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News Analysis: Indian Supreme Court Clears Mauritius Investment Route

by Nishith Desai and Bijal Ajinkya

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NEWS ANALYSIS

Indian Supreme Court Clears Mauritius Investment Route

by Nishith Desai and Bijal Ajinkya

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The Supreme Court of India recently delivered a remarkable ruling in the case of *Union of India, et al. v. Azadi Bachhao Andolan, et al.* that will be a landmark in the history of international tax jurisprudence. A division bench of the Supreme Court, which was presided over by Justice Ruma Pal and Justice Srikrishna, on 10 October delivered the much-awaited verdict on the India-Mauritius treaty for avoidance of double taxation by upholding that the benefits of the treaty should be available to third-country residents investing in India via Mauritius.

Mauritius has been a favorite jurisdiction for investing in India, as is evident from the statistical data regarding foreign direct investment (FDI) in India. With a share of 39.08 percent of total FDI inflows in India from 1991 until April 2002, investments from Mauritius accounted for the largest amount of FDI inflow during that period.[1]

The Supreme Court's decision, summarized below, is important for reasons that extend beyond the facts of the particular case, as the judgment includes discussions of several important tax issues, including double nontaxation, treaty shopping, tax avoidance versus tax planning, and form and substance in tax law.

Facts

The government of India in 1983 entered into a bilateral treaty with the government of Mauritius, the purpose of which, as specified in the preamble, is the "avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment."

As with all bilateral tax treaties, the India-Mauritius treaty provides for the allocation of taxing rights to the contracting states for different categories of income. The treaty is unique in the Indian context, as India has, in article 13 of the treaty, forgone its taxing rights on gains realized by a Mauritius resident on the sale of shares of an Indian company.

To appreciate the effect of the above, it is important to know the source rules of taxation in India. In accordance with those rules, gains realized on the sale of shares of an Indian company are taxable in India because the company is incorporated in India. Thus, regardless of whether the shareholder is a resi-

[1] *The Economic Times*, 22 July 2002.

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dent or a nonresident, capital gains arising on the sale of shares of an Indian company are taxable in India. This differs from the source rule applied by other countries (such as the United States), under which the basic right to tax capital gains on sales of shares lies with the country of residence of the shareholder. This could lead to a conflict of laws, especially when source rules are different, and on occasion when such conflict of laws have arisen the country of tax residence would not provide a credit for the taxes levied by the source country, resulting in double taxation of the same income. It was due to this anomaly that most non-Indian investors who wanted to invest in India routed their investments through a country (like Mauritius) that would insulate them from potential double taxation.

As per articles 4 and 13 of the India-Mauritius treaty, gains realized by a Mauritius resident on the sale of shares of an Indian company would be taxable only in Mauritius. Currently, Mauritius provides for its residents a tax exemption on capital gains arising on sales of shares. As a result, a Mauritius resident deriving gains from the sale of shares of an Indian company would pay tax neither in India nor in Mauritius.

In 1994 the Central Board of Direct Taxes (CBDT), the apex body that issues directions to the Indian tax authorities in the administration of taxes, issued a circular reiterating the provisions of the India-Mauritius treaty concerning the tax treatment of capital gains realized by a Mauritius resident on the sale of shares of an Indian company. As a floodgate reaction to the circular, a large number of Mauritius resident foreign institutional investors (FIIs) invested substantial funds in the Indian capital market.

In 2000 some of the Indian income tax authorities issued show cause notices to a large number of Mauritius resident FIIs with operations in India, calling upon them to show cause as to why they should not be taxed for gains accruing to them in India. The Indian tax authorities alleged that the FIIs, which were mostly shell companies incorporated in Mauritius, and which were controlled and managed from countries other than India or Mauritius, were not in fact residents of Mauritius and thus were ineligible to claim the benefits of the India- Mauritius treaty.

Those notices caused panic, and a large number of FIIs withdrew their investments from India. To remedy the drastic effect on the Indian capital markets, India's finance minister issued a press note clarifying that the views taken by some of the income tax officers pertained to specific cases of assessment and did not represent or reflect the government's policy regarding the denial of treaty benefits to such FIIs.

To reflect the position of the finance minister as enunciated in the release, the CBDT on 13 April 2000 issued Circular 789 clarifying that capital gains derived by a Mauritius resident from the sale of shares of an Indian company were, in accordance with the treaty, taxable only in Mauritius. The circular further indicated that a certificate of residence issued by the Mauritian Authorities would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the treaty.

Shortly after it came into force, the circular was challenged in the High Court of Delhi in two separate public interest litigations (initiated by not-for-profit organization Azadi Bachao Andolan and by a former Commissioner of Income Tax Shiv Kant Jha) alleging that India was losing out on millions of rupees in tax revenues due to abuse of the India-Mauritius treaty. Among other things, the petitioners prayed for quashing of the circular and for the issuance of directions to the central government to initiate a process whereby the terms of the treaty were revised or terminated.

The High Court, after hearing the writ petitions, quashed the circular on 31 May 2002. The Court observed that a phenomenon by which a resident of a third country takes advantage of the provisions of the India-Mauritius treaty is illegal and that India's income tax authorities were entitled to lift the corporate veil to determine whether a company was a resident of Mauritius paying tax there. The Court further declared that neither the India-Mauritius treaty nor India's tax laws contemplated the conclusiveness of a certificate of residence; consequently, the Court observed, residence must be decided by India's tax authorities under the provisions of the Indian rules of evidence. Finally, the Court noted that an agreement for the avoidance of double taxation does not confer an advantage on one party over the other, resulting in a situation in which a person faces tax obligations in neither country.

The government of India and the CBDT, respondents before the High Court, in October 2002 filed a special leave petition (SLP) in the Supreme Court of India. An independent SLP was also filed by the Global Business Institute, a not-for-profit organisation incorporated under the laws of Mauritius comprising international investors, asset managers, management companies, banks, custodians, lawyers, accountants, industry/professional associations, and practitioners in the financial services sector. (The government of India, the CBDT, and the Global Business Institute are jointly referred to as the petitioners.)

Both SLPs were called for hearing in November 2002, at which time the Supreme Court granted interim relief to the petitioners, staying the operation of the High Court order. Thereafter, the final hearing of

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the case took place in January and February 2003. In October 2003, the Supreme Court delivered its much-awaited verdict, which is discussed below.

Issues

The following issues, among others, were raised by the parties before the Supreme Court:

- whether a certificate of residence issued by the tax authorities of one country can be challenged in another country;
- whether a bilateral tax treaty can be entered into in cases in which there is no double taxation;
- the meaning of "liable to tax" in the international tax arena;
- whether treaty shopping is illegal; and
- tax avoidance and the legitimacy of tax planning.

Can a Certificate of Residence Issued by Tax Authorities of One Country Be Challenged in Another Country?

It was the respondent's position that the circular issued by the CBDT, which directed India's income tax authorities to accept as evidence a certificate of residence granted by the Mauritian authorities, was *ultra vires* the provisions of India's tax laws on the basis that it stripped the authorities of investigative powers.

> ***In the application and interpretation of bilateral tax treaties, the concepts of 'liable to tax' and 'fiscal residence' of a company assume importance.***

The Supreme Court ruled that in accordance with the provisions of the India-Mauritius treaty, each contracting state has the authority to determine who will be considered a tax resident of that state. Once the Mauritius tax authorities determine that a particular entity is a resident of Mauritius in accordance with its domestic laws, that determination must be accepted by another country. The Supreme Court relied on a 1995 decision of the Gujarat High Court[2] in which the latter accepted the certificate issued by the U.K. tax authorities certifying that a company was a U.K. resident for tax purposes and held that such certificate was sufficient to supersede the jurisdiction of the Indian income tax officer.

What Is the Effect of Double Nontaxation, and What Is the Meaning of 'Liable to Tax' in the International Tax Arena?

In the application and interpretation of bilateral tax treaties, the concepts of "liable to tax" and "fiscal residence" of a company assume importance.

The respondents relied on the judgment in *Ingemar Johansson, et al. v. United States of America*.[3] The appellant in that case, Johansson, a citizen of Switzerland and a heavyweight boxing champion by profession, had earned money boxing in the United States for which he was called upon to pay tax. Johansson sought to take advantage of a U.S. tax exemption available under the Switzerland-United States tax treaty. He floated a company in Switzerland, of which he became an employee, and argued that all professional fees paid for his boxing bouts were received by that corporate employer and that he was remunerated as an employee. As proof of residence Johansson relied on a determination by the Swiss tax authority that he had become a resident of Switzerland on a particular date. Rejecting Johansson's claim, the U.S. Court of Appeal noted that the term "resident" was not defined under the Switzerland-United States treaty and that, under article II(2) of that treaty, each country was authorised to apply its own definition to terms not expressly defined "unless the context otherwise requires." The court held that the determination of Johansson's residence status by the Swiss tax authority was not conclusive and that, under the treaty, the U.S. tax authorities were entitled to decide his residence status in accordance with U.S. laws. As a result, Johansson was found not to be a resident of Switzerland during the relevant period, and the tax exemption in the treaty was not available to him.

The Supreme Court of India distinguished the situation in *Johansson* from the case before it and found the judgment in *Johansson* inapplicable on the grounds that the India-Mauritius treaty clearly defines the term "residence."

The petitioners relied on the judgment delivered by Canada's Federal Court in the case of *John N. Gladden v. Her Majesty the Queen*.[4] In that case the

[2] *Arabian Express Line Ltd. of United Kingdom, et al. v. Union of India*, [1995] 212 ITR 31.

[3] 336F.2d.809.

[4] 85 D.T.C.5188 at 5190. Also see the decision of the Federal Court in *Commissioner of Taxation v. Lamesa Holdings* (1997) 785 FCA, and *Estate of Michel Hausmann v. Her Majesty The Queen*, reported in 1998 Can. Tax Ct. LEXIS 1140.

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courts, interpreting the provisions of the Canada-United States tax treaty, held that although capital gains were exempt from tax in Canada, the provisions of the treaty would apply even if it would result in a total tax exemption on the capital gains.

Considering this issue, the Supreme Court of India further placed reliance on cases and material put forward by the petitioners. The Supreme Court assented to statements made in *Cahiers De Droit Fiscal International*,[5] in which it was stated that the fiscal residence of a company is a place where the corporation is subjected to unlimited fiscal liability and, in most countries, taxation of the worldwide profit of the resident company.

The Supreme Court examined the Mauritian Income Tax Act, 1995,[6] which defines the term "residence." The Court observed that on a perusal of the provisions of the Mauritius tax legislation, it could not be said that tax incentive companies were not liable to taxation, although they had been granted an income tax exemption for a specified head of income, namely, gains from transactions in shares and securities. The Court agreed with the petitioners that there is a distinction between "liable to taxation" and "pays tax." The petitioners further stated that an exemption granted by a domestic tax statute on a specific category of income does not render a particular entity free from tax liability in that state and cited several decisions in this regard.[7]

The Supreme Court also relied on the commentary for article 4 (at paragraph 4.1) of the OECD Model Convention, which states that "a person does not have to be actually paying tax to be 'liable to tax' — otherwise a person who had deductible losses or allowances, which reduced his tax bill to zero would find himself unable to enjoy the benefits of the convention. It also seems clear that a person who would otherwise be subject to comprehensive taxing but who enjoys a specific exemption from tax is nevertheless liable to tax, if the exemption were repealed, or the person no longer qualified for the exemption, the person would be liable to comprehensive taxation."

Thus, the Supreme Court held that companies incorporated in Mauritius that had been granted a certificate of residence by the Mauritius tax authorities were liable to tax in Mauritius and would be eligible for claiming the benefits of the India-Mauritius treaty, even though that could result in double nontaxation.

Is Treaty Shopping Illegal?

The respondents before the Supreme Court argued that the Mauritius resident companies that were investing in Indian companies were merely shell companies — that they did not and could not carry on any business in Mauritius and that the only reason for which they were incorporated in Mauritius was to take undue advantage of the India-Mauritius treaty. They also argued that treaty shopping was both unethical and illegal and amounted to a fraud on the treaty, and that an anti-treaty-shopping provision should be read into the treaty.

The respondents relied on a decision of the Chancery Division[8] in which the courts lifted the corporate veil of an entity to determine whether there was any fraud. The Supreme Court stated that although the courts were empowered to lift the corporate veil when applying domestic law, limitations were cast when the country entered into a treaty.

The respondents also cited Oppenheim's[9] and the Vienna Convention on the Laws of Treaties, 1969, to emphasize that a contract such as a treaty would bind (as to rights and obligations) only the parties to the contract (treaty), and not a third party.

The petitioners argued that many developing countries, for nontax reasons (for instance, to attract scarce foreign capital or technology), encourage treaty shopping because the nontax benefits outnumber the losses on account of tax. The petitioners also noted that Cyprus had been used as a conduit for capital inflows into Eastern Europe, that Madeira (Portugal) is being successfully used for investments into the European Union, and that Singapore is developing itself as a base for investments in South East Asia and China.[10]

After hearing the parties' arguments, the Supreme Court remarked that there could be many principles in fiscal economy that, although they appear to be evil, are tolerated in a developing economy — in the interest of long term development — and treaty shopping could be just one of them. The Court

[5]Jean-Maic Rivier, *Cahiers de droit fiscal international,* VolLXXIIa at pp.47-76, para 2.2.

[6]Section 73 (b).

[7]*Wallace Flour Mills Contracting State. Ltd. v. Collector of Central Excise*, Bombay Division II reported in (1989) 4 SCC 592. *See also* in this connection the judgment of Madras High Court in *Tamil Nadu (Madras State) Handloom Weavers Contracting State-operative Society Ltd. v. Assistant Collector of Central Excise* 1978 ELT 57 (Mad HC) and *Kasinka Trading and Another v. Union of India, et al.* reported in (1995) 1 SCC 274.

[8]*Re F.G. Films Ltd.*, reported in 53 (1) WLR 483.

[9]L.Oppenheim, *Oppenheim's International Law*, article 626 (9th Ed.).

[10]Roy Rohatgi, *Basic International Taxation* Pg. 373-374 (Kluwer Law International).

further remarked that in such matters, a holistic view must be taken to adjudge what would perhaps be regarded in contemporary thinking as a necessary evil in a developing economy.

The Supreme Court ruled that in the absence of any anti-treaty-shopping (commonly referred to as "limitation of benefits" in the context of U.S. tax treaties) provision in the treaty, the treaty benefits could not be denied to residents of a country even though those residents might be treaty shoppers. The Supreme Court agreed with petitioners that an anti-treaty-shopping provision cannot be artificially read into the treaty. The Court further held that a country concerned about treaty abuse should, in the absence of anti-treaty-shopping provisions in that country's bilateral treaties, introduce the requisite provisions in its domestic laws to curb such activities.[11] In arriving at this conclusion, the Court relied on the treatise of Lord McNair.[12]

Tax Avoidance and Tax Planning

For more than a decade the decision of the Supreme Court in the case of *McDowell & Company v C.T.O*,[13] has been applied by the Indian income tax authorities to counter cases of tax avoidance. In that case, the Supreme Court held: "Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay taxes honestly without resorting to subterfuges." On many occasions the tax authorities misapplied and abused the principles laid down in *McDowell* and denied tax relief even in cases of legitimate tax planning.

The Supreme Court examined the cases decided worldwide regarding tax planning and the legitimacy thereof. It examined the classic case of *IRC v. Fisher's Executors*,[14] in which the courts held that a taxpayer is entitled to arrange his affairs so as to not attract taxes imposed by the state in which he is a subject, provided such tax planning is within the law. The courts also examined the case of *IRC v. Duke of Westminster*,[15] in which that same principle was upheld.

The respondents argued that the decision in *McDowell* had been a radical departure in jurisprudence and was in line with the changed thinking on fiscal jurisprudence by the English Courts, as evidenced in *W.T. Ramsay Ltd. v. IRC*,[16] *Inland Revenue Commissioners v. Burman Oil Company Ltd.*,[17] *Furniss v. Dawson*,[18] and *Craven v. White*.[19]

The Supreme Court analyzed those decisions and stated that the principle pronounced in *IRC v. Duke of Westminster* continued to apply in England (the country of its origin) and that the contentions of the respondents were ill-founded.

The Supreme Court then examined the case of *M.V. Vallipappan, et al. v. ITO*[20] and stated that the courts in that case had rightly concluded that the decision in *McDowell* could not be read as proclaiming that every attempt at tax planning was illegitimate and should be ignored, or that every transaction or arrangement that is permissible under law but that reduces a taxpayer's tax burden should be looked upon with disfavour. The Supreme Court also examined a number of U.S. tax cases in coming to this conclusion.

After hearing all of the arguments, the Supreme Court set aside the order of the Delhi High Court and held that the circular was valid and efficacious. The Court's verdict adds credibility to India's image in that, in essence, it proves that India respects and follows the principle of *pacta sunta servanda*, which is at the heart and soul of international relations and any bilateral treaty.

Conclusion

The judgement of the Supreme Court of India in this case has elevated India's credibility in the international community and has reinforced the confidence of the international community in the Indian legal system.

Today, India's economic policies are designed to attract significant capital inflows into India on a sustained basis, and India is one of the most exciting emerging markets in the world. Policy initiatives taken

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[11]Philip Baker, Double Taxation Convention and International Law, Pg. 91 ((1994) 2nd Ed.). *See also*, paper presented by Dr. Philip Baker at the IFI Barcelona in 1991, Committee on Fiscal Affairs of the OECD in its report styled as "Conduit Companies Report 1987."

[12]Lord McNair, *The Law of Treaties,* Pg. 336 (Oxford, at the Clarendan Press, 1961).

[13][1985] 154 ITR 148.

[14](1926) AC 395 at 412.

[15](1936) AC 1; 19 TC 490.

[16](1982) AC 300.

[17](1982) STC 30.

[18](1984) 1 All ER 530.

[19](1988) 3 All ER 495.

[20](1988) 170 ITR 238. Similar principle laid down in *Banyan and Berry v. Commissioner of Income Tax* (1996) 222 ITR 831 at 850.

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over the last few years have resulted in significant inflows of foreign investment in most areas of the economy. The Court's judgment also enhances the image of Mauritius as a respectable jurisdiction. It is worthwhile to note that the Mauritius financial system was rated highly in the findings of the Financial Sector Assessment Program carried out by the International Monetary Fund in conjunction with the World Bank in December 2002. Had the verdict of the Supreme Court been otherwise, it would have acted as a major impediment to the development of India. We believe this judgment will go a long way in providing India with a distinct cutting edge in global competition. ✦

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