

Tax Hotline

November 13, 2023

TRC ESTABLISHES TAX TREATY ENTITLEMENT IN THE ABSENCE OF COGENT EVIDENCE ESTABLISHING TAX AVOIDANCE

- Delhi ITAT reiterates the sufficiency of a valid TRC for claiming treaty benefits in line with the SC ruling in *Azadi Bachao Andolan* and the Delhi HC ruling in *Blackstone Capital*.
- Burden of proof on the income tax authorities to establish the existence of a “conduit entity” with cogent evidence.
- Non-invocation of GAAR and LOB provisions indicates that the income tax authorities had accepted that the Indian shares acquired prior to 1 April 2017 were exempt from taxation in India in terms of Article 13(4) of the Treaty.

Recently, the Delhi ITAT¹ (“ITAT”) held that in the absence of cogent evidence supporting the claims of tax avoidance, a TRC shall be considered to be sufficient for granting tax treaty relief.

BACKGROUND AND FACTS

The taxpayer was an investment holding company which was a resident of Mauritius. It had a valid TRC for the assessment year 2018-2019, when it earned long-term capital gains from the sale of certain shares in an Indian entity which were acquired prior to 1 April 2017. The taxpayer claimed that these gains were exempt from tax in India under Article 13(4) of the India-Mauritius Tax Treaty. Given that the shares were acquired prior to 1 April 2017, they were grandfathered for the purposes of the application of the amendment to Article 13(4) which rescinded the capital gains tax exemption on sale of Indian shares acquired thereafter.²

The income tax authorities denied this exemption, on the grounds that the taxpayer was merely a conduit entity with no commercial rationale for its establishment. The tax authorities claimed further that the taxpayer had resorted to “treaty shopping” and was not the beneficial owner of the transferred shares. As such, it was argued that the TRC was insufficient to grant treaty benefits to the taxpayer. The specific allegations on the basis of which the tax authorities made these claims were that:

- 75 percent of the shares of the taxpayer were held by a company which was a resident of the United Kingdom, and the remaining 25 percent were held by an individual who was a resident of Canada;
- the taxpayer had invested in only two Indian companies;
- during the year under consideration, the taxpayer had neither booked any operating / passive revenue from its principal activity nor booked any operating expenses;
- the directors, although well-qualified, were not paid any remuneration and they also served as directors in multiple companies in Mauritius. In fact, one of the directors was the Canadian shareholder who owned 25% of the shares of the taxpayer;
- immediately after earning the capital gains, the taxpayer repatriated them to the United Kingdom shareholder.

DECISION

On appeal, the ITAT rejected the contentions of the income tax authorities and granted relief to the taxpayer. The ITAT observed that it is fairly well settled that a TRC issued by the competent authority of a particular country is sufficient for purposes of claiming treaty relief. In this regard, it placed reliance on Circular No. 789 of 2000, the decision of the Supreme Court in *UOI v. Azadi Bachao Andolan*³ and the recent judgment of the Delhi High Court in *Blackstone Capital Partners (Singapore) VI FDI Three Pte. Ltd. v. ACIT*.⁴ Regarding the allegations that the taxpayer was a conduit entity with no commercial rationale and that the transaction was therefore a scheme for tax avoidance, the ITAT observed that these were mere allegations without any cogent evidence. As such, in the absence of any substantial evidence, the ITAT was unimpressed by the tax authorities’ allegation of tax avoidance.

The ITAT also observed that the tax authorities had not invoked the General Anti-avoidance Rule (“GAAR”) under the Income Tax Act 1961, nor had they invoked the Limitation on Benefits (“LOB”) clause under Article 27A of the treaty. The ITAT inferred that the non-invocation of these provisions indicated the tax authorities’ acquiescence to the fact that the transaction was *bona fide*, and that the treaty benefits could not be denied.

NDA ANALYSIS

The judgment underscores the importance of a valid TRC as establishing sufficient evidence for claiming tax treaty benefits in India. Nonetheless, while the judgment does imply that treaty benefits may be disallowed in case the GAAR or the LOB is invoked, such implication is, however, qualified by placing the burden of proof on the income tax

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authorities. The observations regarding the GAAR and the LOB provisions appear to be problematic because, in our view, they were not applicable to the facts of this case. The transaction under the ITAT's consideration should be immune to the GAAR on account of Rule 10U(1)(d) of the Income Tax Rules, 1962. This rule provides that the GAAR shall not apply to “*any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before the 1st day of April, 2017 by such person.*” Whilst Rule 10U(2) does provide that the GAAR shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of tax benefit obtained from the arrangement on or after the 1st day of April, 2017, it applies without prejudice to the provisions of Rule 10U(1)(d). Therefore, the transfer of investments acquired prior to 1 April 2017 should, in our view, be considered grandfathered for the purposes of GAAR.

Similarly, with respect to ITAT's observation on the non-invocation of the LOB clause, it is stated that the LOB clause could have only been invoked for the purposes of the benefit under Article 13(3B) of the Treaty which provides for taxability of gains arising from transfer of investments acquired after 1 April 2017 but transferred during the period between 1 April 2017 and 31 March 2019. As such, the income tax authorities were not, in our view, empowered to invoke the LOB clause in facts of the instant case.

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You can direct your queries or comments to the authors.

¹Veg 'N' Table [TS-657-ITAT-2023(DEL)]

²Article 4 of the *Protocol Amending The Convention Between The Government Of The Republic Of India And The Government Of Mauritius For 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, Signed At Port Louis On 24th August 1982.*

³[2003] 132 Taxman 373 (SC)

⁴[2023] 452 ITR 111 (Delhi HC).

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