Concept of Beneficial Ownership in the context of Article 13 regarding Capital Gains

Background

The Mumbai Income Tax Appellate Tribunal (Tribunal) in a recent decision[1] given on 17 May 2022 has dealt with a crucial international tax issue that whether the requirement of '*beneficial ownership*' be read into Article 13 in respect of the source state tax exemption from capital gains derived from sale of shares of a company situated in that state.

This article evaluates the judgment of the Tribunal in light of the available jurisdiction of Indian and Foreign Courts on the said issue along with the guidance provided in this regard in the Committee Reports.

Facts of the case

- Blackstone FP Capital Partners Mauritius V Ltd. (Assessee) was a company incorporated in and domiciled in the Republic of Mauritius.
- It holds a global business license issued by the Financial Services Commission, Mauritius and is also registered as a foreign venture capital investor with the Securities and Exchange Board of India.
- Assessee has also been issued a tax residency certificate by the Mauritian Revenue Authority.
- Assessee sold equity shares of ABC Ltd. to XYZ Pte. Ltd. in furtherance of a share purchase agreement, on which the Assessee had earned long-term capital gain.

Assessing Officer's view

- The Assessing Officer (AO) was of the view that –
  a) the effective ownership of the Assessee is with certain Cayman Island based entities;
  b) the administrative control of the Assessee is also by these Cayman Island based entities;
  c) the source of investment in the shares in question is remittance from these Cayman Island entities; and
  d) the directions to carry out the transactions in question were issued by the Cayman Island based entities owning the Assessee.
- The AO further held that the entire scheme of purchase and sale of shares was designed for the benefit of the entities in Cayman Islands and that it was a fit case to lift the corporate veil.
- Given the above, the AO held that the Assessee is not entitled for the benefit of Article 13(4) of the India-Mauritius Double Taxation Avoidance Agreement (DTAA).

Tribunal's findings

The Tribunal observed that the AO's observation and approach was based on a fundamental assumption that one can read the '*beneficial ownership*' concept into the scheme of Article 13 (Capital Gains) of the DTAA. Given this, the Tribunal had put to the test of judicial scrutiny this fundamental assumption made by AO.

The Tribunal observed that unlike in Article 10 or Article 11 of the DTAA, which specifically provide for beneficial ownership of dividend or interest in order to be entitled for a treaty protection, there is no such provision in Article 13 of the DTAA. Tribunal was of the view that the concept of beneficial ownership being a sine qua non to entitlement of treaty benefits cannot, in the absence of specific provision to that effect, be inferred or assumed.

[1] Blackstone FP Capital Partners Mauritius V Ltd. v. DCIT (International Taxation) in ITA Nos. 981 and 1725/Mum/2021

The Tribunal took note of the fact that the United Nations Committee of Experts on International Cooperation on Tax Matters had formed a sub-committee and requested them to carry out further work on the issue of beneficial ownership, which included the question whether or not the concept of beneficial ownership could apply with respect to other articles of Model Convention, such as Article 13 and Article 21. The sub-committee, basis a consulting paper on the issue from Prof. Philip Baker concluded that the reading of beneficial ownership test in the treaty, when such test is not embedded in the treaty, would rather than a permissible interpretation of the treaty be a rewriting of the treaty itself.

Tribunal noted that the DTAAs are replete with choices, but once these choices are consciously made by two willing partners, these choices cannot be unilaterally nullified on the basis of perceptions about some underlying notions of what would constitute good public policy. The Tribunal also referred to the principle of *pacta sunt servanda* (Article 26 of the Vienna Convention of the Law of Treaties), which provides that every treaty in force is binding upon the parties to it and must be performed by them in good faith.

In the context of application of General Anti Avoidance Rules (GAAR), reference was made by the Tribunal to the decision of Hon'ble Supreme Court of Canada[2], wherein while interpreting a materially similar Article 13 of the Canada-Luxembourg Double Taxation Avoidance Agreement, the Supreme Court concluded that beneficial ownership is utterly foreign to Article 13

With support from the above findings, the Tribunal rejected the AO's approach. The Tribunal was of the view that the AO had erred by proceedings on the assumption that the concept of beneficial ownership was relevant in the context of Article 13 of the DTAA. Thus, the Tribunal vacated the assessment order and restored the matter back to the file of the AO for deciding the fundamental issue as to whether the requirement of beneficial ownership can be read into the scheme of Article 13 of the DTAA.

Author's remarks

The view adopted by the AO was that since the Assessee was a wholly owned subsidiary of a Cayman Island entity it lacked independent existence, and all the activities of the Assessee were controlled and directed by the Cayman Islands based group entities. In this regard, it is considerable to take note of the fact that there is nothing wrong for a taxpayer to comply with the decisions taken by its holding company. More so, it is imperative that the holding company would be involved in a decision concerning a transaction of transfer of shares involving its subsidiary. Further, the fact that the acquisition of shares by a company was funded through the amount received from its parent company, would not ipso facto mean that the parent company is the beneficial owner of such shares. Reference in this regard may be drawn from the judgments[3] of the Authority of Advance Rulings (AAR) in this context. The AAR has clarified that the existence of a separate and independent status of a subsidiary in another jurisdiction was the core basis and foundation of the application of tax treaties. The AAR has further been of the view that where the parent entities had signed the collusive agreements on behalf of the subsidiary and had paid consideration for the same, the subsidiary could not be considered as an owner of the shares transferred to it, regardless of the entries in the books of accounts of the subsidiary.

Considering the above, the view adopted by the Tribunal in respect of applicability of test of '*beneficial ownership*' to Article 13 of the DTAA seems reasonable and in-line with the view adopted by certain Foreign Courts and reports of Expert Committees.

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[2] In the case of Her Majesty v. Alta Energy Luxembourg SARL dated 26 November 2021

[3] In the case of Becton Dickinson (Mauritius) Ltd. v. AAR in AAR No. 1306 of 2012 and Dow Agro Sciences Agricultural Products Ltd. [2015] 65 taxmann.com 245