Capital Gains arising to Mauritius company not taxable in India under the India-Mauritius tax treaty

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In brief

In a recent decision, the Bombay High Court (HC) held that capital gains arising to Mauritius Company on sale of shares held in an Indian company to another group company of the investee was not taxable in India under the provisions of the Double Taxation Avoidance Agreement (tax treaty) between India and Mauritius.

In detail

Facts

- The taxpayer[1] was a company incorporated in Mauritius holding Category 1 Global Business License issued by Financial Service Authorities of Mauritius and had been issued a Tax Residency Certificate (TRC).
- It acquired shares of A Limited in June 1996 and sold the same in June 2009 to another A Group Company and the entire sale proceeds were reinvested in another A Group Company in July 2009.
- The original investment proposal was made to Foreign Investment and Promotion Board (FIPB) stating J as the proposed investor and later on the investment was routed through the taxpayer.
- The taxpayer sought an advance ruling to ascertain whether capital gains on the transfer of shares of A Limited to another A Group Company was taxable in India in the hands of the taxpayer by virtue of the India-Mauritius tax treaty. The AAR ruled in favour of the taxpayer. The revenue filed a writ petition before High Court.

Issues before the High Court

Whether the capital gains arising to the taxpayer on sale of shares of the Indian company was exempt from tax under the India-Mauritius tax treaty.

Revenue's contentions

- The taxpayer was not the beneficial investor, as it had never nominated anyone on the Board of A Limited at any point of time and employees of J were only on the board of A Limited.
- The taxpayer was a shell company created only for taking advantage of the tax treaty and did not have any business/ commercial substance, as it never incurred any expenses of wages, salaries of staff, electricity, water, etc.
- By the virtue of Explanation 5 to section 9(1)(i) of the Income-tax Act, 1961 (the Act), any income arising outside India from any transaction in respect of any share or interest in a foreign company, which has the effect of transferring directly or indirectly the underlying assets located in India be treated as income accrued and arose in India.
- This was a fit case of treaty abuse and only because the taxpayer held shares of A Limited for a long period of time would not lead to the

[1] TS-308-HC-2017(BOM)

presumption that the taxpayer was not a shell company.

Taxpayer's contentions

- The taxpayer held a valid TRC of Mauritius. Accordingly, capital gains arising to it from transfer of shares located in India would be taxable only in Mauritius as per the tax treaty. Support for this view could be drawn from the administrative circulars.[2]
- As per the judgement of the Apex Court in the case of Azadi Bachao Andolan,[3] TRC was the conclusive evidence for determining the status of residence under the treaty. Thus, treaty shopping was not illegal.

High Court's decision

- The taxpayer company was holding valid business license issued by the Financial Services Authority of Mauritius and a certificate issued by the Mauritius Revenue Authorities, evidencing that the taxpayer was a tax resident in Mauritius during the relevant period and the same had been renewed from time to time.
- The taxpayer had also filed its return in Mauritius, offering its income to tax and paid taxes in Mauritius, thereby, making it eligible to claim the benefit of the provisions contained in section 90(2) of the Act.
- The shares were held by the company for a long period of 13 years, which itself suggests the *bona fide* intent of the company evidencing and it is not a fly-by-night or shell company.
- The Apex Court in the case of Azadi Bachao Andolan[3] observed that treaty shopping was not illegal and its legality could not be judged merely because of one section of thought considers it improper.
- The provisions of Explanation 5 to section 9(1)(i) would not be applicable in the present case, as the taxpayer was covered by the provisions of the tax treaty and as per the tax treaty it could only be taxed in Mauritius.
- That capital gains on the proposed sale of shares by the taxpayer was not liable to capital gains tax in view of Article 13(4) of the tax treaty.

The takeaways

The share transfer transactions involving entities resident in Mauritius had been a subject matter of litigation. The Indian revenue authorities in several instances had questioned the purpose test and denied the treaty benefits where transactions were designed solely to take advantage of the tax treaty.

This ruling reiterates and relies on the principle laid down by the SC in the case of Azadi Bachao Andolan[3] that treaty shopping is not taboo and does not warrant further enquiry.

It may be noted that the India Mauritius tax treaty was amended in May 2016, pursuant to which capital gains on shares acquired on or after 01 April, 2017 shall be taxable in India subject to the prescribed relaxations. However, such benefit shall not be applicable to a shell/ conduit company that do not meet the criteria of Limitation of Benefit prescribed under the amended tax treaty.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

[2] Circular No. 682 dated 30-03-1994; Circular No. 789 dated 13-04-2000

[3] [2003] 263 ITR 706 (SC)

Our Offices

Ahmedabad

1701, 17th Floor, Shapath V,
Opp. Karnavati Club,
S G Highway,
Ahmedabad – 380051
Gujarat
+91-79 3091 7000

Bengaluru

6th Floor
Millenia Tower 'D'
1 & 2, Murphy Road, Ulsoor,
Bengaluru – 560 008
Karnataka
+91-80 4079 7000

Chennai

8th Floor
Prestige Palladium Bayan
129-140 Greams Road
Chennai – 600 006
Tamil Nadu
+91 44 4228 5000

Hyderabad

Plot no. 77/A, 8-2-624/A/1, 4th Floor, Road No. 10, Banjara Hills,
Hyderabad – 500034,
Telangana
+91-40 44246000

Kolkata

56 & 57, Block DN.
Ground Floor, A- Wing
Sector - V, Salt Lake
Kolkata – 700 091,
West Bengal
+91-033 2357 9101/
4400 1111

Mumbai

PwC House
Plot No. 18A,
Guru Nanak Road(Station Road),
Bandra (West), Mumbai – 400 050
Maharashtra
+91-22 6689 1000

Gurgaon

Building No. 10, Tower - C
17th & 18th Floor,
DLF Cyber City,
Gurgaon – 122002
Haryana
+91-124 330 6000

Pune

7th Floor, Tower A - Wing 1,
Business Bay, Airport Road,
Yerwada, Pune – 411 006
Maharashtra
+91-20 4100 4444

For more information

Contact us at
pwctrs.knowledgemanagement@in.pwc.com

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