AAR rejects application relating to transaction designed prima facie for tax avoidance

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Summary

The Authority for Advance Rulings (AAR) has, in a recent ruling, declined to admit an AAR application of a group of Mauritius entities on the ground that the transaction referred to by them in their application was prima facie designed for the purpose of tax avoidance. The transaction in question involved transfer of shares of a Singapore Company (which derived substantial value from assets situated in India) by Mauritius company to a Luxembourg company.

The AAR examined the ownership, holding structure and the financial control of the Mauritius entities (the transferor) and held that the same was controlled by the ultimate beneficial shareholder based in the US. On the facts of the case, it opined that the head and brain of the Mauritius entities was situated in the US and the Mauritius entities were only a "see-through entity" created for the purpose of availing the benefits under the India-Mauritius tax treaty.

The AAR also held that since the transaction involved transfer of shares of a Singapore company (deriving value from India assets) by a group of Mauritius entities to a Luxembourg company, the benefit, if any, under the provisions of India-Mauritius tax treaty was not available to such a transaction.

About the applicants

- The applicants[1] were private companies, limited by shares 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 applicants had been granted a Category 1 Global Business License and were tax residents of Mauritius.
- The applicants held shares in a private company[2], limited by shares incorporated under the laws of Singapore.

The transaction

- The applicants transferred certain shares of Singapore company (SCo) to a Luxembourg based company[3].
- The transfers were undertaken as part of a broader transaction involving the majority acquisition of SCo by a company incorporated in the US[4], from several shareholders, including the applicants.

Application[5] for obtaining Nil tax deduction certificate

- Prior to the transfer of shares, the applicants approached the Indian tax authorities seeking a Nil tax withholding certificate.
- The authorities held that the applicants were not eligible to avail benefit under the tax treaty as the control over the decision-making of the purchase and sale of the shares did not lie with them.
- The tax authorities, accordingly, did not grant the Nil withholding tax certificate[6].

Application before the AAR

- The applicants filed an application before the AAR for an advance ruling on the question that whether gains arising to the applicants (i.e. private company incorporated in Mauritius) from the sale of shares held by it in SCo would be chargeable to tax in India under the Income-tax Act, 1961 read with India-Mauritius tax treaty.

[1] Tiger Global International II Holdings, Tiger Global International III Holdings and Tiger Global International IV Holdings
[2] Flipkart Private Limited
[3] Fit Holdings S.A.R.L.
[4] Walmart Inc.
[5] under section 197 of the Act
[6] They passed an order allowing tax deduction at 6.05%, 6.92% and 8.47% respectively.

- The tax department's objected to admissibility of the application on three grounds[7], i.e.
  - (i) proceedings were pending before the income-tax authority or appellate tribunal or court
  - (ii) it involved determination of fair market value (FMV)
  - (iii) transaction or issue was designed prima facie for avoidance of tax

The AAR rejected tax department's contentions on 'pendency of proceedings' and 'determination of FMV' and held as follows:

Pendency of proceedings

- No proceedings were pending in respect of the question raised in the present application on the date on which the application is filed.
- Section 197 proceedings get concluded on the date[8] on which the certificates are issued by the tax department.

Determination of FMV

- The question raised in the present application is the taxability of the gains. The issue of valuation of shares of SCo or computation of capital gains is not involved in the question raised by the applicants.
- The exercise of valuation of shares (if at all necessary) and the computation of capital gains has to be undertaken by the tax officer only when the issue of taxability of capital gain on sale of shares is decided in the favour of the tax department.

Whether the transaction/issue was designed prima facie for avoidance of tax

Tax department's contention

The tax department submitted that the facts of the case were examined in detail at the time of proceedings,[9] where it was found that the entire scheme was designed to avoid tax. It highlighted the following:

Ownership structure and control

The applicants were held by a US-based investment entity[10] (ABC LLC), that invests in public and private markets across the world through a web of entities based out of low tax jurisdictions in Cayman Islands and Mauritius.[11]

The applicants were set up for:

- Making investment in India and that the funds for making investment were provided by the promoter.[12]
- Claiming benefit under the India-Mauritius tax treaty.

Thus, the tax department argued that the real control of the applicants does not lie within Mauritius and the applicants were not acting independently but only as a conduit for the real beneficial owners based out of the US.

Decision-making

All board meetings in which crucial decisions were taken was attended by:

- Mr. X, a non-resident USA director (who was also the general counsel of ABC LLC)[13]
- Mr. X or one of the representatives of the ABC LLC was always present to advise the board of the applicants.

Thus, the Mauritius directors were mere puppets and not independent and took advice from Mr. X.[14]

Financial control

In addition to Mr. X, the applicants had appointed two more authorised signatories (Mr. Y, Founder Member and partner of ABC LLC and Mr. Z, Chief Operating officer of ABC LLC) for all transactions above USD 250,000.

- Both Mr. Y and Mr. Z were not on board of the applicant but were key personnel of ABC LLC.
- Mr. Y was also the authorised signatory for the immediate parent companies and was also the sole director of the ultimate holding company[15].

[7] as stipulated in provisos to Section 245R(2) of the Act
[8] 17 August 2018
[9] under section 197(1) of the Act
[10] Tiger Global Management LLC ('ABC LLC')
[11] Relying on the notes to financial statement of the applicants
[12] As per their business plan
[13] On the basis of minutes of meeting
[14] Reliance placed on the decision of the Supreme Court in the case of Vodafone International Holding BV 341 ITR 1 (SC).
[15] being Tiger Global PIP Management V Ltd. and Tiger Global PIP Management VI Ltd. till July 2019

Hence, the tax department argued that the funds were controlled by Mr. Y and under his overall control by other senior personnel of ABC LLC.

Beneficial ownership

- At the time of obtaining global business licence in Mauritius, the applicant had submitted that Mr. Y is the beneficial owner of the applicant.

Other arguments

- Treaties should be interpreted in good faith. Therefore, the good faith interpretation of these treaties requires the element of tax avoidance and treaty abuse to be examined by the tax administration while invoking treaty provisions.
- If ABC LLC directly held shares in SCo, it would have been liable to pay tax on gain on sale of those shares.
- Considering the peculiar facts and circumstances of the case, it was entitled to disregard form of the arrangement and re-characterise the transfer of shares according to its economic substance and thereby, tax the actual controlling non-resident enterprise.
- The tax department concluded its arguments by stating that the applicants were a 'see-through entity' and the transaction was designed for avoidance of tax.

Applicant's contention

- The transaction involved was sale of shares undertaken between two unrelated independent parties which cannot be considered as being designed for the avoidance of tax.
- It must be proven that the transaction itself and not the structure of the entity undertaking the transaction was designed for the avoidance of income-tax.
- A transaction cannot be designed for the prima facie avoidance of tax if there is business rationale surrounding the transaction.

Ownership structure and control

- Holding structure of the applicant was of no relevance and the transaction was not prima facie found to be designed for avoidance of tax.
- The applicants had beneficially held shares of SCo and were not accountable to any third party.

Decision-making

- The applicant was managed and controlled by its board in Mauritius in accordance with its constitution.
- The decision to invest and ultimately sell the shares of SCo was taken by the directors in Mauritius after proper discussions and deliberations.

Financial control

- The mere fact that the board have given a limited authorisation to certain persons to operate the bank account does not ipso facto mean that the applicants did not have control over its funds.
- The department has not been able to establish that the funds invested as well as the sale proceeds received from the transaction were legally and beneficially owned by the applicants in its sole, independent and exclusive capacity.

Beneficial ownership

- The mere fact that certain disclosures were made and maintained for Mauritius corporate law purposes does not mean that the legal owner does not enjoy the benefits of the shares in its independent capacity for income tax purposes.
- The logic adopted by the tax department would result in an absurd and legally unintended situation, whereby no Indian company with foreign shareholders would ever be able to claim treaty benefits in India.

Held by AAR

- The requirement for rejecting an application is **not** to conclusively establish that there was tax avoidance, rather it has to be demonstrated that prime facie the transaction or the issue was designed for avoidance of tax.
- The applicant's contention that the issue only pertains to sale of shares is too simplistic to be accepted. The precise question raised in the application is chargeability of capital gains on sale of shares under the Act read with India-Mauritius tax treaty. Thus, it would involve looking at the transaction as a whole, i.e. both the purchase and sale.

- The principal objective[16] of the applicant was to act as an investment holding company for a portfolio investment domiciled outside Mauritius. The investment made by the applicants in SCo, with an Indian subsidiary, was with a prime objective to obtain benefits under India-Mauritius tax treaty and the treaty between Mauritius and Singapore.
- Although a holding-subsidiary structure might not be a conclusive proof for tax avoidance, the purpose for which the subsidiaries were set up indicates the real intention behind the structure and that the applicants were set up for making investment in order to derive benefit under the India-Mauritius tax treaty.
- In order to ascertain the control and management of the applicants, it is necessary to understand where the 'head and brain' of the applicants is situated. In this regard, the AAR has referred to the following facts:
  - Overall control of the companies vis-à-vis routine control of affairs must be determined.
  - The authority to operate bank accounts for transactions above USD 250,000 was with Mr. Y. Considering the principal account of the applicants is maintained in Mauritius, a local person authorised to operate the bank accounts would have been more prudent.
  - Mr. Y was also the beneficial owner of the applicants as disclosed earlier.
  - Mr. Y was also the authorised signatory of the immediate parent company of the applicant and the sole director of the ultimate holding company.
  - This proves that the funds of the applicant were ultimately controlled by Mr. Y.
  - Therefore the 'head and brain' of the company viz. their control and management was situated in USA and not Mauritius.
- The applicant companies were only a 'see-through entity' to avail the benefits of India-Mauritius tax treaty.
- A tax treaty should be interpreted in good faith. Accordingly, the benefit under India-Mauritius tax treaty (both under amended as well as unamended treaty) was available to a resident of Mauritius earning capital gains from sale of shares of Indian company.[17] However, in the present case, capital gain is arising on the sale of shares of SCo.
- Since exemption from capital gains tax on sale of shares of foreign company was never intended under the original or the amended tax treaty, the applicant were not entitled to claim benefit of capital gain tax exemption on the sale of shares of SCo.
- Since there was no foreign direct investment made by the applicant in India, there cannot be any question of participation in investment. In the absence of any direct investment in India one can only conclude that the arrangement was a pre-ordained transaction which was created for tax avoidance purpose.[18]
- Thus, the AAR held that question raised in the present application was designed prima facie for avoidance of tax.
- The applicants had contended that since shares of the SCo derived their value substantially from assets located in India, it was eligible to take benefit of Article 13(4) of India-Mauritius tax treaty. Here, the AAR maintained that the fact remains that what the applicants had transferred was shares of SCo and not that of an Indian company.
- Therefore, it concluded that the entire arrangement made by the applicant was with an intention to claim benefit under India-Mauritius tax treaty, which was not intended by the lawmakers, and such an arrangement was nothing but an arrangement for avoidance of tax in India. Therefore, the AAR rejected the application made by the applicants.

[16] As per the Notes to Financial Statement
[17] Relying on CBDT Circular No. 682 dated 30 March 1994
[18] Relying on Supreme Court decision in the case of Vodafone

Our comments

This ruling relates to the admissibility of application filed before the AAR and mentions that the requirement for rejecting an application is not to conclusively establish that there was tax avoidance, rather it has to be demonstrated that prime facie the transaction or the issue was designed for avoidance of tax. It is also interesting to note the AAR's observation of non-availability of treaty benefit in case of indirect transfers.

The observations of the AAR highlight the need to examine and evaluate multi-tier structures and transactions in the light of the substance over form doctrine.

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