Gains on sales of equity shares and compulsorily convertible debentures characterised as capital gains and not as interest income

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In brief

The Delhi High Court (HC) has set aside the ruling of the Authority for Advance Ruling (AAR) in the case of **Zaheer Mauritius**. The AAR had ruled that the gains arising on sales of equity shares and compulsorily convertible debentures (CCDs) were taxable as interest income. The HC has now held that these gains should be characterised as capital gains.

In detail

Facts

- Zaheer Mauritius[1] was a company incorporated in Mauritius and was a tax resident of Mauritius. It was engaged in investing in Indian companies undertaking construction and development activities in India.
- SH Tech Park Developers Private Limited (the JV Company), an Indian company, was incorporated as a wholly owned subsidiary of Vatika Limited (Vatika).
- Zaheer Mauritius entered into a Securities Subscription Agreement and a Shareholder's Agreement (SHA) with Vatika and the JV Company to invest in the JV Company by subscribing to equity shares and CCDs.
- The SHA recorded the terms of the relationship between Zaheer Mauritius, Vatika and the JV Company and their *inter se* rights and obligations, including matters relating to transfer of equity shares and the management and operation of the JV Company. The SHA also ascribed a call option to Vatika to buy the securities from Zaheer Mauritius and a put option to Zaheer Mauritius to sell the securities to Vatika.
- Vatika exercised the call option, and purchased all the CCDs and some of the equity shares from Zaheer Mauritius.
- Zaheer Mauritius filed an application under section 197 of the Income-tax Act, 1961 (the Act) before the Tax Officer (TO), requesting a nil withholding tax certificate in relation to the transfer of CCDs and shares. However, the TO held that the gains on the transfer of equity shares and CCDs would be treated as interest, and that tax at 20% (plus applicable surcharge and education cess) should be withheld.
- Zaheer Mauritius filed an application before the AAR to obtain a ruling on whether the gains arising on the sale of equity shares and CCDs were exempt from capital gains tax in India under Article 13(4) of the India-Mauritius Double Taxation Avoidance Agreement (tax treaty).
- The AAR ruled that the gains were taxable as interest within the meaning of section 2(28A) of the Act and Article 11 of the tax treaty.

[1] Zaheer Mauritius *v.* DIT [TS-464-HC-2014(Del)]

Issues before the High Court

Whether the gains arising on the transfer of equity shares and CCDs by Zaheer Mauritius to Vatika were taxable as capital gains or as interest income.

Zaheer Mauritius's contentions

- There was no debtor and borrower relationship between Zaheer Mauritius and Vatika.
- The CCDs were held by Zaheer Mauritius as a capital asset and the transfer of these investments was liable to be treated as capital gains, and was accordingly exempt under Article 13(4) of the tax treaty.
- The transaction entered into between Zaheer Mauritius, Vatika and the JV Company was an investment in shares and CCDs, and not a loan transaction.

Revenue's contentions

- The transaction entered into by Zaheer Mauritius and Vatika was essentially in the nature of external commercial borrowing (ECB).
- Under the terms of the agreement, Zaheer Mauritius was entitled to receive a fixed rate of return determined by the duration of the investment. Hence, the transaction should be viewed as a loan transaction and returns on the investment should be taxed as interest income.

High Court's ruling

- The HC stated that under normal circumstances, gains arising on the transfer of a debenture held as a capital asset by the transferor would be taxable as capital gains and not interest.
- The HC found that the AAR's conclusion (that returns on the investment should be taxed as interest income) had been based on the following findings:
  - There was a fixed rate of return on the investment;
  - The JV Company's affairs were controlled by Vatika/ its shareholders;
  - The transaction was structured as an investment in equity shares and CCDs to avoid tax.
- The HC observed that the clauses in the SHA relating to the call/ put options could not be read to mean that Zaheer Mauritius was entitled to a fixed return on its investments. Merely because an investment agreement provided an exit option to the investor, this would not change the nature of the investment made.
- The HC held that it was common in any joint venture agreement for the co-venturers to include covenants for buying each other's stakes. Although the SHA enabled Zaheer Mauritius to exit the investment by receiving a reasonable return on it, this could not be read to mean that the CCDs were fixed-return instruments. Zaheer Mauritius also had the option to continue with its investment as an equity shareholder in the JV Company (following the conversion of the CCDs into equity shares).
- Based on the reading of the corporate governance and other related clauses in the SHA, the HC observed that the affairs of the JV Company were managed separately and distinctly from those of Vatika.
- The HC acknowledged that in accordance with the foreign direct investment guidelines, CCDs were the most appropriate way of routing investments in the JV Company. In such circumstances, it ought not to be readily inferred that the entire structure of the transaction was designed solely for the purposes of avoiding tax.
- The HC considered that if the gains were considered as interest paid by Vatika, they would also qualify as deductible expenditure in the hands of Vatika. In view of this, it would be an error to conclude that the transaction had been structured to avoid tax.
- The HC, relying on the principles laid down by the Supreme Court in the case of Vodafone International Holdings BV[2], held that there was no reason to ignore the legal nature of the CCDs or to lift the corporate veil to treat the JV Company and Vatika as a single entity.

The takeaway

The ruling of the HC reinforces the position that gains arising on the transfer of CCDs should be taxed as capital gains. By adopting a holistic view of the transaction, the HC has emphasised the importance of the "look at test" to ascertain the true nature of transactions. If there are sufficient commercial reasons for structuring a transaction in a particular way, the form of the transaction should be respected, and the legal nature of the transaction should not be ignored.

Further, the said decision is rendered taking into consideration various clauses and terms of the SHA. Hence, it would be important to examine the actual documentation and facts of each case for deciding the applicability.

[2] Vodafone International Holdings BV *v.* Union of India and Anr [2012] 341 ITR 1 (SC)

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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