Tax Hotline

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INDIAN TRIBUNAL RULES ON PRINCIPAL PURPOSE TEST!

In a first-of -a-kind decision, the Delhi Tribunal has upheld satisfaction of the principal purpose test ("**PPT**") under the India-Luxembourg tax treaty ("**Tax Treaty**") and allowed a taxpayer to avail benefits under the Tax Treaty. This is one of the first cases where an Indian Tribunal has examined the PPT.[1]

FACTS OF THE CASE

- The taxpayer was a category II foreign portfolio investor ("**FPI**") incorporated as a limited liability company in Luxembourg. The FPI was the wholly owned subsidiary of a Cayman based company. The FPI earned income from its investment in Indian AIFs, securitization trusts, sale of debentures issued by Indian companies and interest received from debt investments. The FPI filed its income-tax return claiming benefits under the Tax Treaty on basis of the tax residency certificate ("**TRC**") issued to it by Luxembourg tax authorities.
- The Indian tax authorities denied the benefits under the Tax Treaty by concluding that (i) scheme of arrangement employed by the taxpayer is a tax avoidance mechanism through treaty shopping, (ii) the taxpayer was a conduit entity, and the real owner was its holding company, (iii) TRC is not sufficient to establish tax residency is substance establishes otherwise, (iv) the taxpayer was not the beneficial owner of the income and (v) there was no commercial rationale for establishment in Luxembourg. The tax authorities alleged the taxpayer was established in Luxembourg merely to take benefit of the Tax Treaty as India does not have a tax treaty with Cayman Island – an organization chart was also submitted which showed that the taxpayer was held by two Cayman feeder funds which pooled money form investors globally.

TRIBUNAL DECISION

- The Tribunal allowed the taxpayer benefit under the Tax Treaty holding that TRC should be considered as sacrosanct. The Tribunal placed reliance on the decisions in case of Vodafone[2] and Tiger Global[3] to hold that the circumstances under which Revenue could pierce corporate veil of a TRC holding entity is restricted to extremely narrow cases of tax fraud, sham transactions, camouflaging of illegal activities etc. Further, the establishment of these charges would have to meet stringent and onerous standard of proof and required to base such conclusions on cogent and convincing evidence and not merely suspicion alone
- It also held that the taxpayer satisfies the PPT by noting the following:
  - Taxpayer was established in Luxembourg in 2015 as an investment holding company and continues to exist and hold several investments till date;
  - Taxpayer has obtained registration as an FPI with the Indian securities market regulator;
  - More than 86% of the investments made by the taxpayer were outside India i.e. the activities of the taxpayer is beyond Indian jurisdiction;
  - Taxpayer also filed tax returns and paid tax in Luxembourg on its worldwide income, i.e., income earned from investments made in India as also income from other investments in different jurisdictions;
  - Taxpayer had incurred substantial operational expenditure relating to investments in Luxembourg in the nature of consulting fees, legal and litigation fees, other professional fees apart from other administrative expenses such as rent paid for office premises, bank account charges, accounting fees, etc.;
  - Taxpayer controls the assets as well as income on its own and cannot be termed as conduit;
  - The tax authorities have not bought any cogent evidence on record to indicate that the taxpayer is a conduit in substance

NDA COMMENTS

While the PPT was not invoked by tax authorities at audit stage, the revenue argued the applicability of PPT before the Tribunal. The Tribunal decision examines the common master-feeder structures wherein investor money is pooled in one jurisdiction and investments across jurisdictions are made through the feeder fund. While the Cayman Islands does not have a tax treaty with India, it is often a choice of jurisdiction for several investors for commercial reasons. The findings of the Tribunal are welcome and should provide guidance in relation to PPT in future matters as well. The decision reiterates the importance of having commercial justification for choosing a jurisdiction for Indian investments. It is key to note the facts on basis of which the Tribunal ruled that the taxpayer satisfied the PPT – diversification of investments across jurisdiction by the feeder fund, existence of feeder fund since over a decade, substantial expenses incurred by taxpayer in home jurisdiction etc.

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Another important aspect analyzed by the Tribunal was the taxation of income received by the taxpayer from securitization trusts in India. The tax authority had characterized business income received by the taxpayer from securitization trust as interest income. Considering section 115TCA[4] of the Indian Income-tax Act, 1961, the Tribunal ruled that tax authorities cannot re-characterize the nature of income received by the taxpayer. Further, once it was concluded that the taxpayer was eligible to claim benefits under the Tax Treaty, business income earned by the taxable should not be taxable in India, in absence of a permanent establishment.

The Tribunal also examined whether the taxpayer satisfied the 'beneficial ownership' criteria under the Tax Treaty to take benefit of the lower tax rate on interest income. On analyzing the facts of the case and noting that the taxpayer was under no contractual or legal obligation to transmit the interest income to the shareholder / ultimate shareholder, it concluded that the taxpayer was the beneficial owner of the interest income. The decision also reiterates that the tax authorities have the onus to proof that taxpayer is not the beneficial owner of income received by it.

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You can direct your queries or comments to the relevant member.

[1]SC Lowy P.I. (Lux) SARL vs ACIT; ITA No. 3568/DEL/2023

[2][2012] 341 ITR 1 (SC)

[3]Tiger Global International III Holdings [W.P.(C) 6764/2020]

[4]Section 115TCA provides that income arising to the investors out of investments in securitization trusts is chargeable to tax in the same manner as if it were the income accruing or arising to, or received by, such person, had the investments by the securitization trust been made directly by him

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