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Recent Developments in International Taxation

India

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Introduction

India is currently undergoing General Elections to elect a new Central Government. The full Union Budget setting out the tax proposals for fiscal year 2024–2025 was expected in July 2024. Given that the budget process is presently outstanding, this report summarises the key judicial and administrative developments in the last year that may be of interest to the international tax community.

India’s Supreme Court ruling on the most favoured nation (MFN) clause under double taxation avoidance agreements (DTAAs)

Indian DTAAs with jurisdictions such as the Netherlands, France and Switzerland (‘MFN States’) incorporate an MFN clause. In summary, the MFN clause incorporates the principle of non-discrimination. It states that if India enters into a DTAA with another Organisation for Economic Co-operation and Development (OECD) country, that subsequently has more beneficial terms, lower withholding tax (WHT) rates or a more restricted scope for the exercise of source-based taxation on passive income streams, such as royalties, fees for technical services, dividends and interest, such benefits will have to be extended to the DTAA with the MFN States.

India signed DTAAs with Slovenia, Lithuania and Colombia (who were not OECD members at the time the DTAA was signed), providing a lower WHT rate on dividend income. A few years pursuant to signing of the DTAA with India, Slovenia, Lithuania and Colombia became members of the OECD. Consequently, the MFN States issued declarations/official communication confirming that the DTAAs with India stood amended and that their residents would be eligible for the lower WHT rate on dividend income from the date on which Slovenia, Lithuania and Colombia became OECD members.

However, the Indian tax office has been contesting the application of the MFN clause because:

- Lithuania, Slovenia and Columbia were not OECD members at the time when India entered into tax treaties with them; and
- the MFN clause would not take effect in India unless there was separate notification by the Indian Government (the unilateral notification by the MFN States was not binding on the Indian Government).

Notably, Indian courts relying on these declarations by the MFN States decided the issue in favour of taxpayers claiming the lower WHT rate pursuant to the MFN clause. The Delhi High Court in the cases *Concentrix Services* [2021] 127 taxmann.com 43 (Delhi) and *Nestle SA vs Assessing Officer Circle (International Taxation)*, WP(C) 3243/2021, allowed the five per cent WHT rate on the basis that treaties should be interpreted in line with the interpretation of the treaty partner.

Further, in the case of *Steria India* [2016] 72 taxmann.com 1 (Delhi), the Delhi High Court allowed the taxpayer to import the narrower scope of the ‘fee for technical services’ (FTS) from the India-UK DTAA in the India-France DTAA by invoking the MFN clause. In doing so, the Delhi High Court

decisions laid down the following principles regarding the applicability of MFN clauses in these DTAAs:

- when countries provide notification of a DTAA, the protocol, which is an integral part of that DTAA, automatically becomes applicable;
- when the protocol contains an MFN clause or the principle of parity, there is no need for a separate notification to incorporate the beneficial provisions of the DTAA signed with the third state; and
- the MFN clause is triggered automatically when the third country becomes an OECD member after signing the subject DTAA with the second country.

The Indian tax authorities appealed to the Indian Supreme Court on two questions of law. First, whether the MFN clause could be invoked based on a DTAA with a third country that was not a member of the OECD at the time India signed the DTAA with it. Second, whether the benefit of the MFN clause would be automatic once the subsequent DTAA was entered into or would again require separate notification by the Indian Government.

Meanwhile, the Central Board of Direct Taxes (CBDT) also issued a Circular (Circular 3/2022 dated 3 February 2022) to clarify its stand on the applicability of MFN clauses under India's DTAAs. The CBDT prescribed conditions for conferring benefits under the MFN clause, such as: (1) a specific notification is required to be issued by CBDT to effectuate the Protocol of the DTAA (in relation to the MFN clause); and (2) the third state (whose DTAA provided for beneficial provisions/tax rates) must be an OECD member at the time of signing the DTAA with India and not accede to OECD membership later on.

In this context, the India Supreme Court has ruled in favour of the Indian tax authorities, as follows:

Need for separate notification

The beneficial provisions of the MFN clause contained in the Protocol of a DTAA would not have automatic application and would require separate notification under the Indian tax statute, notwithstanding the fact that the protocol otherwise forms part of the DTAA for which notification has been duly issued.

In this context, the Supreme Court based its decision on past practice of India observing that under the Indian Constitution, there is a clear segregation of powers of Parliament and the Union with respect to international treaties. The Union has exclusive executive power to enter international treaties and conventions, but it is Parliament that holds the exclusive power to legislate on such conventions or treaties.

Thus, even a validly negotiated treaty duly ratified by the Union does not *ipso facto* acquire enforceability unless backed by parliamentary law, which in the context of Income Tax is through the issuance of notification under section 90(1) of the Income tax Act, 1961.

Timing of OECD membership of the third state

In the case in which beneficial provisions are imported from the DTAA of the other jurisdiction that was not a member of the OECD at the time when India signed the DTAA, but later becomes an OECD member, the relevant date for determining the admissibility of the MFN clause benefits will be the date when the other jurisdiction signed the DTAA with India and not the date on which the taxpayer is claiming benefits under the MFN.

In this context, the Supreme Court resorted to the interpretation of the word '*is*' as mentioned under the MFN clause of the protocol, which is of utmost importance and connotes a present signification. In this context, it means that the other jurisdiction (the benefits of which are to be imported) should be the member of OECD at the time of entering the DTAA with India.

Impact

The Supreme Court's decision has had wide ramifications for European investors who relied on the MFN clause in the past to claim lower WHT rates on dividends and equipment royalties. It has also raised concerns in relation to the service fee that was earned by residents of the MFN States, which was not subject to WHT in India on the basis of the MFN clause. Investors are also concerned about back taxes that may be recovered by the Indian Government for prior periods where MFN benefits were claimed based on high court rulings. MFN States are likely to engage with the Indian Government to separately issue notification of the MFN clause under the relevant DTAAs pursuant to India's treaty obligations.

Inclusion of the principal purpose test (PPT) under the India-Mauritius DTAA

Mauritius has historically been the preferred jurisdiction for foreign investors to make investments into India, primarily on account of the Indian capital gains tax exemption for Mauritian residents and DTAA protection (until 31 March 2017). India renegotiated its right to tax capital gains income vide an amendment to the India-Mauritius DTAA (while grandfathering investment up to the 31 March 2017) (the '2016 Protocol').

However, the 2016 Protocol did not contain the base erosion and profit shifting (BEPS)-related changes. While Mauritius was a part of a list of DTAAs, as notified by India, to be amended through multilateral instruments (MLIs), India was not notified by Mauritius under its list of DTAAs for MLI purposes. Accordingly, the India-Mauritius DTAA was not subject to amendment in line with the MLI pursuant to the BEPS framework.

On 7 March 2024, India and Mauritius signed a protocol to amend the DTAA to better align with the OECD proposals on BEPS (the '2024 Protocol'). Key changes to the 2024 Protocol are set out below.

- The existing preamble to the India-Mauritius DTAA has been replaced, omitting the phrase 'for the encouragement of mutual trade and investment', to expressly provide that the purpose of the DTAA is not only limited to the elimination of double taxation but also to prevent double non-taxation/reduced taxation, including the prevention of the inappropriate use of the DTAA by residents of a third country.

- The PPT is a minimum standard under the MLI that aims at tackling instances of 'treaty shopping'. As per the PPT, tax benefits under the DTAA may be denied if one of the 'principal purposes' of the arrangement is to obtain a tax benefit, and providing such a benefit is not in line with the objectives and purposes of the DTAA.

- The 2024 Protocol requires both India and Mauritius to notify each other about the completion of the procedures required by their respective laws to implement the provisions of the protocol. Once notification has been issued by both countries, the 2024 Protocol will enter into force on the date of the later of the two notifications. The

2024 Protocol shall also enter into effect on the same day (viz the date of the later of the two notifications) *without regard to the date on which the taxes are levied or the taxable years to which taxes relate*.

The italicised phraseology of the 2024 Protocol has caused some confusion among tax advisers as it alludes to the 2024 Protocol having retroactive application. In this context, the CBDT issued clarification on 12 April 2024, stating that the concerns raised in this regard are premature as the protocol is not yet ratified and notified by the Indian Government, and clarified that any concerns in this regard will be addressed as and when the protocol comes into force. Investors are eagerly awaiting the final notification and clarification from the Indian Government to discern whether the newly inserted PPT will impact their existing investment structures or settled tax assessments.

Tax incentives for India's International Financial Services Centre

Finance Tec-City ('GIFT City') is India's International Financial Services Centre (IFSC) and a multi-service special economic zone. India's IFSC regime, exemplified by GIFT City, was developed with the objective of creating a globally competitive financial and technological hub within the country. By offering tax benefits, regulatory support, global connectivity and a robust infrastructure, IFSCs aim is to attract foreign investment, foster financial innovation and position India as a key player in the international financial landscape. GIFT City was set up in 2015 with the vision to become a leading global financial centre, providing a business-friendly regulatory regime on a par with other financial centres in Asia, including Dubai and Singapore.

While physically located within India, GIFT City has been structured as India's gateway to offshore global financial services and products, and a platform to undertake offshore transactions within Indian territory, without any capital account convertibility concerns from a foreign exchange standpoint. The IFSC Authority (IFSCA) is accordingly a unified regulator for the IFSC and has been vested with the powers of several financial and securities law regulators, including the Reserve Bank of India, which governs India's financial system encompassing banks and non-banking financial companies; Securities and Exchange Board of India, which oversees listed companies, investment activities in Indian public markets and funds constituted in India for investment in certain asset classes; and Insurance Regulatory and Development Authority of India, which governs the insurance business in India.

India's GIFT City offers unique tax benefits, inter alia, which are set out below:

- a ten-year tax holiday to units set-up in an IFSC in respect of their business income (subject to certain conditions being met);
- a lower minimum alternate tax rate of nine per cent (as against 15 per cent) applicable to domestic companies (that have not opted for concessional tax regimes) and foreign companies with a permanent establishment in India;
- a lower WHT of ten per cent (plus applicable surcharge and cess, subject to tax treaty benefits, if any) instead of 20 per cent (plus applicable surcharge and cess) on dividends received by non-residents from an IFSC unit;
- any interest payable by a unit located in an IFSC to a non-resident is tax exempt in the hands of the non-resident; and

- tax neutral relocation of foreign funds to GIFT City.

As such, while the Indian Government has been focusing on phasing out tax incentives under domestic law in place of lower tax rates, it has followed the contradistinctive approach of offering new tax incentives each year to popularise GIFT City, with a view to attract foreign capital into India.

Characterisation of carried interest

The taxation of carried interest has, until recently, remained settled and undisturbed. Under income tax law, carry was treated as income from 'capital gains' by fund managers, arising from investment in a special class of securities. Similarly, the position under indirect tax laws (both the earlier service tax and the current goods and services tax (GST) regime) was that carried interest was income from securities (and therefore exempt) and not a fee received for services rendered.

It is relevant to note that carried interest, where treated as a return on investment on unlisted shares and securities, is subject to a long-term capital gains tax rate of 20 per cent (plus applicable surcharge and cess) in the hands of the resident fund manager. However, where it is treated as a service fee and taxed as ordinary income, the tax rate could go as high as 30 per cent (plus applicable surcharge and cess) along with an additional GST of 18 per cent.

As such, the uncontroverted attractive tax treatment on carried interest has hitherto remained a key incentive for fund managers, being a key driver of increased fund management activity in India in the past decade.

The Bengaluru Bench of the Customs, Excise and Service Tax Appellate Tribunal (CESTAT) in 2021 in the case of *ICICI Econet internet and Technology Fund and Ors* in Service Tax Appeal No 2900 of 2012 created controversy regarding the accepted treatment of carried interest for tax purposes, when it ruled that a venture capital fund (VCF) set up as a trust is a separate legal entity, and upheld the levy of service tax on carried interest distributed by the VCF, equating it to a performance fee earned by the management company.

The CESTAT observed that the appellants were managing the funds of the contributors and therefore rendering asset management services to the contributors, which fall under 'banking and other financial services'. With respect to consideration, the CESTAT observed that consideration for such services was in the form of withholding profits that would otherwise be distributed to the contributors. The CESTAT observed that the said trusts had been floated for drawing contributors and to facilitate them regarding earning profits. Any amount retained by the said trusts out of income that was otherwise distributable to the contributors would constitute a fee for the services rendered and therefore an such amount was subject to service tax. The CESTAT found that the fund structure enabled the investment manager and its nominees to receive huge amounts as a performance fee and in the guise of carried interest, benefitting the recipients at the expense of the subscribers and avoiding the taxes arising from such a payment.

On appeal before the Karnataka High Court, in the lead case, *Ms India Advantage Fund III & Ors v The Commissioner of Central Tax & Ors* in CEA No 20/2021 reversed the decision of the CESTAT, holding that the VCF acts as a 'pass through', wherein funds from contributors are

consolidated and invested by the investment manager. It acts as a trustee holding the money belonging to contributors to be invested as per the advice of the investment manager. The Karnataka High Court applied the principle of mutuality to hold that there is commonality between the contributors and VCF, and there cannot be any service to the self. Transactions between the VCF and investors represent an investor-investee relationship, not of a service provider and service recipient.

While the Karnataka High Court order is not very detailed, the decision clarifies that there is no provision of service from the fund to its investors. The principle laid down by the Karnataka High Court can be relied on in income tax matters as well, fortifying the view that the nature of carried interest is not akin to a service fee and therefore should correctly be taxed as capital gains, especially in view of the fact that the carry earned by fund managers is often disproportionate compared to the investment made by them and quite unlike a service fee that would be payable irrespective of the outcome or performance of the underlying investment.