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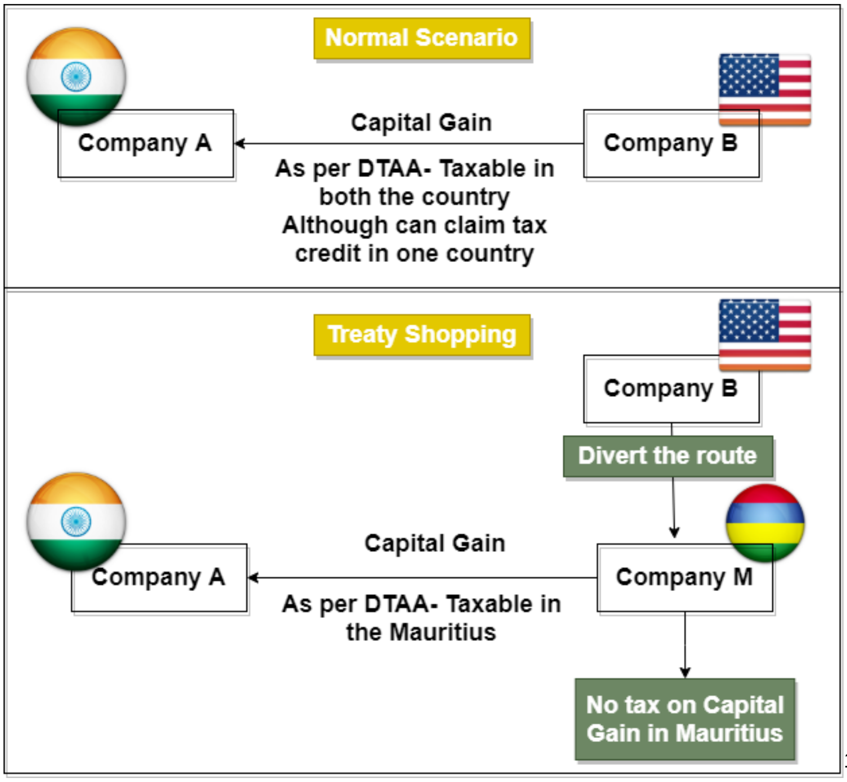
Union of India v. Azadi bachao Andolan
Landmark Judgment Series



[1]

Introduction:

- The double taxation avoidance agreement is an agreement entered into between two countries which helps the resident of the respective country to get relief from double taxation on the same income. The purpose of this Agreement, as specified in the preamble, is "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".

- Till now India has entered with more than 100 countries/jurisdictions for double taxation avoidance agreements (Comprehensive and limited) which helps the taxpayers to claim relief of the tax paid in other foreign countries and therefore this agreement is a useful tool for the taxpayers and also this encourages investment in such countries.

[1] The above situation was valid till 2017 & only for guidance purpose, please refers to recent DTAA- https://www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx.

- One of the agreement between The Government of India and the Government of Mauritius dated April 1, 1983, is the subject matter of controversy in this case law.

Background:

- This all started with circular No. 682 dated 30.03.1994 issued by the CBDT where it clarified that any 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 to tax in India. Relying on this, various FII (Foreign Institutional Investors), which were resident in Mauritius, invested large amounts of capital into shares of Indian companies with expectations of making profits by sale of such shares without being subjected to tax in India. Somewhere in the year 2000, the income tax department issued show cause notices to some FII which in their opinion are 'shell' companies, operating profit from India, stating that why not their income related to shares of Indian company be taxed in India. These show cause notices resulted in panic and consequent hasty withdrawal of funds by the FIIs.

- Thereafter on 13th April, 2000 CBDT again came up with a new Circular, No.789 and in that clearly stating-

- Income driven from dividend and capital gain of shares to the resident of Mauritius will be taxable in Mauritius only as per DTAA.

- And certificates of residence issued by Mauritius authorities will be sufficient evidence of the residential status and for claiming benefit of India Mauritius DTAA.

Against this circular a Writ petition was filed by the applicant- Azadi bachao Andolan a non profit organization, before the Delhi High Court.

Principles challenged under this Case law:

- **Can provisions of The Income Tax Act overrule the DTAA?**

- **Legality of the Circular issued under section 119.**

- **Whether CBDT can limit the powers of authorities by stating "Certificate of residence" is a sufficient evidence.**

- **Treaty shopping - Is it illegal?**

- **Meaning of 'Liable to taxation', whether it is necessary in a DTAA that the tax should be paid in at least one country.**

Circular No.789

F.No.500/60/2000-FTD

GOVERNMENT OF INDIA

MINISTRY OF FINANCE

DEPARTMENT OF REVENUE

CENTRAL BOARD OF DIRECT TAXES

New Delhi, the 13th April, 2000

To

All the Chief Commissioners/ Directors

General of Income-tax

Sub:Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC) - Reg.

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.

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.

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 would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of article 13.

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

Discussions on the Principles:

1. Can provisions of The Income Tax Act overrule the DTAA?

- **Purpose & Necessity of a Double taxation treaty:** In the Income Tax Act a special chapter IX is devoted to the subject “Double Taxation Relief”.

- **Section 90** of the Act has provided special power to the Central Government to enter into an agreement with other countries/special territories outside India for: Grating relief and avoidance of double taxation.

- Also **section 4** (Charge of Income Tax) & **5** (Total Income) of the act which are expressly made "Subject to the provision of the Act", which would include section 90 of the Act. By necessary implication, they are subject to the terms of the Double Taxation Avoidance agreement, if any, entered into by the Government of India. (Andhra Pradesh High Court in *CIT* v. *Visakhapatnam Port Tru, CIT* v. *Davy Ashmore India Ltd.)*

- A **Circular No. 333** dated April 2, 1982 stated that where a specific provision is made in the Double Taxation Avoidance Agreement, that provision will prevail over the general provisions contained in the Income-tax Act, 1961. Thus, where a Double Taxation Avoidance Agreement provided for a particular mode of computation of income, the same should be followed, irrespective of the provisions in the Income-tax Act. Where there is no specific provision in the Agreement, it is the basic law, i.e, the Income-tax Act, that will govern the taxation of income.'

Therefore, considering various past case laws and circular, the hon'ble Supreme court ruled that the agreement will always prevail over the Income Tax Act.

2. Legality of the Circular issued under section 119:

- **High court judgement:**
  - The court held that the said circular was **not explicitly issued under section 119** of the Act, due to which it is not binding on the Revenue.
- **Supreme court:**
  - **Section 119** of the Income Tax Act has provided power to the CBDT to issue such order instructions and direction to other income-tax authorities "as it may deem fit" for proper administration of this Act and such will be bound to all other persons employed in the execution.

    There are two exceptions to this power -
    - **First**, that the CBDT cannot require any income-tax authority to make a particular assessment or to dispose of a particular case in a particular manner.
    - **Second,** is with regard to interference with the discretion of the Commissioner (Appeals) in exercise of his appellate functions.
  - As per this section 119, CBDT has full power to bring out such direction for the proper administration of fiscal laws which does not fall under the exceptions, therefore while commenting adversely upon the validity of the circular where high court said that the said circular itself does not show the same has been issued under section 119 of the Act, the court held that by stating that **It is trite law that as long as an authority has power, which is traceable to a source, the mere fact that source of power is not indicated in an instrument does not render the instrument invalid**, the circular falls well within the parameters of the powers exercisable by the CBDT under section 119 of the Act.

3. Whether CBDT can limit the powers of authorities by stating "Certificate of residence" is a sufficient evidence:

- **High court judgement:**

  - The CBDT cannot issue any instruction, which would be ultra vires the provisions of the Income-tax Act, 1961. Inasmuch as the impugned circular directs the income-tax authorities to accept a certificate of residence issued by the authorities of Mauritius as sufficient evidence as regards status of resident and beneficial ownership, it is ultra vires the powers of the CBDT;

  - Income tax officers are entitled to **lift the corporate veil**, in order to see whether a company is a resident of Mauritius or not, any interference by the CBDT for the said will be Quasi-Judicial power (Referring to the Supreme court case - McDowell & Co. Ltd. vs C.T.O) .

- **Supreme court judgement:**

  - Held that The circular no.789 does not in any way crib, cabin or confine the powers of the assessing officer with regard to any particular assessment. It merely formulates broad guidelines to be applied in the matter of assessment of assessees covered by the provisions of the DTAC.

  - The Court has an opinion that the circular in any way does not take away or curtails the jurisdiction of the assessing officer to assess the income of the assessee before him. In our view, therefore, it is erroneous to say that the impugned circular No.789 dated 13.4.2000 is ultra vires the provisions of section 119 of the Act. the Court held that the powers conferred upon the CBDT by sub-sections (1) and (2) of Section 119 are wide enough to accommodate such a circular.

4. Treaty shopping - Is it illegal?

- **High Court judgement:**

  - Relying on the arguments of the applicant the court opined that provision of the agreement, enunciated further in the circular in question, make the Indo-Mauritius investments prone to unethical use of the **Treaty Shopping.**

- **Supreme court:**

  - *'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. The weighty recommendations of the Working Group on Non-Resident Taxation are again about what the law ought to be, and a pointer to the 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 resident of a third party to take advantage of the existing provisions of the DTAC illegal.*

  - The court is of the view that the recommendations of the Working Group of the JPC are intended for Parliament to take appropriate action. The JPC might have noticed certain consequences, intended or unintended, flowing from the DTAC and has made appropriate recommendations. Based on them, it is not possible for us to say that the DTAC or the impugned circular are contrary to law, nor would it be possible to interfere with either of them on the basis of the report of the JPC.

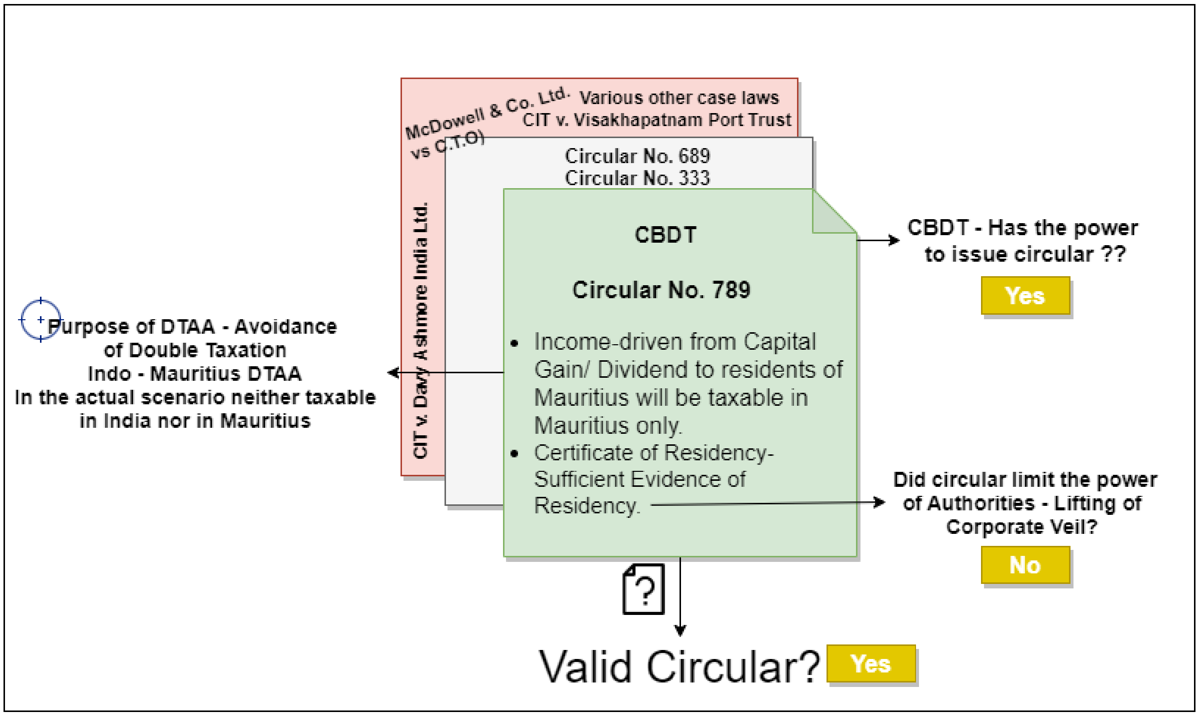
5. Meaning of "Liable to Taxation":

- The Applicant contend that the FIIs incorporated and registered under the provisions of the law in Mauritius are carrying on no business there; they are, in fact, prevented from earning any income there; they are not liable to income tax on capital gains under the Mauritius Income-tax Act. They are liable to pay income-tax under Indian Income-tax Act, 1961, since they do not pay any income-tax on capital gains in Mauritius, hence, they are not entitled to the benefit of avoidance of double taxation under the DTAC.

- **Supreme court:**
  - According to Article 4 of the DTAA, 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. The terms 'resident of India' and 'resident of Mauritius' are required to be construed accordingly. This takes us to the test to determine when a company is 'liable to taxation' in Mauritius.

  - The Hon'ble Supreme court agrees with the submission of the appellants that, merely because exemption has been granted in respect of taxability of a particular source of income, it cannot be postulated that the entity is not 'liable to tax' as contended by the respondents. Commenting particularly on German Double Taxation Convention with the United States, Vogel comments: "Thus, it is said that the treaty prevents not only 'current', but also merely 'potential' double taxation"

Conclusion:



    - In the given case, although the corporate veil was not lifted but in the recent cases we are seeing that corporate veils are being lifted by the authorities such as the recent judgement in the case of Tiger Global International II, III and IV Holdings, Mauritius to stop treaty shopping.

    - Also now against such practices, there are various other provisions introduced by the Act/law which helps to avoid such treaty shopping such as GAAR (General anti-avoidance rule), MLI (Multilateral Instrument) etc.

- Thus, the tide is shifting from “only legal form” to “substance over form” and the genuineness/purpose of the transaction needs to be proven.

Note: Case law name in Red- in favour of the Revenue, Green- In favour of the Assessee, Orange = Partial.

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Thank you