities: The tax authorities contended that as per certain disclosures made under Mauritian law, Charles was the beneficial owner of the Applicants. Emphasising on the 'good faith' interpretation of tax treaties, the tax authorities argued that had TGM USA directly held the shares in Flipkart, it would have been liable to pay tax on the capital gains on the sale of shares as per the India-USA Tax Treaty. Accordingly, considering the peculiar facts and circumstances of the case, the tax authorities were entitled to disregard the form of the arrangement, re-characterize the share transfer according to its economic substance, and impose tax on the actual controlling non-resident enterprise.

Arguments by Applicants: The Applicants argued that they beneficially held shares of Flipkart and were not accountable to any third party. It was further argued that they were neither sham entities nor conduits. It was contended that beneficial ownership disclosures made in accordance with Mauritian law did not take away the legal owner's actual ownership in its independent capacity. The Applicants stressed that if the arguments advanced by the tax authorities are accepted, no Indian company with foreign shareholders would ever be able to claim treaty benefits in India.

**AAR's Ruling**

The AAR accepted the arguments of the Indian tax authorities and rejected the applications on the ground that the transactions were designed for avoidance of tax, for the following reasons:

- The transaction has to be looked at as a whole, and hence not only the sale but also the purchase of the shares would have to be examined.

- Though the holding-subsidiary structure might not be conclusive proof of tax avoidance, the fact that subsidiaries were set up for claiming benefit under the India-Mauritius Tax Treaty was an 'inescapable conclusion'.

- The AAR rejected the contention of the Applicants that Mauritius was a preferred jurisdiction for investors due to its comprehensive treaty network with various countries and not just India. The AAR noted from the financial statements of the Applicants that they had not made any investment other than the investment in Flipkart. The AAR thus concluded that the real intention of the applicants was to avail the benefit of India-Mauritius Tax Treaty.

- Regarding the 'control and management' of the Applicants, the AAR held that the control and management had to be deduced from the 'head and brain' of the entities, and not their day to day affairs. The AAR accordingly questioned the reasoning behind allowing a non-resident of Mauritius access to Mauritian bank accounts of the Applicants. Additionally, the AAR noted that Charles was also a signatory to the bank accounts of the immediate parent entities of the Applicants, a director of the ultimate holding companies of the Applicants, and was also declared as the beneficial owner of the Applicants. The AAR also noted that Charles was controlling the decisions of the board of directors of the Applicant entities through the non-resident US director. Linking all these facts and considering the influence of Charles over the TGM group, the AAR held that the appointment of Charles by the Applicants as the authorised signatory of bank cheques could not be considered as a mere coincidence. Consequently, the AAR held that the 'head and brain' of the Applicants and their control and management was not situated in Mauritius, but in USA.

- The holding structure of the Applicants coupled with their control and management lead the AAR to conclude that the Applicants were only '*see through*' entities set up to avail benefits of the India-Mauritius Tax Treaty.

- Interestingly, the AAR also opined that since the sale involved shares of a Singapore company (Flipkart) by the Applicants, the benefit provided under India-Mauritius Tax Treaty will not be available. It held that the intention of the India-Mauritius Tax Treaty was to exempt investments by Mauritius companies in Indian companies, whereas in the instant case, the investment was in a Singapore entity deriving substantial value from India and hence, the benefit under the Tax Treaty is not available to the Applicants. The AAR thus held that the Applicants failed on treaty eligibility as well.

**Comments**

While this is certainly an important advance ruling, it is important to note that the view taken by the AAR is attributable to specific facts in the present case, such as extensive influence of a US resident on the decision making and overall control and management of the Applicants, coupled with lack of independence of the local directors of the

Applicant entities. For this reason, we believe that this ruling should not affect the otherwise settled jurisprudence on the India-Mauritius Tax Treaty in light of the ruling of the Supreme Court of India in the Azadi Bachao Andolan and Vodafone case, the CBDT Circular No 789, other High Court decisions and several rulings from AAR itself.

This ruling further touches upon the aspect of whether indirect transfers of Indian assets are exempt under India-Mauritius Tax Treaty. Notably, the view in the professional fraternity till date has been that 'indirect transfers' of Indian assets are exempt from Indian capital gains tax under India-Mauritius Tax Treaty. Further, judicial pronouncements in the past have also upheld the eligibility to claim Tax Treaty exemption in respect of indirect transfers. However, in this ruling, the AAR has ruled that the benefit under India-Mauritius Tax Treaty does not apply to an 'indirect transfer' of an Indian company's shares.

Another interesting and important aspect of this ruling is technical in nature. The scheme of advance rulings under the IT Act provides that AAR should not rule on questions raised in an application if the concerned transaction was designed prima facie to avoid tax in India. This would mean that if in a given case, the AAR reaches a finding (on a prima facie basis) that the transaction covered in an advance ruling application was designed for avoiding income tax in India, the application must be rejected. However in the instant case, even though the AAR held that the subject transaction was designed prima facie to avoid tax in India, it considered the application on merits and held negatively to deny the Applicants benefits of India-Mauritius Tax Treaty on the facts of the case. This seems to be an issue with the jurisdiction of AAR, and whether it had the legal ability to rule on merits after it rejected the application on the ground that the transaction was a case of prima facie tax avoidance, thereby attracting the exclusion mandated in Section 245R(2) of the IT Act.

One key take-away from this AAR ruling is that tax authorities are increasingly looking at substance in the Mauritius entities which claim benefits of the Tax Treaty. Tax authorities are also diving deep into various important factual aspects, such as conduct and credibility of the local board of directors, perusal of minutes of board meetings, ascertaining who is really in the driving seat and so on.

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