

Tribunal holds that units of an equity-oriented mutual fund are not “shares” for purposes of the article relating to capital gains in the India-UAE tax treaty

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In brief

The Cochin Bench of the Income-tax Appellate Tribunal (Tribunal)¹ held that units of mutual fund cannot be regarded as “shares,” and hence, short-term capital gains earned by the taxpayer on transfer of such units should be exempt from tax under Article 13(5) of the India-UAE Double Taxation Avoidance Agreement (tax treaty).

In detail

Facts

- The taxpayer, a resident of the UAE for Assessment Year (AY) 2012-13 (Financial Year 2011-12). The taxpayer sold units of equity-oriented mutual funds and earned short-term capital gains (STCG).
- The taxpayer filed his return of income claiming such STCG to be exempt from tax under Article 13(5) of the tax treaty.
- During the course of assessment proceedings, the Tax Officer (TO) held that the underlying instruments of equity-

oriented mutual funds are nothing but “shares,” and therefore, the gains should be taxable in India under Article 13(4)² of the tax treaty. Accordingly, the TO added the STCG in the order passed under section 143(3) of the Income-tax Act, 1961 (the Act).

- On appeal, the Commissioner of Income-tax (Appeal) [CIT(A)] was of the view that units of equity-oriented mutual funds are not “shares,” and therefore, the case was governed by Article 13(5) of the tax treaty. Accordingly, the CIT(A) rejected the TO’s

contention and decided in favour of the taxpayer and held that STCG derived by the taxpayer from the sale of units of equity-oriented mutual funds are not taxable in India.

Issue before the Tribunal

Whether CIT(A) was justified in considering the units of equity-oriented mutual fund separate from “shares,” and hence, STCG earned by taxpayer should be exempt under Article 13(5) of the tax treaty?

Tribunal’s ruling

- The Tribunal noted the difference between paragraphs 4 and 5 of

¹ ITA No. 423/ Coch/ 2018

² Articles 13(4) and 13(5) are reproduced as follows –

- Article 13(4) - “Gains from the alienation of shares other than that those mentioned in paragraphs 3 in a company which is resident of a Contracting State may be taxed in that State.”
- Article 13(5) - “Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 above shall be taxable only in the Contracting State of which the alienator is a resident.”

Article 13 of the tax treaty. The Tribunal noted that Article 13(4) of the tax treaty covers capital gains arising on the transfer of shares and not any other property.

Therefore, Article 13(4) of the tax treaty cannot be applied in the instant case, unless the units of the mutual fund transferred by the taxpayer qualify as “shares” for the purpose of the tax treaty.

- The Tribunal further noted that, as the term “share” is not defined under the tax treaty, as per Article 3(2) of the tax treaty, it shall have the meaning it has under the laws of the country whose tax is being applied.
- As the term “share” is not defined under the Act, the Tribunal referred to the Indian Companies Act, 2013. As per section 2(84) of the Indian Companies Act, 2013, the term “share” means “a share in the share capital of a company and includes stock.” The term “company” means “company incorporated under the Companies Act, 2013 or previous company law.”

- The Tribunal observed that under the Securities and Exchange Board of India (Mutual Funds) Regulations, 1995, mutual funds in India can be established only in form of “trusts” and not “companies.” Therefore, the units issued by the mutual funds cannot be regarded as shares for the purpose of the Companies Act, 2013.
- The Tribunal also noted that as per the definition of the term “securities” under the Securities Contract (Regulation) Act, 1956, “shares” and “units of mutual fund” are two separate types of securities.
- The Tribunal placed reliance on the Mumbai bench of the Tribunal’s ruling,³ wherein on similar facts and in context of India-Switzerland tax treaty, it was held that in the absence of specific provisions under the Act, units cannot be deemed as shares. Hence, the Mumbai bench of the Tribunal granted capital gains tax exemption in case of transfer of units under Article

13(6) of the India-Switzerland tax treaty.

- Accordingly, the Tribunal held that gains arising from the transfer of units of mutual fund should be covered under Article 13(5) of the tax treaty. Therefore, STCG arising to the taxpayer on transfer of units of mutual funds should not be liable to tax in India, in accordance with the provisions of Article 13(5) of the tax treaty.
- Thus, the Tribunal upheld the action of the CIT(A) in deleting the addition of STCG by the TO.

The takeaways

This ruling reaffirms that units of mutual funds and shares are separate securities. Hence, capital gains arising on transfer of units of mutual funds should be eligible for exemption under the tax treaties wherever available.

Let’s talk

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

³ ITO (IT) v. Satish Beharilal Raheja [2013] 37 taxmann.com 296 (Mumbai-Trib)

Our Offices

Ahmedabad

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

Hyderabad

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

Gurgaon

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

Bengaluru

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

Kolkata

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

Pune

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

Chennai

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

Mumbai

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

For more information

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

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