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Supreme Court Ruling Good News for Investors

On October 7 2003, a landmark decision by the Supreme Court of India effectively narrowed the scope of enquiry that a tax officer in India can make in certain cases and reinforced the government's legislative and executive prerogatives to enter into bilateral treaties on terms the government determines are most favourable.

India and Mauritius have a Double Tax Avoidance Agreement (Tax Treaty) that treats investments made in India by Mauritius companies in a favourable manner. Therefore, a major chunk of foreign investment coming into India comes through Mauritius companies. This is particularly true of foreign institutional investors (FIIs) investing in India's equity markets. Most do not have any substantive business in Mauritius and have incorporated there only to take advantage of the Tax Treaty. Over the past few years, India's tax authorities have been less tolerant of this practice. Certificates of residence produced by Mauritius-incorporated FIIs were not automatically recognized and, in some cases, such FIIs

were being asked to pay tax as if they were resident in India. Acting through the Central Board of Direct Taxes (CBDT), in April 2000 the Government of India issued a circular (Circular) in which it declared that a Mauritius certificate of residence should be treated as sufficient evidence of corporate and beneficial residence of a company or FII. It further declared that FIIs resident in Mauritius would not be subject to capital gains tax in India on capital gains arising from the sale of shares in India.

This was rapidly followed by two public interest litigations that challenged the government's decision and the Circular in the Delhi High Court. The petitioners contended that the Tax Treaty makes the Mauritius resident companies liable to capital gains tax in the country of their residence. But, because the Mauritius *Income Tax Act*, 1995 exempts from income tax, gains or profits derived from the sale of units or securities quoted on the Official List or on such stock exchanges as may be approved by the Mauritius authorities, Mauritius resident companies effectively pay no capital gains tax either in Mauritius or in India. The petitioners contended that this was not the intent and purpose of the Tax Treaty. The Delhi High Court agreed and quashed the Circular and the government's decision

and held that the tax authorities should determine whether a company is resident in Mauritius on a case-by-case basis.

The government appealed the decision to the Supreme Court of India, arguing that the Delhi High Court ruling was an impermissible interference with the legislative and executive functions of the government and would have the effect of curbing foreign investment into India. The government also argued that its decision was rational and balanced because it did not exempt all Mauritius-based companies from capital gains tax. Companies which had dual residency (i.e., Mauritius and India) would still be taxed in India if their effective place of control and management was in India. The legal issue before the court was whether the government or the CBDT had the power to interpret the Tax Treaty in a manner that may be inconsistent with the intent of a country's tax statute.

The Supreme Court of India upheld the government's decision and reversed the Delhi High Court's order to quash the Circular. It ruled that the government's power to enter into double tax avoidance agreements included the power to issue interpretations to these agreements, as was the case when the Circular was issued. The Supreme Court went on to hold that such interpretive circulars or notifications would be valid even when they were inconsistent with the provisions of the tax statute. This ruling clearly upheld the supremacy of the government's executive powers to enter into bilateral treaties and to interpret them.

The Court rejected the respondents' contention that treaty shopping is unethical and illegal, holding that so long as there is no limiting language in a treaty, a person is free to treaty shop to achieve a favourable tax result. With this decision, the Supreme Court has emphatically given the green light to higher levels of inward foreign investment.