P. L. RAJ MAINS Q & A – DAY 81

Taxing Times - Decoding the Supreme Court's Verdict on DTAA and Tax Avoidance.

Introduction - A Watershed Moment in Tax Jurisprudence

Taxation is the price of civilization, but for multinational corporations, it is often an exercise in optimization. The recent Supreme Court (SC) judgment involving Tiger Global and the Indian tax authorities marks a pivotal moment in India's tax history.

The case, revolving around the sale of Flipkart shares by Mauritius-based entities to Walmart, has reopened the Pandora's box of the Double Taxation Avoidance Agreement (DTAA) and the sanctity of tax treaties.

The Core Issue - The Tiger Global-Flipkart Case

The controversy stems from a transaction where Tiger Global's Mauritius-based entities sold their shares in Flipkart (a company incorporated in Singapore but deriving value from assets in India) to Walmart.

The Claim - The assessees (Tiger Global entities) sought an exemption from capital gains tax in India, citing the India-Mauritius DTAA. Historically, under this treaty, capital gains arising from the sale of shares were taxable only in the country of residence of the seller (Mauritius), which effectively meant zero tax due to Mauritius's tax laws.

The Revenue's Rebuttal - Indian tax authorities denied this benefit. They argued that the transaction was a classic case of "Treaty Shopping"—a practice where a company routes investments through a tax-friendly jurisdiction (like Mauritius) solely to avoid taxes, without having substantial economic presence there.

The Ruling - The Authority for Advance Rulings (AAR) initially ruled against the assessees, stating the transaction was designed for tax avoidance. Although the Delhi High Court overturned this, the Supreme Court has now upheld the tax authorities' stance, effectively denying the treaty benefit.

Explanation of the Supreme Court Judgment

The SC's verdict is significant for two main reasons -

1. **Rejection of the Tax Residency Certificate (TRC) as Conclusive Proof -** Previously, a TRC issued by the Mauritian government was considered sufficient evidence of residency, entitling the holder to treaty benefits (as per the *Azadi Bachao Andolan* judgment). The SC has now indicated that authorities can look *beyond* the TRC to the "substance" of the transaction. If the management and control are not effectively in Mauritius, the entity may be deemed a "shell company" created just for tax avoidance.
2. **Denial of Grandfathering -** The court rejected the argument for "grandfathering" (exempting old investments from new rules). It held that since the *sale* occurred after the General Anti-Avoidance Rules (GAAR) provisions were conceptualized (even if not fully enforced at the time of acquisition), the intent to avoid tax could be scrutinized.

Court's Stand on Tax Sovereignty

A critical aspect of the judgment is the judiciary's assertion of Tax Sovereignty. One of the concurring judges penned an advisory emphasizing that while tax treaties are essential for trade, they cannot be used to erode India's sovereign right to tax value generated within its borders. The judgment reinforces the principle that "Substance over Form" must prevail. Mere legal structuring (incorporating in

Mauritius) cannot override the economic reality (value creation in India). This aligns with global movements like the OECD's Base Erosion and Profit Shifting (BEPS) framework, which India actively supports.

Implications of the Judgment

The ripples of this verdict will be felt far and wide -

1. **Investment Climate -** Foreign investors prize certainty above all. By revisiting the validity of TRCs and applying anti-avoidance principles retrospectively to older investments, the judgment introduces an element of unpredictability. It raises fears that legitimate tax planning might now be labeled as tax evasion.
2. **End of the Mauritius Route -** The judgment effectively puts the final nail in the coffin of the "Mauritius Route" for tax avoidance. Future investments will likely pivot to jurisdictions where companies have genuine economic substance.
3. **Increased Litigation -** Empowering tax officers to question TRCs may lead to a surge in litigation, as "substance" is often subjective.

Way Forward

While protecting the tax base is vital, India must ensure it doesn't become a hostile destination for capital.

Prospective Application - As the article argues, if loopholes exist, they should be closed prospectively. Retrospective interpretation of laws damages the "ease of doing business" narrative.

Executive Prerogative - Tax treaties are diplomatic instruments. The executive (government) is best placed to negotiate terms that balance revenue needs with investment attraction. The judiciary should ideally interpret the law, leaving policy decisions on treaty renegotiation to the government.

Clarification - The government must issue swift clarifications to reassure existing investors that this judgment will not lead to a "tax terror" regime where every past transaction is reopened.

Conclusion

The Supreme Court's judgment is a victory for tax sovereignty but a warning bell for investment stability. It underscores that in the modern economy, value creation cannot be divorced from tax liability. However, for India to achieve its $5 trillion economy goal, it must ensure that the pursuit of tax justice does not come at the cost of policy consistency. Agreements must be honored in letter and spirit, ensuring that the taxman collects his due without killing the golden goose of foreign investment.

Mains practice Question

1. "The recent Supreme Court judgment on the India-Mauritius DTAA reasserts the principle of 'substance over form' in taxation. Critically analyze the implications of this verdict on India's investment climate and the sanctity of Tax Residency Certificates." (15 marks)

Answer Guidelines

1. Introduction - Contextualize with the Tiger Global/Flipkart case and the SC's rejection of treaty benefits. Define 'Substance over Form' - Looking at the economic reality of a transaction rather than just its legal structure.

2. Body

1. Implications on Investment Climate (Critical Analysis)

Positive - Reduces tax evasion/round-tripping; aligns with global BEPS standards; protects the sovereign tax base.

Negative - Creates uncertainty for foreign investors; perceived as "retrospective" interpretation; undermines the reliability of existing treaties.

2. Sanctity of Tax Residency Certificates (TRC)

Discuss the shift from the *Azadi Bachao Andolan* era (where TRC was conclusive proof) to the current stance (TRC is necessary but not sufficient). Explain how this empowers tax officers to pierce the corporate veil but risks increasing litigation.

3. Conclusion - Conclude that while curbing tax avoidance is necessary, policy certainty is the bedrock of investment. The government must balance tax rights with investor confidence through clear, prospective guidelines.

Prelims Practice questions

1.Which of the following statements best reflects the concept of "Tax Sovereignty" as elucidated in the context of the recent Supreme Court judgment on the India-Mauritius DTAA?

(a) Tax Sovereignty implies that a nation has the absolute right to unilaterally revoke any international tax treaty if it believes the treaty is resulting in revenue loss, without regard for diplomatic consequences.

(b) The judgment reinforces that Tax Sovereignty allows the judiciary to prioritize the economic substance of a transaction over its legal form to prevent the erosion of the domestic tax base, even in the presence of a DTAA.

(c) Tax Sovereignty mandates that all foreign investments must be routed through domestic entities to ensure full tax compliance, effectively rendering DTAAs obsolete.

(d) The principle of Tax Sovereignty requires the executive branch to strictly adhere to the text of a DTAA, prohibiting any domestic anti-avoidance rules (like GAAR) from overriding treaty provisions.

2. With reference to the Supreme Court's judgment on the India-Mauritius Double Taxation Avoidance Agreement (DTAA) involving Tiger Global, consider the following statements regarding the Tax Residency Certificate (TRC) -

1. The judgment reaffirms the principle established in the *Azadi Bachao Andolan* case that a TRC is conclusive proof of residency and beneficial ownership for claiming treaty benefits.
2. The Supreme Court held that tax authorities can look beyond the TRC to the "substance" of the transaction to determine if the entity has genuine economic presence in the treaty country.
3. The judgment validated the "grandfathering" clause, allowing full tax exemption for shares acquired before the implementation of General Anti-Avoidance Rules (GAAR), regardless of when they were sold.

Which of the statements given above is/are correct?

a) 1 and 2 only b) 2 only c) 2 and 3 only d) 1, 2 and 3

Answers

For Question -1

Correct Answer - 2

Explanation -

Option 1 is incorrect - While sovereignty includes the power to revoke treaties, doing so unilaterally and arbitrarily is contrary to international law and diplomatic norms. The judgment focuses on *interpreting* treaties to prevent abuse, not revoking them outright.

Option 2 is correct - This captures the essence of the judgment. "Tax Sovereignty" means a country retains the right to tax value generated within its borders. The Court affirmed that tax treaties (like DTAAs) are meant to prevent double taxation, not to facilitate double non-taxation or tax evasion. Therefore, the state (via its judiciary and tax authorities) can look at the "substance" (economic reality) to ensure its sovereign tax base isn't eroded by shell companies, even if a treaty exists.

Option 3 is incorrect - DTAAs are a standard part of international trade and investment. Sovereignty doesn't mean isolationism or forcing all investment through domestic entities; it means ensuring foreign entities pay their fair share based on value creation.

Option 4 is incorrect - This is the opposite of the current trend. Domestic anti-avoidance rules (like GAAR) are specifically designed to prevent treaty abuse. The principle of sovereignty supports the application of domestic laws to curb evasion, ensuring that treaty benefits are only granted to genuine residents, not shell companies. The judgment confirms that domestic anti-avoidance principles *can* interact with and qualify treaty benefits.

For Question -2.
Correct Answer - b)
Explanation -
Statement 1 is incorrect - The *Azadi Bachao Andolan* (2003) judgment had indeed held that a TRC was sufficient proof. However, the *recent* Supreme Court judgment involving Tiger Global *overturned* or significantly qualified this by ruling that a TRC is *not* conclusive proof if the transaction lacks substance or is designed solely for tax avoidance.
Statement 2 is correct - The core of the recent judgment is the assertion of "Substance over Form." The Court held that authorities can examine whether the management and control were actually in Mauritius. If the entity is found to be a shell company with no real economic substance, treaty benefits can be denied despite holding a TRC.
Statement 3 is incorrect - The Supreme Court *rejected* the argument for grandfathering in this specific context. It held that even though shares might have been acquired earlier, the *sale* took place after anti-avoidance principles (like GAAR) were conceptualized/enforced, and thus the transaction could be scrutinized for tax avoidance intent.