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Tax Certainty Come Undone? Mauritius Seller denied Treaty Benefits, Gains Taxed in India

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The Authority for Advance Rulings (AAR) in its recent verdict in the matter of *Bid Services Division (Mauritius) Ltd, In re* ([2020] 114 taxmann.com 434 (AAR – Mumbai)), denied the benefits of the capital gains tax exemption under the India – Mauritius Tax Treaty (Treaty) to the taxpayer on the sale of its Indian investment.

As per Article 13(4) of the Treaty (prior to the 2017 amendment, inapplicable to the present case) capital gains arising to a Mauritian resident from the sale of shares of an Indian company will be chargeable to tax only in Mauritius. Further, Mauritius exempts taxation of capital gains under its domestic tax law.

Background

Bid Services Division (Mauritius) Ltd., (Taxpayer) is a Mauritian company and a wholly owned subsidiary of its South-African parent, Bid Services Division (Proprietary) Limited which is in turn held by Bidvest Group Limited, a South-African listed company. The Taxpayer has been issued a valid Tax Residency Certificate (TRC) by the Mauritian revenue authorities and has its place of effective management in Mauritius.

The Airports Authority of India (AAI) had invited bids for the acquisition of 74% interest in the joint venture companies for each of the Mumbai and Delhi airports. During this process, the GVK-SA consortium comprising M/S. GVK Industries Limited and SA Airport Operators filed its expression of interest. The latter comprised of three entities, Airports Company South Africa Limited (ACSA), M/s Old Mutual Life Assurance Company (South Africa) Limited and M/s Bidvest Group Limited. Importantly, the said consortium did not include the Taxpayer as one of its members during the entire preliminary stage and for the most part of secondary stage of the bidding process.

Thereafter, pursuant GVK-SA consortium successfully winning the bid for the operation, management and development of the Mumbai airport, the Taxpayer along with GVK Airport Holdings Private Limited (GAHPL) and ACSA Global Limited (AGL) formed a joint venture company in India called Mumbai International Airport Private Limited (MIAL or Indian Target). In 2006, a shareholders' agreement was signed between the AAI, Taxpayer, GAHPL, AGL and MIAL to govern their mutual relations and rights. The Taxpayer thus subscribed to 27% of the Indian Target.

In 2011 the Taxpayer sold 13.5% of its holding in the Indian Target for an agreed consideration of USD 231 Million. The Taxpayer approached the AAR for its ruling on whether the capital gains arising from sale of shares in the Indian Target shall be taxed in India in light of the beneficial Treaty provisions.

Arguments Advanced

The Taxpayer argued that the (Indian) Income-tax Act 1961 (Act) allows for the application of the Treaty and since the Taxpayer satisfies the fiscal residence test prescribed therein, any capital gains arising from the sale of the shares of the Indian Target should only be taxed in Mauritius.

The Indian tax authorities countered the Taxpayer's argument relying on the 'substance over form' principle and contended the following:

- As mentioned above, there was no mention of the Taxpayer, only its group entities during the key stages of the bid process. In fact, the Taxpayer was not in existence then, having been incorporated only two weeks prior to the submission of the binding consortium bid;

- The ideal location of any Special Vehicle Purpose (SPV) should have been in Mumbai or South Africa, not Mauritius. The only apparent advantage of being set up in Mauritius was to obtain a tax benefit, and hence the commercial substance and a bona fide business purpose was lacking;

- Section 93 of the Act, an anti-avoidance provision was applied to demonstrate that the South African parent of the Taxpayer had acquired rights enabling it to enjoy income of the Taxpayer and therefore such income should be taxed in accordance with the India – South Africa Tax Treaty which did not provide for any capital gains tax exemption, unlike the Treaty. Common management, directors on the Board of the Taxpayer and its parent corroborated this; and

- The source of funding for the share subscription by the Taxpayer was pursuant to capital sums advanced by the ultimate and immediate parent entities of the Taxpayer. Further, during the bid process, these group entities reiterated their commitment to provide necessary funds.

As a result, the tax authorities, looking through the structure sought to apply the India – South Africa Tax Treaty which allows India to tax capital gains arising from the sale of shares of an Indian company.

The Taxpayer justified the manner in which the sale transaction was undertaken by emphasising the common commercial practice of using SPVs, the efficacy of Mauritius as an investment jurisdiction and the inapplicability of Section 93 of the Act to the present case since there was no resident undertaking a transaction to externalise the assets while continuing to enjoy income therefrom. What was envisaged was the opposite, whereby a non-resident (here, Taxpayer) transferred its holdings to a resident purchaser.

Further, the Taxpayer, without prejudice to its arguments above, contended that the Treaty did not include any Limitation of Benefits (LOB) clause or anti-avoidance provision (unlike the India – Singapore Tax Treaty) and therefore, it could not be denied the benefits of the Treaty.

Ruling

The AAR deciding in favour of the tax authorities, ruled that Taxpayer was disentitled to the Treaty benefits, LOB or not, and the capital gains arising from the sale of shares of the Indian Target was subject to tax in India. The AAR ruled that the dominant purpose of interposing the Taxpayer in the structure was to avoid taxes.

The AAR did not take kindly to the non-existence of the Taxpayer during the bid process and stated that the joint venture essentially comprised of two groups headquartered in India and South Africa. The Taxpayer was merely a shell company without any tangible assets, employees or experts on its payroll. Interesting comparisons were made between Mauritius and London, New York (known financial centres, vibrant business hubs), and the AAR observed that there was no commercial justification for the Taxpayer to have been set up in Mauritius.

The AAR frowned upon the practice of 'treaty shopping' and noted that although the funds were routed through the Taxpayer in Mauritius, the beneficial owners of the investment in the Indian Target were the parent entities of the Taxpayer (outside Mauritius).

Comment

While the apex court, the Supreme Court of India in the *Azadi* case (263 ITR 706 (SC)) clearly paved the way for Mauritian resident companies to avail the capital gains benefit under the Treaty so long as they possessed a valid TRC, the AAR has sought to identify factual grounds to uphold the tax authority's argument that the sale transaction lacked commercial substance and was structured to avoid tax.

Interestingly, despite the *Vodafone* case ((2012) 17 taxmann.com 202) not dealing with the provisions of the Treaty, both the Taxpayer and the tax authorities have sought to rely on observations therein buttress their argument.

India's general anti-avoidance rules (GAAR) have been in effect from 1 April 2017 with investments prior to that being grandfathered from the application of GAAR (including the present case). However, the tax authorities as well as the AAR have tested the 'commercial substance' and 'business purpose' which according to the AAR, the Taxpayer failed to justify.

What is clear is that despite dealing with cases in the pre-GAAR, the substance of the transaction has been given priority. A TRC no longer reigns supreme since minute details such as source of funding, date of incorporation, presence of the taxpayer in terms of employees, office space etc., as well as the commonality in management between the seller and its parent shall continue to be reviewed closely. Also factors such as the role played by the parent in negotiations for transactions to be entered into by its subsidiary / SPV would play an important role in the overall determination.

Despite the fact that AAR (a quasi-judicial body) rulings are binding only upon the concerned taxpayer and tax authorities, since they hold persuasive value, this ruling comes as yet another blow to taxpayers seeking to avail the benefits of a tax treaty.

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