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BEFORE THE AUTHORITY FOR ADVANCE RULINGS (INCOME TAX)
NEW DELHI

22nd Day of March, 2010

PRESENT

Mr.Justice P.V.Reddi (Chairman)
Mr.J.Khosla (Member)

A.A.R. No.826 of 2009

Name & address of the applicant	:	**E*Trade Mauritius Ltd.** C/o Abax Corporate Services Ltd. Level 6, One Cathedral Square, Jules Koenig Street, Port Louis, Mauritius
Commissioner concerned	:	DIT(International Taxation), Mumbai
Present for the applicant	:	Mr. S.E. Dastur, Sr. Advocate Mr. Madhur Agarwal, Advocate Mr. Sanjay Sanghvi, Mr. Ronak Ajmera & Mrs. Daksha Baxi, Advocate of M/s. Khaitan & Co.
Present for the Department	:	Mr. G.C. Srivastava, Advocate

R U L I N G
(By Hon'ble Chairman)

1. This application for advance ruling has been filed by a non-resident company under section 245Q(1) of the Income-tax Act (hereinafter referred as IT Act). The following facts are stated in the application:

1.1 The applicant, E*TRADE Mauritius Limited (**'Applicant')**, is a company incorporated in Mauritius, holding a Global Business Company Licence issued by the Financial Services Authority of Mauritius and is a tax resident of Mauritius. It has been issued a

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Tax Residency Certificate by the Mauritius Tax Authorities. The Applicant is a subsidiary of Converging Arrows Inc. USA which in turn is a subsidiary of E*TRADE Financial Corporation, USA.

1.2 The Applicant held equity shares in IL&FS Investsmart Limited (**'Indian Company')** which are listed on Stock Exchange in India. The Applicant had acquired these shares in the years 2005, 2006 and 2007. The shares were acquired by way of direct purchases as well as upon conversion of the Global Depository Receipts ("GDRs") as per the details set out in **Exhibit 'A'.** The Applicant has transferred 30,625,692 shares in the Indian Company to HSBC Violet Investment (Mauritius) Limited, a company organized under the laws of Mauritius, at Rs.200/- per share on 29th September 2008 and realized long term capital gains there-on in India. A Share Purchase Agreement was entered into on 16th May, 2008.

1.3 Being a tax resident of Mauritius, the Applicant is governed by the provisions of the India-Mauritius DTAA in respect of its tax liability in India. As the provisions of the India-Mauritius DTAA are more beneficial, the provisions of that DTAA would be applicable, as specifically provided for in Section 90(2) of the IT Act. Further, during the period the Applicant held shares in the Indian Company, it did not have any Permanent Establishment (**'PE')** in India as defined in Article 5 of the India-Mauritius DTAA.

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1.4 Upon sale of the said shares in the Indian Company, the Applicant had approached the Assistant Director of Income-tax, Mumbai to obtain the "nil" rate withholding tax certificate under section 197 of the IT Act. The ADIT denied the request and determined that the capital gains tax of 21.11% would be applied to the total sale consideration of the shares without deduction for the cost of acquisition. Being aggrieved by it, the Applicant approached the Bombay High Court by way of a Writ Petition. The High Court, without going into the merits, directed the Applicant to approach the Director of Income-tax (International Taxation)(**"DIT")** for a revision of the Certificate under section 264 of the IT Act and also directed HSBC Violet Investment (Mauritius) Ltd. to deposit an amount of Rupees Twenty Four crores & fifty lakhs with the Court until the disposal of the revision petition by the DIT. On 1st January 2009, the DIT disposed of the revision petition. He concurred with the view of the ADIT that the transaction prima facie gave rise to a chargeable capital gains and upheld the denial of nil rate withholding Certificate. He computed the capital gains tax liability of Rs.24,31,05,710/-. The summary proceedings regarding issuance of tax deduction Certificate thus ended with the issuance of the order of DIT.

1.5 The Applicant has now approached this Authority to determine whether by virtue of being a Mauritius resident, it is

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eligible to the benefits of the India-Mauritius DTAA and hence not subject to tax in India on the capital gains realized.

2. The applicant has formulated the following questions for seeking advance ruling:

> ***(i) Whether on the stated facts and in law, the Applicant, a tax resident of Mauritius, is exempt from payment of capital gains tax in India under the Double Taxation Avoidance Agreement (or "DTAA") between India and Mauritius ("India-Mauritius DTAA") in respect of the transfer of 30,625,692 shares in IL & FS Investmart Ltd. an Indian Company to HSBC Violet Investments (Mauritius) Limited?***
>
> ***(ii) If the answer to question (i) is in negative, whether on stated facts and in law, the Applicant will be liable to pay tax on long term capital gains at 10% under the proviso to Section 112(1) of the Income-tax Act, 1961 ("IT Act")?***

3. The contentious issue that arises for consideration is whether the profit arising from the transfer of shares of Indian company is chargeable to Capital Gains tax under the I.T.Act. The answer is plain. If we go by the I.T.Act, the profits arising from the transfer of share are liable to be taxed under the head Capital Gains at the appropriate rate. However, the position of taxability of Capital Gains is otherwise under the provisions of DTAA (Tax Treaty between India & Mauritius). To be more specific, Article 13, Paragraph 4 of the DTAA confers the power of taxation of the gains derived by a resident of a contracting State from the alienation of specified property only in the State of residence i.e. in Mauritius. The fact that the capital asset is located in India is immaterial. In most of the Treaties, we find that the situs or location of the capital

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asset determines the competence of the State to tax the capital gain. Yet, there is no doubt that the tax payer is entitled in law to seek the benefit under the DTAA if the provision therein is more advantageous than the corresponding provision in the domestic law. This well settled principle has been re-stated by the Supreme Court in the case of *Union of India vs. Azadi Bachao Andolan*[1] - a case which will be referred to hereinafter extensively. For the proposition which we have just now stated, the following passage in the said decision would suffice:

> *"A survey of the aforesaid cases makes it clear that the judicial consensus in India has been that section 90 is specifically intended to enable and empower the Central Government to issue a notification for implementation of the terms of a double taxation avoidance agreement. When that happens, the provisions of such an agreement, with respect of cases to which where they apply, would operate even if inconsistent with the provisions of the Income-tax Act. We approve of the reasoning in the decisions which we have noticed. If it was not the intention of the Legislature to make a departure from the general principle of chargeability to tax under section 4 and the general principle of ascertainment of total income under section 5 of the Act, then there was no purpose in making those sections "subject to the provisions" of the Act. The very object of grafting the said two sections with the said clause is to enable the Central Government to issue a notification under section 90 towards implementation of the terms of the DTAs which would automatically override the provisions of the Income-tax Act in the matter of ascertainment of chargeability to income-tax and ascertainment of total income, to the extent of inconsistency with the terms of the DTAC.*

3.1 The contention of the respondents which weighed with the High Court, viz., that the impugned Circular No.789 (*see [2000] 243*

[1] [(2003) 263 ITR 706(SC)]

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ITR (St.)57) is inconsistent with the provisions of the Act, is a total non sequitur. As we have pointed out, Circular No.*789* is a circular within the meaning of section 90; therefore, it must have the legal consequences contemplated by sub-section(2) of section 90. In other words, the circular shall prevail even if inconsistent with the provisions of the Income-tax Act, 1961, in so far as assessees covered by the provisions of the DTAC are concerned."

4. Now, let us see the relevant provision in the DTAA i.e. Article 13:

Article 13- Capital gains:

"1. Gains from the alienation of immovable property, as defined in paragraph (2) of article 6, may be taxed in the Contracting State in which such property is situated

.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in that other State.

3. Notwithstanding the provisions of paragraph (2) of this article, gains from the alienation of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains derived by a resident of a Contract State from the alienation of any property other than those mentioned in paragraphs (1),(2) and (3) of this article shall be taxable only in that State."

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4.1 Obviously and undisputedly, Paragraph 4 of Article 13 governs because the property alienated – being shares in the company, does not fall under any of the preceding three paras. The applicant seeks to fortify its claim for non-liability to pay Indian income-tax on the strength of the Tax Residency Certificate issued by the Mauritius Revenue Authority.

4.2 Thus far, there is no problem. The controversy has arisen on account of the stand taken by the Revenue. The stand of the Revenue is that there is scope and sufficient reason to infer that the capital gain from the transaction arises in the hands of the US entity which holds the applicant company. In other words, the beneficial ownership vests with the US company which according to the department has played a crucial role in the entire transaction. Though the legal ownership ostensibly resides with the applicant, the real and beneficial owner of the capital gains is the US Company which controls the applicant and the applicant company is merely a façade made use of by the US holding Company to avoid capital gains tax in India. It is pointed out that in the order passed under section 264 of the IT Act, the DIT has taken a *prima facie* view that the capital gains is taxable in the hands of the US entity. Certain aspects were pointed out to conclude that there was sufficient justification to make further enquiries to arrive at the finding as who is really the beneficial owner of the gains. Though

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certain details have been ascertained from the applicant, still some more enquiries are necessary to unravel the correct facts as regards the source of funds, treatment of share holdings, the manner of accounting and the role played by the US Company in the deal. It is, therefore, inappropriate at this stage to give a ruling on the questions raised by the applicant, according to the Revenue's counsel. It has been clarified in the course of arguments that the Department has not come to a definite conclusion, but such a conclusion could only be reached after fuller investigation. It is pointed out that if the Department comes to the conclusion that the beneficiary and real owner of the capital gains arising from the transfer of shares is the US holding Company, the Indo-USA Tax Treaty governs in which case the tax liability under the I.T.Act will be fastened on the US Company. The relevant Article in India USA Treaty is as follows:-

> Article 13 – Gains: "Except as Provided in Article 8 …, each Contracting State may tax capital gains in accordance with the provisions of its domestic law."

4.3 In reply to the stand taken by the department the learned Senior counsel for the applicant contended that beneficial ownership is really irrelevant in the context of Article 13. In contrast, such expression is used in Articles 10 & 11. In any case, it is submitted that the applicant has already furnished the information required by the Revenue at the stage of Section 264 Proceedings and filed before the AAR all the relevant material and clarifications

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to dispel the doubts entertained by Revenue. In fact, the enquiry is a futile and wholly unnecessary exercise in view of the clear Circular of CBDT which is binding on the Department and the law clarified by the Supreme Court in *Azadi Bachao Andolan* case.

4.4 Thus, strong reliance has been placed on behalf of the applicant on the two Circulars issued by the Central Board of Direct Taxes (CBDT) and the decision of the Supreme Court in *Azadi Bachao Andolan* case Supra. First we shall refer to those Circulars.

> *"Circular No.682, dated 30th March, 1994:*
>
> *Subject: Agreement for avoidance of double taxation with Mauritius – Clarification regarding.*
>
> *A Convention for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes of income and capital gains was entered into between the Government of India and the Government of Mauritius and was notified on 6th December, 1983. In respect of India, the Convention applies from the assessment year 1983-84 and onwards*
>
> *2. Article 13 of the Convention deals with taxation of capital gains and it has five paragraphs. The first paragraph gives the right of taxation of capital gains on the alienation of immovable property to the country in which the property is situated. The second and third paragraphs deal with right of taxation of capital gains on the alienation of movable property linked with business or profession enterprises and ships and aircrafts.*
>
> *3. Paragraph 4 deals with taxation of capital gains arising from the alienation of any property other than those mentioned in the preceding paragraphs and gives the right of taxation of capital gains only to that State of which the person deriving the capital gains is a resident. In terms of paragraph 4, capital gains derived by a resident of Mauritius by alienation of shares of companies shall be taxable only in Mauritius according to Mauritius tax law. Therefore, any resident of Mauritius deriving income from alienation of shares of Indian companies will be liable to capital gains tax only in Mauritius as per Mauritius tax law and will not have any capital gains tax liability in India.*

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4. Paragraph 5, defines "alienation" to mean the sale, exchange transfer or relinquishment of the property or the extinguishment of any right in it or its compulsory acquisition under any law in force in India or in Mauritius.

(Sd.)

Secretary, Central Board of Direct Taxes"

4.5 Circular No.789, dated 13th April, 2000

"*Subject : Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC) – Regarding*

The provisions of the Indo-Mauritius DTAC of 1983 apply to "residents" of both India and Mauritius. Article 4 of the DTAC defines a resident of one State to mean "any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature." Foreign institutional investors and other investment funds, etc., which are operating from Mauritius are invariably incorporated in that country. These entities are "liable to tax" under the Mauritius Tax Law and are, therefore, to be considered as residents of Mauritius in accordance with the DTAC.

2. Prior to 1st June, 1997, dividends distributed by domestic companies were taxable in the hands of the shareholder and tax was deductible at source under the Income-tax Act, 1961. Under the DTAC, tax was deductible at source on the gross dividend paid out at the rate of 5% or 15% depending upon the extent of shareholding of the Mauritius resident. Under the Income-tax Act, 1961, tax was deductible at source at the rates specified under section 115A, etc. Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a certificate of residence is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.

3. The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, FIIs, etc. which are resident in Mauritius should not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13.

4. The aforesaid clarification shall apply to all proceedings which are pending at various levels."

5. In the course of hearing, the learned counsel for the Revenue has stated that the residential status and the application

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of benefits of India Mauritius Treaty is not in dispute. Further, Revenue is not taking any stand which goes against the Circular No. 789 issued by the CBDT. However, it is contended that the terminology ‘beneficial ownership’ referred to in the Circular was used in the Circular in the context of the Article dealing with dividends and it shall be confined only to dividends. Therefore, as far as beneficial ownership vis-a-vis capital gains is concerned, the circular cannot be relied on by the applicant. The learned counsel for the Revenue then clarified that Revenue is not seeking to argue that the treaty benefit should be denied merely because the applicant is controlled and managed by the US entities or that the financial assistance was extended by the holding company for acquisition of shares. It is pointed out that the Revenue’s case is that despite setting up a subsidiary in Mauritius, if US holding company factually does the business in India and exercises rights of ownership in shares, the US entity cannot get out of tax net. What the US entity is doing in India can be the subject matter of inquiry and the Income-tax authority is not inhibited to undertake such inquiry. Among other things, it is submitted that the inquiry can be made into the question whether the US company directly appropriated the income from the transfer of shares or it went into to the profits of the applicant company. If it is latter, there can possibly be no objection. In short, it is submitted that ownership is

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a question of fact and it is only after inquiry, it will be known whether the apparent is real. From the mere fact that the receipts are reflected in the books of account, it does not follow that the inquiry is precluded to identify the entity to whom the gains actually belong to. Referring to *Azadi Bachao* case, it is submitted that the question of colourable device still survives for consideration and the Revenue can very well examine whether the real nature of transaction is different from what it purports to be.

6. The background in which the Circulars were issued has been indicated in *Azadi Bachao Andolan* case at page 716 of ITR thus:

> *"By Circular No.682, dated March 30, 1994 (see[1994] 207 ITR (St.)7) issued by the Central Board of Direct Taxes in exercise of its powers under section 90 of the Act, the Government of India clarified that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius taxation laws and will not be liable totax in India. Relying on this, a large number of foreign Institutional Investors (hereinafter referred to as "the FIIs"), which were resident in Mauritius, invested large amounts of capital in shares of Indian companies with expectations of making profits by sale of such shares without being subjected to tax in India. Some time in the year 2000, some of the income-tax authorities issued show cause notices to some FIIs functioning in India calling upon them to show cause as to why they should not be taxed for profits and dividends accrued to them in India. The basis on which the show cause notice was issued was that the recipients of the show cause notice were mostly "shell companies" incorporated in Mauritius, operating through Mauritius, whose main purpose was investment of funds in India. It was alleged that these companies were controlled and managed from countries other than India or Mauritius and as such they were not "residents" of Mauritius so as to derive the benefits of the DTAC. These show cause notices resulted in panic and consequent hasty withdrawal of funds by the FIIs. The Indian Finance Minister issued a press note dated April 4, 2000 clarifying that the views taken by some of the Income-tax Officers pertained to specific cases of assessment and did not*

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represent or reflect the policy of the Government of India with regard to denial of tax benefits to such FIIs.

Thereafter, to further clarify the situation, the Central Board of Direct Taxes issued Circular No. 789 dated April 13, 2000. Since this is the crucial circular, it would be worthwhile reproducing its full text."

6.1 On the scope and validity of the Circular, the learned Judges said:

"As early as on March 30, 1994, the Central Board of Direct Taxes had issued Circular No. 682 (see [1994] 207 ITR (St.7)) in which it had been emphasized that any resident of Mauritius deriving income from alienation of shares of an Indian company would be liable to capital gains tax only in Mauritius as per Mauritius tax law and would not have any capital gains tax liability in India. This Circular was a clear enunciation of the provisions contained in the DTAC, which would have overriding effect over the provisions of sections 4 and 5 of the Income-tax Act, 1961 by virtue of section 90(1) of the Act…."

6.2 It may be noted that the Circular No. 789 of the year 2000 was quashed by the Delhi High Court in a public interest litigation initiated under Article 226 of the Constitution of India. The High Court, inter alia, held (i) in asmuchas the impugned Circular directs the Income-tax authorities to accept a certificate of residence issued by the authorities of Mauritius as sufficient evidence of the status of resident and beneficial ownership, it is *ultra vires* the powers of the CBDT, (ii) the ITO is entitled to lift the corporate veil in order to see whether or not a company is actually a resident of Mauritius paying income-tax in Mauritius; as this function is quasi-judicial in nature, the CBDT cannot interfere with the exercise of that power, (iii) conclusiveness of a Certificate of residence issued

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by Mauritius income-tax authorities is not contemplated either under the DTAA or under the IT Act, (iv) 'Treaty shopping' by which the resident of a third country takes advantage of the provision of the DTAC is illegal, (v) the Circular confers power to lay down a law which is not contemplated under the Act for reasons of political expediency and, therefore, it cannot but be *ultra vires* , (vi) having regard to the law laid down by the Supreme Court in *Mc Dowell* case[2], it is open to the ITO in a given case to lift the corporate veil for finding out whether the purpose of the corporate veil is avoidance of tax or not, (vii) the impugned Circular takes away the power of the assessing authority to hold that the assessee is a resident of a third country having only paper existence in Mauritius without any economic impact with the sole object of taking advantage of DTAC and is therefore illegal.

6.3 The Supreme Court expressed its disagreement with all these findings of the High Court and reversed the decision of the High Court and upheld the Circular No. 789. The Circular was strongly supported by the Union of India which challenged the decision of the High Court in the Supreme Court.

6.4 At the risk of repetition, the crucial part of the Circular is extracted below:

> *"Doubts have been raised regarding the taxation of dividends in the hands of investors from Mauritius. It is hereby clarified that wherever a certificate of residence is issued by the Mauritian*

[2] 154 ITR 148

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> *authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.*
>
> *The test of residence mentioned above would also apply in respect of income from capital gains on sale of shares. Accordingly, FIIs, etc. which are resident in Mauritius should not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 3 of DTAC."*

6.5 The learned counsel for the Revenue attempted to draw some subtle distinctions to make out the point that the Circular is to be confined only to dividends and secondly the aspect of beneficial ownership is not to be found in the third para of the circular dealing with the capital gains. We do not think that there is any substance in this contention. There is nothing in the language of the Circular to support the contention. As seen from the 'Subject', the Circular purports to give clarification both in respect of dividends and capital gains. May be, as pointed out by the counsel for Revenue, the reason for issuing the circular was to give quietus to certain doubts raised regarding the taxation of dividends turning on the residential status, but, it is crystal clear that the Circular also applies in respect of income from capital gains arising from sale of shares of Indian companies. Both paras 2 & 3 of the circular shall be read together. It seems to be an untenable proposition to say that as far as capital gains is concerned, a certificate of residence will not be relevant to determine the beneficial ownership of the gains, but it would only be relevant for the purpose of dividend income. If a resident of Mauritius who gets dividends from the shares is considered to be

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beneficial owner thereof, there is no rational reason to view the ownership of gains arising from their transfer on a different footing. Of course, a doubt does arise as to why the residence or the certificate of residence is made a determining factor to infer beneficial ownership. Is there inextricable nexus between the two? These doubts, though linger in our minds, should however not impel us to question the wisdom or rationale behind the clarification given in the Circular especially when it has received the seal of approval of the Supreme Court in *Azadi Bachao* on all aspects.

7. Apart from considering the validity of the circular, the Supreme Court examined various aspects revolving round the avoidance of tax by Mauritian business entities set up by the holding companies in other countries for the purpose of taking advantage of India-Mauritius DTAC. In the context of the arguments advanced by the Revenue, the views expressed by the Supreme Court on these various aspects such as the motive and device adopted to avoid the tax, Treaty shopping, lifting the corporate veil, the import of the expressions 'sham' and 'device', the implications of McDowell case deserve serious attention. We would like to refer to the pertinent observations made by the learned Judges rather extensively.

7.1 At page 753, the Supreme Court referred to the argument of the respondent based on the dicta of Chinnappa Reddy J, in

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McDowell[3] case, repelled the same and reiterated the well-settled principles on tax planning and avoidance of tax by means open to a subject under law.

7.2 At page 753 it was observed:

> *"There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long-term development. Deficit financing, for example, is one; treaty shopping, in our view, is another. Despite the sound and fury of the respondents over the so-called "abuse" of "treaty shopping", perhaps, it may have been intended at the time when the Indo-Mauritius DTAC was entered into. Whether it should continue, and, if so, for how long, is a matter which is best left to the discretion of the executive as it is dependent upon several economic and political considerations. This court cannot judge the legality of treaty shopping merely because one section of thought considers it improper.*
>
> *The respondents strenuously criticized the act of incorporation by FIIs under the Mauritian Act as a "sham" and "a device" actuated by improper motives. They contend that this court should interdict such arrangements and, as if by waving a magic wand, bring about a situation where the incorporation becomes non est. For this they heavily rely on the judgment of the Constitution Bench of this court in McDowell and Co. Ltd. v. Commercial Tax Officer (1985) 154 ITR 148. Placing strong reliance on McDowell's case it is argued that McDowell's case has changed the concept of fiscal jurisprudence in this country and any tax planning which is intended to and results in avoidance of tax must be struck down by the court. Considering the seminal nature of the contention, it is necessary to consider in some detail as to why McDowell's case, what it says, and what it does not say."*

7.3 At page 754, the dicta of Lord Tomlin in *IRC vs. Duke of West Minister* (1936 AC-1 (HL) was quoted with approval. We are quoting the same:

> *"Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however, unappreciative the Commissioners of Inland*

[3] 154 ITR p.148

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Revenue or his fellow tax payers may be of his ingenuity, he cannot be compelled to pay an increased tax."

7.4 In the next para, it was said in *Azadi Bachao* case:

"These were the pre-Second World War sentiments expressed by the British courts. It is urged that McDowell's case has taken a new look at fiscal jurisprudence and "the ghost of Fisher's case (1926) AC 395 at 412 (HL) and Westminister's case (1936) AC 1(HL) have been exorcised in the country of its origin". It is also urged that McDowell's case (1985) 154 ITR 148 (SC) radical departure was in tune with the changed thinking on fiscal jurisprudence by the English courts.

As we shall show presently, far from being exorcised in its country of origin, Duke of Westminister's case (1936) AC 1 (HL) ; 19 TC 490 continues to be alive and kicking in England. Interestingly, even in McDowell's case (1985) 154 ITR 148 (SC), though Chinnappa Reddy J. dismissed the observation of J.C.Shah J. in CIT vs. A Raman and Company (1968) 67 ITR 11(SC) based on Westminister's case and Fisher's Executors case (1926) AC 395 at 412 (HL), by saying (page 160 of 154 ITR) "we think that the time has come for us to depart from the Westminister principle as emphatically as the British courts have done and to dissociate ourselves from the observations of Shah J., and similar observations made elsewhere", it does not appear that the rest of the learned judges of the Constitutional Bench contributed to this radical thinking."

7.5 Further, criticizing the opinion of Chinnappa Reddy J in *Mc Dowell's* case the learned Judges observed : "*the basic assumption made in the judgment of Chinnappa Reddy J in Mc Dowell's case that the principle in Duke of West Minister has been departed from subsequently by the House of Lords in England, with respect, is not correct*." Then, the decision of House of Lords in *Cravon vs. White* (1990) 183 ITR 216) was referred to. The opinion of Lord Keith in the following passage is quite apposite for our purpose.

"In our view the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether a provision should be construed literally or liberally nor whether the transaction is not unreal and not prohibited by the statute, but

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> *whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."*
>
> *"The principle does not involve, in my opinion, that it is part of the judicial function to treat as nugatory any step whatever which a taxpayer may take with a view to the avoidance or mitigation of tax. It remains true in general that the taxpayer, where he is in a position to carry through a transaction in two alternative ways, one of which will result in liability to tax and the other of which will not, is at liberty to choose the latter and to do so effectively in the absence of any specific tax avoidance provision such as section 460 of the Income and Corporation Taxes Act, 1970."*

7.6 After elaborate discussion on the above points, the Supreme Court observed at page 758:

> *"With respect, therefore, we are unable to agree with the view that Duke of Westminister's case (1936) AC 1 (HL) ; 19 TC 490 is dead, or that its ghost has been exorcised in England. The House of Lords does not seem to think so, and we agree, with respect. In our view, the principle in Duke of Westminister's case (1936) AC 1 (HL); 19 TC 490 is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of Shah J. in CIT vs. Raman (1968) 67 ITR 11 (SC) are very much relevant even today."*

7.7 However, in *Azadi Bachao,* the Supreme Court referred to the opinion of Ranganath Misra J speaking for the majority (in *McDowell's case)* to the effect that "*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".* Immediately thereafter, the learned Judges commented that this opinion of the majority is a "far cry from the view of Chinnappa Reddy J" who spoke in the following words:

> *"In our view the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether a provision should be construed literally or liberally nor whether the*

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transaction is not unreal and not prohibited by the statute, but whether the transaction is a device to avoid tax, and whether the transaction is such that the judicial process may accord its approval to it."

Then, the learned Judges in *Azadi Bachao* commented :

"W*e are afraid that we are unable to read or comprehend the majority judgment in Mc Dowell's case as having endorsed this extreme view of Chinnappa Reddy J which in our considered opinion, actually militates against the observations of the majority of the Judges which we have just extracted*".

7.8 In *Azadi Bachao* case, the learned Judges also referred to the Judgment of the Gujarat High Court in *Banyan & Berry vs. CIT* (222 ITR 831) and quoted the following passage :

"The facts and circumstances which lead to McDowell's decision leave us in no doubt that the principle enunciated in the above case has not affected the freedom of the citizen to act in a manner according to his requirements, his wishes in the manner of doing any trade, activity or planning his affairs with circumspection, within the framework of law, unless the same fall in the category of colourable device which may properly be called a device or a dubious method or a subterfuge clothed with apparent dignity".

Then, it was observed that "*this accords with our own view in the matter"*.

7.9 Explaining the words 'sham' and 'device', it was observed at page 761:

"Though the words "sham", and "device" were loosely used in connection with the incorporation under the Mauritius law, we deem it fit to enter a caveat here. These words are not intended to be used as magic mantras or catch-all phrases to defeat or nullify the effect of a legal situation."

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In the previous para, the learned Judges also referred to the decision in *Barber-Greene Americas Inc vs Commissioner of IR* (35 TC 365) para wherein it was observed that :

> *"A corporation will not be denied Western Hemisphere trade corporation tax benefits merely because it was purposely created and operated in such way as to obtain such benefits. Similarly, a corporation otherwise qualified should not be disregarded merely because it was purposely created and operated to obtain the benefits of the United States-Swiss Confederation Income Tax Convention."*

Then, the following observations of Lord Tomlin in *Duke of West Minister's* case were quoted with approval:

> *"There may, of course, be cases where documents are not bona fide nor intended to be acted upon, but are only used as a cloak to conceal a different transaction".*

8. At page 763, the proposition was emphatically stated thus : *"We are unable to agree with the submission that an act which is otherwise valid in law can be treated as non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents."*

8.1 The legal position was summed up as follows at page 762:

> *"If the court finds that notwithstanding a series of legal steps taken by an assessee, the intended legal result has not been achieved, the court might be justified in overlooking the intermediate steps, but it would not be permissible for the court to treat the intervening legal steps as non est based upon some hypothetical assessment of the "real motive" of the assessee. In our view, the court must deal with what is tangible in an objective manner and cannot afford to chase a will-o'-the-wisp."*

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8.2 Earlier, the learned Judges quoted several judgments to reinforce their view that the motive of tax avoidance is irrelevant in considering the legal efficacy of a transaction.

9. Now, we shall refer to the relevant passages in *Azadi Bachao Andolan* case dealing with 'Treaty shopping'. 'Treaty shopping' broadly means "*the use of a Tax Treaty by a person who is not resident in either of the treaty countries, usually using a conduit entity residing in one of the countries*". (see Glossary of International Tax Terms, - Appendix to Vol.I of Basic International Taxation by Mr. Roy Rohtagi).

9.1 The following passages at pages 746, 749 and 752 may be noted:

> *"The respondents vehemently urge that the offshore companies have been incorporated under the laws of Mauritius only as shell companies, which carry on no business therein, and are incorporated only with the motive of taking undue advantage of the DTAC between India and Mauritius. They also urged that "treaty shopping" is both unethical and illegal and amounts to a fraud on the treaty and that this court must be astute to interdict all attempts at treaty shopping*
>
> *.*
> *"Treaty shopping" is a graphic expression used to describe the act of a resident of a third country taking advantage of a fiscal treaty between two Contracting States."*
>
> *"We are afraid that the weighty recommendations of the Working Group on Non-Resident Taxation are again about what the law ought to be, and a pointer to Parliament and the executive for incorporating suitable limitation provisions in the treaty itself or by domestic legislation. This per se does not render an attempt by a resident of a third country to take advantage of the existing provisions of the DTAC illegal."*
>
> *"Many developing countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues.*

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> *Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities. Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc. (see Roy Rohtagi, Basic International Taxation, pages 373-374. Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them."*

The other relevant passages at p. 753, we have already quoted earlier.

9.2 Thus, in *Azadi Bachao Andolan* case, the Supreme Court found no legal taboo against 'treaty shopping'. Treaty shopping and the underlying objective of tax avoidance/mitigation was apparently not equated to a colourable device. That means, if a resident of a third country, in order to take advantage of the tax reliefs and economic benefits arising from the operation of a Treaty between other countries through a conduit entity set up by it, the legal transactions entered into by that conduit entity cannot be declared invalid. The motive behind setting up such conduit companies and doing business through them in a country having beneficial tax treaty provisions was held to be not material to judge the legality or validity of the transactions. The approach adopted in *Mc Dowell's* case by one of the Judges that judicial approval should not be accorded to a transaction meant to be a device to avoid the

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tax irrespective of whether it is prohibited by Statute was not endorsed. The principle pithily stated in *Duke of West Minister* that *"every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be*" was emphatically approved. However, a colourable device adopted through dishonest methods is one of the areas which could be looked into in judging a legal transaction from the tax angle[$]. At the same time, it was made clear in *Azadi Bachao* case that the word 'device' cannot be used 'in any sinister sense' and the design of tax avoidance by itself is not objectionable if it is within the framework of law and not prohibited by law. However, a transaction which is 'sham' in the sense that "the documents are not bona fide in order to intend to be acted upon but are only used as a cloak to conceal a different transaction" (per Lord Tomlin in *Duke of West Minister*) would stand on a different footing, as noted by the learned judges at pages 761 and 762. It was pointed out that for acts or documents to be a 'sham', the parties thereto must have a common intention that the they are not to create the legal rights and obligations which they give the appearance of creating. Thus, in regard to 'colourable devices' and 'sham' arrangements, the scope is still left to ignore such dubious methods subject to the clarifications and caveat entered on the import of the said

[$] *vide the dicta of Ranganath Mishra, J. (as he then was) and of the Gujarat High Court in Banyan & Berry.*

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expressions. It is in the light of the law laid down in *Azadi Bachao Andolan* and the principles succinctly stated therein, that we have to approach the whole issue in the instant case.

10. The indisputable facts are: the applicant received the funds for the purchase of shares from the parent company, namely, Converging Arrows, USA by way of capital contribution and loans. GDRs were also utilized for the acquisition of some shares. The FIPB Unit of Ministry of Finance by its communication dated 29.12.2004 approved the increase in foreign equity participation in the equity capital of IL&FS investsmart Ltd. by the applicant (ETM Mauritius) The shares were registered in the name of the applicant. IL&FS has recognized it as the share holder. The dividends from the shares were being received by the applicant. The applicant represented by its Secretary, namely, Abacus Management Solutions Limited entered into a Share Purchase agreement on 16th May, 2008 with HSBC Violet Investments (Mauritius) Limited. It is clarified by the applicant that a corporate entity can be a Secretary of the company under the Mauritius law. The resolution of the applicant's Board of Directors was passed on the same day approving the sale of 30,625,629 shares held in IL&FS and Abacus Management Solutions Limited was authorized to execute the Share Purchase Agreement and Escrow agreement for and on behalf of the applicant's company. The legal formalities

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for transfer of shares have been gone through by the applicant. The consideration for the sale of shares was credited to the applicant's accounts, as borne out from the entries in the audited accounts. On receipt of the sale price, the applicant passed a resolution on 9th October, 2008 reducing its capital and paying dividends to its parent. It is thus clear that the applicant – undoubtedly the legal owner of the shares entered into a transaction of sale of shares backed up by Board's resolution and received the sale price. In this fact situation, *ex-facie,* it is difficult to assume that the capital gain has not arisen in the hands of the applicant, more so when according to the binding pronouncement of the Supreme Court, the motive of tax avoidance is not relevant so long as the act is done within the framework of law, the 'treaty shopping' through conduit companies is not against law and the lifting of corporate veil is not permissible to deny the benefits of a tax treaty. None of the grounds on which the Delhi High Court struck down the circular no. 789 would be of any avail to attribute the capital gains to the holding company situated in USA. By virtue of the circular no. 789 issued by CBDT (which has been upheld by the Supreme Court), the tax residency certificate issued by the Mauritius authorities is at least a presumptive evidence of the beneficial ownership of the shares and the gains arising therefrom, even if it does not give rise to a conclusive presumption. The indisputable facts noted above

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together with the normal course of dealings between a subsidiary and its holding company, viewed in the background of the law declared in *Azadi Bachao* case, do not go to displace the presumption arising from the operation of the Circular. The facts that the source of funds for the purchase of shares is traceable to the holding company or that the holding company had played a role in suggesting or negotiating the sale or that the consideration received ultimately goes to the parent company in the form of dividends or the diminution of capital do not lead to a legal inference that the holding company in reality owned the shares and/or the recipient of capital gains arising from transfer of shares is the holding company but not the subsidiary. To take such a view would be clearly contrary to the ground realities of the mutual business and economic relations between a holding and subsidiary company and the inter-se legal structure. The fact that the subsidiary has its own corporate personality and is a separate legal entity cannot be overlooked. The fact that the holding company exercises acts of control over its subsidiary does not in the absence of compelling reasons dilute the separate legal identity of the subsidiary. It is unrealistic to expect that a subsidiary should keep off the clutches of the holding company and conduct its business independent of any control and assistance by the parent company. It would have been a different matter if the Supreme Court had disapproved the

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treaty shopping and the tax avoidance measures. In the present state of law i.e. the treaty provision, the Circular of CBDT, the law laid down in *Azadi Bachaoo Andolan* and the legal incidents of corporate personality, the attempted distinction between legal and beneficial ownership cannot be sustained on any reasonable basis.

11. The Revenue's counsel, in the course of the arguments, has broadly indicated certain aspects into which an inquiry/verification would be necessary which according to him will have bearing on the question as to who is the beneficial owner of the capital gains. Some of these points also find place in the order of the DIT passed under section 264. In reply thereto, certain clarifications have been furnished by the learned counsel for the applicant in the course of arguments, followed by a written note. Before we may briefly refer to them, we would like to point out that the counsel for the Revenue stated more than once that the question whether the US company was actually exercising acts of ownership over the shares is one relevant point which needs to be looked into. However, it has not been elaborated as to what exactly is meant by exercising acts of ownership and what would be the possible line of inquiry especially in view of the fact that the record discloses the applicant as the owner, the recipient of dividend and the party which entered into the Share Purchase Agreement. Be that as it may, we shall refer to some of these points.

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11.1. The first doubt raised is about the execution of the contract - that no employee or director of the applicant signed the SP Agreement dated 16th May, 2008. It has already been noted that according to the applicant, Abecus Management Solutions Limited, which is the Secretary of the applicant has been authorized to sign and it is competent to act as a Secretary. Then it is pointed out by the Revenue that Mr. Todd Mackay who negotiated for the sale of shares signed on behalf of ETFC – the original holding company – but not on behalf of the applicant. In response to this, the applicant has stated that Mr. Todd Mackay had negotiated the sale of shares in his capacity as Director of the applicant though he is also one of the Directors in the foreign holding company. Mr. Donald Layton, Chairman of ETFC signed on behalf of ETFC which figured as ‘seller guarantor’ in the agreement. Another point raised by the Revenue in its submissions dated 24.2.2010 that certain Directors connected with ETFC were on the board of IL&FS in which the applicant was a share holder. ETFC was also deputing its senior executives to IL&FS to work there. The applicant states that the parent company never exercised any rights as shareholder in IL&FS. The applicant’s name was entered in the register of shareholders and it was receiving dividends in its bank account and deputing its own representative to attend the shareholder meeting. As regards the appointment of directors and other executives, it

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was the prerogative of IL&FS and such appointments were made pursuant to the Board's resolutions. Another point raised in the Revenue's comments of 24.2.2010 is about the movement of funds between ETFC and the applicant. It is pointed out that not only the funds for investments in shares were sourced from the parent company, even the dividend amount was being remitted to the ETFC as reimbursement of excess fund. As noted earlier, the applicant has admitted that the funds for purchase of shares were received from the parent company by way of capital contributions and loans. The learned counsel for the Revenue has fairly stated that there could be no objection for such sourcing of funds. There is nothing unnatural in the subsidiary company approaching the holding company for additional capital to acquire the shares. It is stated that the nature of the receipt i.e. whether it is capital contribution or loan can be seen from the accounts and the balance sheet. As per the bank account, the funds were sent for closing investments in India. With reference to this, it is clarified that it only shows the purpose for which the funds have been sent and the nature of the receipt i.e. whether it is a capital contribution or loan can be clearly seen from the final accounts and the balance sheet. It is asserted that there is no basis for the allegation that the accounts have been falsified. Regarding the submission of Revenue that on earlier occasions, funds were sent as "return of

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excess funds and inquiry is therefore needed to find out how the funds have been remitted back to the parent", the applicant has reiterated that there are board's resolutions for declaring the dividends and reduction of share capital by utilizing from the proceeds of the sale of shares (those copies of resolutions have been filed). It is pointed out that the applicant could not have declared the dividends to reduce the shares capital, if funds on sale of shares were not received. Upon receiving dividends from IL&FS, there is nothing unusual in a company reducing its liabilities and or reducing its capital and paying dividends to its parent on receipt of the sale price of shares. The short interval within which the dividends were paid and capital reduction were affected in October, 2008 is not a factor which establishes the beneficial ownership of the shares or the gains resting with the holding company. The applicant maintains that it is free to declare dividends and reduce its capital according to its discretion. The need for passing two resolutions i.e. one for sale of shares and the other for sale of P-notes has been explained. With reference to the comment of the Revenue that the inquiries are likely to lead to the conclusion that the investment was made by the parent company directly in the Indian company "as their own investment" and the sale proceeds were also appropriated by them, it is submitted that such inquiry is unwarranted in view of the undeniable facts discernible from the

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accounts of the applicant and the resolutions of the board. The applicant's counsel further clarified: the fact that the applicant is the owner of the shares is borne out by record; the source of funds for purchase of shares has been explained with reference to the accounts; and the factum of sale proceeds being received by the applicant is not a matter of dispute. The fact that the sale proceeds were not retained for long by the applicant but remitted to its parent company in USA after taking steps to declare the dividend and reducing the capital are not legally impermissible steps going by the ratio of the decision in *Azadi Bachao* case In regard to the exercise of ownership rights allegedly by ETFC, it is pointed out that the Directors on the Board of IL&FS is appointed by the share holders and moreover the executive control are in the hands of two directors who are connected with IL&FS Group and not ETFC. It is reiterated that the applicant has always been recognized as the share holder and it is submitted that its status as share holder of IL&FS is not in any way affected by the overall control exercised by the holding company.

11.2. The learned counsel for the Revenue has also made some comments on the Transitional Services Agreement dated 28th May, 2008 entered into between ETFC and IL&FS wherein it is stated that ETFC sold the shares to HSBC Violet. The applicant's counsel has stated that there is no such clause in the Transitional

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Services Agreement, a copy of which has been filed in the paper book. Even if such recital was to be found in the draft agreement furnished by IL&FS, the final agreement does not contain such recital. Further, the applicant is not a party to the said agreement dated 28th May, 2008. It was an agreement between ETFC & IL&FS for the purpose of providing certain services by ETFC to IL&FS on completion of sale of shares.

12. We have adverted to the clarifications furnished by the applicant supported by its accounts and other documents to see whether there is anything to rebut the presumptive evidence of beneficial ownership arising from the tax residency certificate and to see whether there is any compelling reason for not giving effect to the Circular of CBDT issued in the context of Treaty provisions. We have looked into the facts presented before us in the light of Revenue's submissions to satisfy ourselves whether there is anything demonstrably clear to show that the capital gain has not arisen in the hands of the applicant or whether any colourable device is apparent. In doing so, the legal position expounded by the Supreme Court in *Azadi Bachao* case have been kept in view. The said decision, it may be recalled, has explained what are not objectionable devices in the context of the India-Mauritius Treaty and the treaty shopping. On such consideration, this Authority is of the view that the question raised by the applicant shall be

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answered in the affirmative. On the basis of the facts stated and clarified by the applicant, we uphold the contention of the applicant that by virtue of Article 13.4 of India-Mauritius DTAA, capital gain tax is not liable to be charged in India. We find no justification to accept the Revenue's contention that the advance ruling should be refused at this stage as further inquiries might unravel some incriminating facts.

13. We would like to make it clear that it is not within the domain of this Authority to restrain inquiries or eliciting further informations from the US Holding company. The scope of inquiry in the light of the law discussed above is limited and could only be within the confines of the legal position clarified by the Supreme Court and this Authority. On the basis of the facts presented by the applicant, many of which are not in dispute and some of which find support from the records, we have recorded the answer to the question posed by the applicant.

14. Though it looks odd that the Indian tax authorities are not in a position to levy the capital gains tax on the transfer of shares in an Indian company, this is an inevitable effect of the peculiar provision in India-Mauritius DTAA, the Circular issued by CBDT and the law laid down by Supreme Court in Azadi Bachao case. Whether the policy considerations underlying the crucial Treaty provisions and the spirit of the Circular issued by the CBDT would

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still be relevant and expedient in the present day fiscal scenario is a debatable point and it is not for us to express any view in this behalf.

15. On the facts presented by the applicant and in the light of legal position discussed, the applicant is not liable to pay capital gains tax in India in respect of the transfer of shares held in IL&FS Investsmart Ltd. (Indian Company) to HSBC Violet Investment (Mauritius) Ltd. having regard to the provisions of India-Mauritius DTAA. The question is thus answered in the affirmative.

Accordingly, the ruling is given and pronounced on this day the 22nd March, 2010.

sd/- **(J.Khosla)** **Member**	**sd/-** **(P.V. Reddi)** **Chairman**

F.No. AAR/826/2009 Dated: ----/03/2010

This copy is certified to be a true copy of the Ruling is sent to:-

1. The applicant.
2. The DIT (International Taxation), Mumbai.

(Batsala Jha Yadav)
Addl. Commissioner of Income-tax, AAR