Indian court restores tax savings for investors through Mauritius

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In a judgment last month, the Supreme Court of India restored the certainty that investors into India through Mauritius will benefit from the double tax treaty between the two countries. The Court overturned a ruling by the Delhi High Court that had cast doubt over the taxability of investment through Mauritius by stating that a certificate of residence issued by the Mauritian authority would no longer be sufficient proof of residence for a foreign investor.

The Supreme Court's decision affirms India's attractiveness as an investment destination, not just because of the tax benefits available, but also because of the taxation certainty for pension fund managers and mutual funds that are investing money from overseas.

During the past 12 years there has been over $6.8 billion of investment into India through Mauritius (see table) because of a favourable tax treaty between the two countries. But in early 2000 Indian tax officers began asking foreign financial institutions to prove their residence in Mauritius.

To quell uncertainty and an outflow of foreign funds, the Indian government, through the Central Board of Direct Taxes (CBDT), issued circular No 789 of 2000 in April 2000 to clarify that a certificate of residence issued by the Mauritian authorities should be taken as sufficient evidence. The circular said: "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."

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This circular was issued in line with the Double Tax Avoidance Convention between India and Mauritius. This states that the determination of residence of a *person* of Mauritius shall be made according to the laws of Mauritius where the *person* is liable to tax.

But People's Union for Civil Liberties, along with a retired income tax officer, Mr Jha, filed a writ petition before the Delhi High Court in the public interest, challenging the validity of the circular. An order by the Delhi High Court in May 2002 quashed circular 789, holding that it was *ultra vires* section 90 of the Income Tax Act, which allows treaties only for the purpose of avoiding double tax, not for encouraging trade and investments (as was provided in the preamble of the treaty).

The Delhi High Court also held that because Mauritius charged no capital gains tax there was no question of double taxation, that the circular took away the discretion of the Indian income tax officer to determine the residence of a *person* and that a right granted by statute could not be removed by a mere circular.

The High Court also said: "Treaty shopping which amounts to abuse of the Indo-Mauritius bilateral treaty, may amount to fraudulent practice and cannot be encouraged."

Response

On October 4 2002 the Global Business Institute (GBI), filed a Special Leave to Petition before the Supreme Court of India, appealing against the Delhi High Court order. Although GBI – a company incorporated under the laws of Mauritius and including international investors, asset managers, management companies, banks, custodians, lawyers and accountants – was not a party before the Delhi High Court, it was allowed to make the petition because it was a *person* aggrieved by the order. The government of India and the CBDT, being the respondents in the proceedings before the Delhi High Court, also filed a Special Leave to Petition.

The petitions were heard together. Both petitions challenged the power of Indian income tax officers to question residency of a Mauritian entity, given this determination is the sovereign right of the Mauritian government. It is analogous to the issue of a passport of a foreign country, which unless forged should be taken as sufficient proof of citizenship.

Judgment

After hearing both sides of the case for several weeks the Court finally pronounced its judgment on October 7 2003, reversing the Delhi High Court

Certainty over time

April 1 1983
India and Mauritius enter into double tax treaty.

March 30 1994
Circular issued by the Indian government clarifies that capital gains derived by a Mauritian resident by alienating shares of an Indian company shall be taxable only in Mauritius.

Early 2000
Indian Income tax authorities issue notices to various foreign investors asking why they should not be subject to Indian capital gains and dividend taxes.

Foreign investors approach the Finance Ministry seeking clarification on the applicability of the treaty.

Foreign direct investment

Amount $ million

Country	September 1991 to December 1995	January 1996 to December 2000	2001 (January to December)	2002 (January to October)	Total foreign direct investment inflow	Percentage of total
Mauritius	$551	$3,596	$1,625	$1,038	$6,811	38.7%
US	$537.5	$2,108	$322	$225	$3,194	17.1%

Source: Secretariat for Industrial Assistance, Ministry of Commerce

order on the basis of no fewer than 10 points.

First, the charging section of the Income Tax Act (sections 4 and 5) are made subject to the Act and therefore also to section 90. The Indo-Mauritius tax agreement therefore prevails over the Income Tax statute. Unless the treaty gives away something that the Income Tax Act charged, the treaty would be meaningless.

Second, the circular falls within the provisions of section 90 and is not *ultra vires* section 119 – which provides the power to issue circulars – merely because no reference is made to the source of power in the circular.

Third, if in the teeth of this clarification the assessing officers chose to ignore the guidelines and spent their time, talent and energy on inconsequential matters, it was held that the CBDT was justified in issuing directions, under its section 119 powers, to eliminate any waste of the time, talent and energy of the assessing officers collecting revenue.

Fourth, according to the Court, the argument that the treaty itself is beyond section 90 of the Act "deserves short shrift… on account of its susceptibility to treaty shopping on behalf of the residents of the third countries".

Fifth, liability to pay tax is not the same thing as actual payment of tax. Therefore a *person* does not need to pay tax so long as they are liable to pay tax in Mauritius. The Court said: "It is therefore not possible for us to accept the contentions so strenuously urged on behalf of the respondents that avoidance of double taxation can arise only when tax is actually paid in one of the contracting states."

Sixth, in terms of treaty shopping, the Court said: "It is urged by the learned counsel for the appellants, and rightly in our view, that if it was intended that a national of a third state should be precluded from the benefits of the Double Tax Avoidance Convention, then a suitable term of limitation to that effect should have been incorporated therein."

The Mauritius treaty contrasts with the Indo-American treaty, which specifically provides for such a term. The Court rhetorically asked: "Can they be denied the benefit on some theoretical ground that treaty shopping is unethical and illegal?"

Seventh, the Court stated that if there are abuses, such as those reported by the Joint Parliamentary Committee of Indian residents involving misusing the treaty for manipulation of the stock market, then the legislature and the regulator are free to take corrective steps.

Eighth, treaties are a result of political bargaining and there are several considerations behind entering into these agreements. Said the Court: "In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology…. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays [and] grants."

Ninth, the Court said: "The loss of tax revenues could be insignificant compared with the other non-tax benefits to their economy." These practices might appear to be evil but "are tolerated in a developing economy, in the interest of long term development".

Tenth, the Court found that not every attempt at tax planning is illegitimate. Citing an authority the Court endorsed "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, cannot be doubted". The Court should not be guided by the assessee's real motive and must deal with what is tangible in an objective manner.

The Court thus endorsed the treaty and the circular, refusing to interfere in what are essentially legislative and executive functions.

Where now?

The judgment clearly puts across the view that there were policy reasons for the treaty to exist even if some believe it to be morally unfair. With the Court giving its approval, the burden of removing the benefits available to foreign investors now falls on the government alone.

Yet Atal Behari Vajpayee, the Indian prime minister, on his visit to Mauritius last year, promised the Mauritian government that the treaty would not be revoked. The Mauritian government has also overhauled the transparency of its systems, and has signed an agreement between its financial regulator and the Securities and Exchange Board of India.

Using Mauritius as a route for Indian investments is now possible once again for foreign investors. With the associated tax advantage, the Indian economy should be more attractive to overseas investors.

April 13 2000
CBDT issues circular to clarify that the Certificate of Residence issued by the Mauritian authorities would constitute sufficient evidence for accepting the status of residence.

May 22 2000
Filing of writ petition filed in public interest seeking to quash the CBDT circular.

May 31 2002
Delhi High Court strikes down the circular as *ultra vires* the Income Tax Act and passes adverse comments about the treaty.

October 7 2003
Supreme Court overturns the High Court order on all counts and declares the treaty and the circular valid.