Morgan Stanely – A New & Meaningful Interpreation of DTAA

- Contributed by CA Sri Harsha

In this article, we get to one of the recent interesting judgment in the arena of international taxation. The judgment is authored by Honourable Vice President, Mr Pramod Kumar of Mumbai ITAT[1]. As a student and learner of International Taxation, I would never miss reading a judgment of Mr Pramod Kumar. The way he interprets the law, the vast knowledge he possess and adequate application to the facts of the case, is no match. Let us proceed to understand the facts in the matter of Morgan Stanley Mauritius Co Limited vs. Deputy Commissioner of Income Tax, International Taxation Circle, 3(2)(2), Mumbai[2].

Morgan Stanely Mauritius Co Limited (for brevity 'MS - Mauritius') is a company incorporated and fiscally domiciled in Mauritius and has a tax residency certificate issued by Mauritius Revenue Authorities. The assessee is an investor in Indian Depository Receipts (for brevity 'IDR') issued by Standard Chartered Bank – Indian Branch (for brevity 'SCB – India'). The underlying assets of IDRs are the shares of Standard Chartered Bank Plc (for brevity 'SCB -UK'), held by the custodian Bank of New York (for brevity 'BNY-US'). SCB – UK is listed on London Stock Exchange and the IDRs so issued are listed on Indian Stock Exchange.

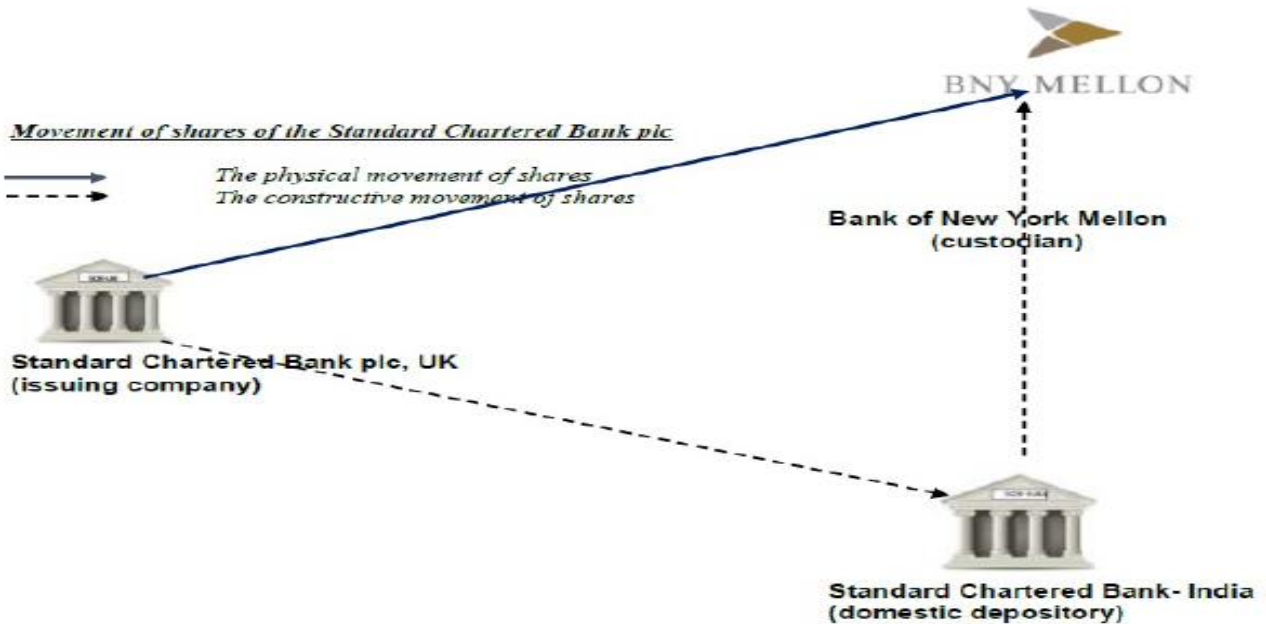
MS - Mauritius has received Rs 9,74,66,595 as dividend from SCB-India, in respect of dividends for the underlying shares relatable to IDRs in which the investment is made. The Assessing Officer (for brevity 'AO') was of the opinion that since the dividends were received by MS - Mauritius in India, the same would be deemed to accrue or arise in India and accordingly be subjected to tax in India. However, MS – Mauritius contended that just because the dividends are received in a bank account maintained in India, that alone, would not trigger taxation in India and the dividends were received outside India and thereby no income could be said to be accrued or arisen or deemed to accrue or arise in India. Further, MS – Mauritius has also contended that the right article in the current set of facts is Article 22 and not Article 10 of Indo-Mauritius Double Taxation Avoidance Arrangement (for brevity 'DTAA'). Accordingly, the AO has passed an order confirming the demand of tax @ 20% under Section 115A(1)(a) of Income Tax Act, 1961 (for brevity 'ITA').

The main question that fell before the Honourable Tribunal is that, whether the dividends were received outside India and accordingly falling out of Section 9 of ITA and the appropriate article in terms of DTAA is Article 22 instead of Article 10? Now, let us proceed to understand, as to how the Tribunal analysed the above issue.

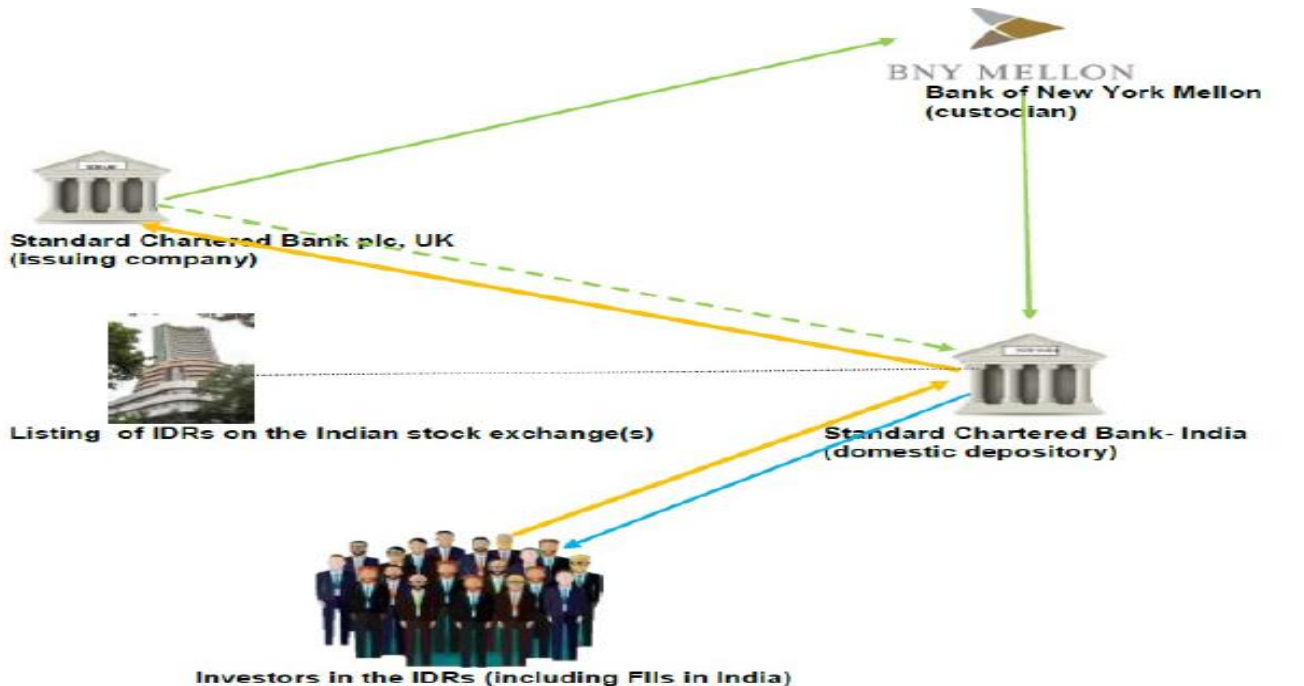
The Tribunal started with the understanding of IDRs, stating that IDR is a derivative financial instrument, i.e., a financial instrument that draws its value from the underlying asset and is tradable on or more approved stock exchanges. While the financial instrument, tradable in one or more of Indian Stock Exchanges, when issued by Indian Depository, the IDRs derive their value from the underlying asset in form of Equity Shares of a foreign company. Hence, the benefits accruing from the shares in question are, subject to the terms on which Depository issues IDRs are passed on to the IDR holders, and, in that sense, the IDR holders are beneficiaries of the underlying shares of foreign company. The Tribunal after making specific references to Companies (Issuance of Depository Receipts) Rules, 2004, stated that an IDR is an instrument issued by a custodian of underlying shares of foreign company, registered with Securities Exchange Board of India (for brevity 'SEBI'), and authorised by the foreign company in this respect. The said instrument is to be denominated in Indian Rupee, listed on or more stock exchanges and the money raised through the IDRs can be repatriated to the foreign company, as may be permissible under Foreign Exchange Management Act, 1999 and the IDRs can be freely tradable. Thus, the IDRs are means to tapping of India Investor market by the foreign companies, only difference being, that the investor would not be subscribing to the share capital of foreign company and the IDR holders

[1] Income Tax Appellate Tribunal
[2] 2021 (5) TMI 968 – ITAT Mumbai

cannot be said to be shareholders of foreign company (unless the IDRs are converted into Equity after a prescribed time period). Further, the foreign company issues the equity shares to the domestic depository on strength of which IDRs were issued, the equity shares would never reach the domestic depository and instead reach the custodian. The custodian actually holds the shares on behalf of domestic depository, which itself is the trustee of the issuing company. The Tribunal has explained the above through a diagram as under:



The flow of dividend, which is the subject matter of the current issue, is also explained by the Tribunal in form of the below diagram:



From the above, it is evident that the dividend physically flows from SCB – UK to BNY and then to SCB – India, since BNY is just a custodian and the shares are actually held by SCB – India. Further, on receipt of such dividend by SCB – India, as per the terms of agreements with IDR holders, the dividend gets distributed. This also gains strength from Rule 12 of Companies (Issuance of Indian Depository Receipts) Rules, 2004, wherein it states that on receipt of dividend or other corporate actions on the IDRs as specified in the agreement between the issuing company and the domestic depository, the domestic company shall distribute them to the IDRs in proportion to their holding of the IDRs. **The Tribunal made an important observation, which lays down the foundation for the entire adjudication of the litigation by stating that, the IDR holders are not entitled to the benefits of the shareholding related to IDR, and to the extent, they are entitled to get proportionate amount of cash dividends, as much as of any other receipts by the depository in respect of the equity shares of the foreign company, received by SCB – India.**

The issue before Tribunal is that, when is the amount, so distributed to IDR holders on account of dividend receipts, can be said to be received in the hands of IDR holders:

- at the point of time when the amount is received by BNY outside India, on behalf of SCB – India or
- at the point of time when the amount is received by IDR holders in India from SCB – India

The response to the above is critical and the moot point of the entire discussion. If the dividend is said to be received by IDR holders, that is, MS – Mauritius, at the time the same was received by BNY, then the dividend is out of scope of taxation. On the other hand, if the dividend is said to be received by MS – Mauritius at the time when the same is declared by SBC – India, on their receipt from BNY, then there would be a chance to say that the dividend has accrued or arisen or deemed to accrue or arise in India. Let us proceed to see, how the Tribunal tackled the subject issue.

MS – Mauritius's plea is that, since SCB – India is acting as a bare trustee, the dividend declared by SCB – UK is deemed to be received by MS – Mauritius, when the same was received by custodian, BNY. The subsequent physical cash flow cannot be used to interpret that the dividend is received in India. Since the income which can be taxed in the hands of MS – Mauritius, is only which is falling under the scope mentioned in Section 5(2) and the subject dividend, being received outside India, the same would not be taxable in India. They have also pleaded that in terms of Section 9(1)(iv), the dividend paid by Indian Company outside India shall be deemed to be an income accruing or arising in India, but since, in the instant case, the dividend is declared by foreign company, the said provision does not apply.

However, the Tribunal has not accepted the above arguments by stating that BNY is only a custodian and the shares are actually owned by SCB – India. Hence, any receipt of amount from SCB – UK by BNY is only in the capacity of custodian of SCB – India. The Tribunal stated that SCB – India is Indian depository of the underlying shares in question, the IDRs, in respect of which dividend is received, are issued by SCB – India. Hence, in terms of Section 9(1)(i), all incomes accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any assets or source of income in India, will be deemed to accrue or arise in India, and accordingly, the dividends declared has a clear connection with the property, the shares of SCB – UK, though held by the custodian BNY. The Tribunal stated that, the subject income is not a dividend simplicitor from a foreign company. It has a clear, significant, and crucial business connection with India. The Tribunal further confirmed that, just because a dividend income other than that from an Indian company, which cannot be taxed in Section 9(1)(iv), it cannot escape the rigour of Section 9(1)(i). Further, the Tribunal stated that what is received by MS – Mauritius is the net dividend amount as declared by SCB – India and not the dividend of foreign company, despite of the fact that dividend declared by SCB – India could be and indeed is, on the basis of dividend declared by SCB – UK , but then what MS – Mauritius is entitled to are the benefits flowing from the shareholdings in SCB – UK as an underlying asset of

IDRs. What is rightfully due to MS – Mauritius in income character is the net amount received from Indian Depository and not the dividend simplicitor as declared by SCB – UK. Hence, the income accrues to IDR holder, MS – Mauritius at the point of time when the Indian depository works out the amount payable to IDR holders and then pays it accordingly. The point of time when income accrues to IDR holder is when the Indian depository declares the outgo and is received when the Indian depository pays the money. The Tribunal further not accepted the plea that SCB – India is a bare trustee by stating that if BNY was acting as bare trustee, then the dividend may be said to be received outside India. Since, that was not the facts of the subject matter, the plea that SCB – India acts as a bare trustee is not accepted by Tribunal. Accordingly, the Tribunal concluded that dividends received by MS – Mauritius are deemed to accrue or arise in India in terms of Section 9(1)(i).

The pleas put forward by MS – Mauritius in the context of DTAA are in fact the basis for coming up with this article. MS – Mauritius has taken a plea that, since they are tax resident of Mauritius, Article 10 comes into play only when one of the residents of contracting state, India or Mauritius pays the dividend. However, in the instant case, the dividend was declared by SCB – India, which is a branch of SCB – UK, the dividend declared by the former, does not fall under the scope of Article 10. Since the same does not fall under Article 10, the taxing rights have to be determined based on Article 22, which states that income is taxable only in the state of residence, that is Mauritius.

The Tribunal has accepted the above plea of MS – Mauritius. In coming to the said conclusion, the Tribunal held that what the treaty protects is the taxes covered in Article 2 and thus the fact of these tax levies in India which are sought to be protected by the treaty. ***The Tribunal held as under:***

As to who made the payment of income in question, i.e., a resident of the other contracting state or any other person, is not relevant so far as the treaty protection is concerned. What essentially flows is that when the person making the payment of income in question is not resident of one of the contracting states and yet such an income has tax implications in one of the contracting states, the person resident in the other contracting state will nevertheless, therefore, have treaty protection in the contracting state where the income is being subjected to the taxes protected by the treaty. What is thus relevant is the fact of taxation in the other contracting state.

Hence, the Tribunal lays down the interpretation that, the person who is making the payment need not be one of the residents of the contracting state but can be a third person also, but still the subject payment would be covered under the treaty protection, if such payment has tax implications in the hands of one of the residents of contracting states. Accordingly, SCB – UK, though not resident of either India or Mauritius to invoke the India - Mauritius DTAA, the MS – Mauritius, can still invoke the India – Mauritius DTAA, since the income has reached India and subjected to taxes covered under the Article 2 of India – Mauritius DTAA, despite being paid by SCB – UK.

Basis above, the Tribunal concluded that MS – Mauritius can invoke the Article 22 and since the taxing rights for the incomes which do not fall under any of the article, rests with Mauritian Tax Authority and SCB – India need not hold any tax, when such income are further paid.