Foreign companies to establish facts to claim treaty benefit

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In brief

The Authority for Advance Rulings (AAR) has recently pronounced two rulings[1] in respect of taxability of capital gains arising in the hands of Mauritius companies on transfer of shares of an Indian company. The AAR held that the beneficial provisions of India–Mauritius tax treaty shall be available where Mauritius company can demonstrate that the investment was genuine with flow of funds through proper banking channels, and not mere accounting entries.

In detail

Facts

Ruling I

- The applicant, a Mauritius company (M1), having a US parent (C Group), was engaged in the business of making investment.
- It had made investments in an Indian company (IN1), by investing funds using proper banking channels, post obtaining necessary approvals.
- The C Group had set up a regional headquarter in Singapore (S Co). As a part of business reorganisation, M1 transferred the shares held in IN1 to S Co.

Ruling II

- The applicant, a Mauritius company (M2), subsidiary of C Group, was engaged in the business of making investment.
- C Group entered into Stock Purchase Agreement (SPA) for acquiring shares in an Indian company (IN2) from two US companies (US Co), against cancellation of the loan payable by the US Co to C Group.
- As per SPA, 99% of the shares of IN2 were acquired on behalf of M2 and only 1% was kept by C Group.
- Also, M2 entered into a loan agreement with C Group, and recognised the loan advanced by C Group in its financial statements.
- Subsequently, as part of a business reorganisation, M2 transferred the shares held in IN2 to a group company, S Co.

Key issues before the AAR – Ruling I & Ruling II

- Whether the gains arising to M1 and M2 on account of transfer of shares in IN1 and IN2, respectively, would not be liable to tax in India by virtue of Article 13(4) of the India–Mauritius tax treaty and thus there would be no requirement to withhold taxes in India?
- Whether Indian transfer pricing provisions would apply on income arising to M1 and M2 from transfer of shares?

Applicant's contention – Ruling I & Ruling II

- M1 and M2 were companies incorporated in Mauritius, as evidenced by their certificates of incorporation and valid tax residency certificates (TRC).
- They were eligible to claim tax treaty benefit under Article 13(4) of the India–Mauritius tax treaty, for non-taxability of capital gains in India on transfer of shares of Indian companies.
- The sale of shares would not give rise to any tax incidence in India, and hence, the transfer pricing provisions would not apply.

[1] Ruling I - AAR No 1129 of 2011; and Ruling II – AAR No 1128 of 2011

Revenue's contention

Ruling I

- M1 was a conduit company with no address of its own or any assets or employees of its own in Mauritius. It was incorporated as a device to avoid tax qua India and should not be eligible for India–Mauritius tax treaty.
- The place of effective management and control of M1 was located in the US and not in Mauritius
  - The key decisions in the board of directors meetings were taken by one director, who mainly operated from the US. He participated in board meetings through telephone or video conference from the US.
  - The two other directors of M1, located in Mauritius, were more like finance/legal managers or non-executive directors.

Ruling II

- The investment in IN2 shares was made by C Group, the consideration flowed from them, and, the capital gains arose to C Group, being the real investor.
- M2 being only the name lender, was not a legitimate owner of the shares of IN2.

AAR's ruling

Ruling I

- M1 was a tax resident of Mauritius, eligible for benefits of the India–Mauritius tax treaty
  - It possessed a valid TRC from Mauritius tax authorities.
  - It had ongoing business of investment for almost 7 years, and thus was not a fly-by-night operator.
  - Investment was done by M1 out of its own resources, and through proper banking channels. It was immaterial that the money was received by M1 from its holding company.
  - M1 was the registered and beneficial owner of shares of IN1, as per the shareholders register.
- M1 made genuine investment in IN1 shares, and had documentation to substantiate it
  - RBI approval was obtained in the form of Foreign Inward Remittance Certificate.
  - The actual flow of funds for initial and subsequent investments along with investment details was accounted for in the financial statements.
- The holding company could have a role to play in the affairs of the subsidiary. The control and management in instant case, was not in the US, but in Mauritius
  - Movements of the directors in and out of Mauritius, could not alone conclude that control and management was not in Mauritius.
  - The physical absence of one director in board meeting and his attendance through telephone or video conference from the US was a valid communication.
  - The other two directors of M1 were well-qualified to engage in meaningful discussions and were involved in the decision making process.
  - Investment holding companies such as M1, did not require huge offices/staff or incur multiple account expenses, as opposed to manufacturing or trading companies.
- The transaction was not undertaken for tax avoidance as a colourable device. Thus, the capital gains arising from sale of IN1 shares would not be liable to tax in India pursuant to provisions of India–Mauritius tax treaty and thus there was no obligation of withholding taxes in India.
- The transaction of sale of shares of IN1, being an international transaction, would have to be benchmarked as per the transfer pricing provisions in India, irrespective whether it is chargeable to tax in India or not.

Ruling II

- M2 was a tax resident of Mauritius, as it possessed a valid TRC from Mauritius tax authorities.
- Since M2 could not satisfy that it was acting on its own behalf, and that the shares of IN2 actually belonged to it, tax treaty benefit was denied to M2.
- M2 played no role in the decision of acquiring the shares of IN2, and the decision of investment was that of C Group
  - The SPA to acquire shares of IN2 was signed in year 2003 between M2 and C Group as buyers and US Co as sellers. However, no signatory from M2 actually signed the SPA, and thus M2 was not privy to the SPA.
  - The acquisition of IN2 shares for and on behalf of M2, was ratified in 2004 by M2 in a board meeting, one

  year after the signing of SPA.
  - In this meeting, a director of C Group (who was not a director of M2 at that time) informed about the reorganisation and directed the board to incorporate the transaction in its books.
- There was no flow of consideration from M2 to acquire the shares of IN2, which was in essence paid by C Group in the form of cancellation of its receivables due from the US Co. –
  - No cash was exchanged and mere book entries were passed. The only consideration paid for the shares was by C Group in the form of cancellation of its debts and nothing was actually paid by M2.
  - The SPA accorded shares to M2, without any clause informing or indicating its liability for such acquisition.
  - Subsequently, the loan was accounted for by M2 and it was claimed as a consideration to the IN2 shares, while there was no document to support the facts.
  - The financial statements of M2 reflecting the share acquisition, were filed in 2005. This was done after its due date of filing in June 2004 and post the board meeting in November 2004 where M2 was directed to incorporate shares and loans in its books of accounts.
- The overall fact pattern reflected that M2 was a mere spectator to the shares acquisition of IN2 and was not its beneficial owner.
- Thus, the capital gains on transfer of shares arose to C Group, and was taxable in India as per the India–US tax treaty, with corresponding withholding tax obligation.
- The transaction of sale of shares of IN2, being an international transaction, would have to be benchmarked as per the transfer pricing provisions in India.

The takeaways

The rulings emphasise the importance of demonstrating ownership by way of intention to invest, actual flow of consideration, control and decision-making, besides other requirements to avail tax treaty benefits.

Let's talk

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

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