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Capital gains on direct and indirect transfer of shares of Indian company by Mauritius tax resident not taxable in India under the India-Mauritius DTAA

In case of corporate owners, legal ownership of shares outweighs beneficial ownership for determining taxability of capital gains

Background

In a recent case of Moody's Analytics Inc[1]., the Authority for Advance Rulings (AAR) has ruled in favour of the applicants, in the context of capital gains taxation under the Double Taxation Avoidance Agreement between India and Mauritius (the tax treaty). The ruling throws light on some crucial aspects of-

- Whether for a corporate assessee, beneficial ownership of an asset outweighs legal ownership for the purpose of capital gains taxation;
- The place of management test for a company;
- Eligibility of tax treaty benefits in case of indirect transfer of shares of an Indian company;

[1] Moody's Analytics Inc, USA., *In re* [2012] 24 taxmann.com 41 (AAR)

- Eligibility of tax treaty benefits on an income which is not taxed in the country of residence and cannot be taxed in the source country by virtue of the provisions of the tax treaty; and

- Taxability of earn-out consideration

An application for the Advance Ruling was made to the AAR by the acquirers (Moody's Group companies) and the transferors (Copal Group companies). The AAR disposed off these applications by way of a single ruling.

Facts

- Copal Partners Ltd., a company incorporated in Jersey (CPL Jersey), held 100% of the shares in Copal Research Ltd., a company incorporated in Mauritius (CRL Mauritius). CRL Mauritius, in-turn, held 100% of the shares in Copal Research India Pvt. Ltd. (CRIPL), a company incorporated in India.

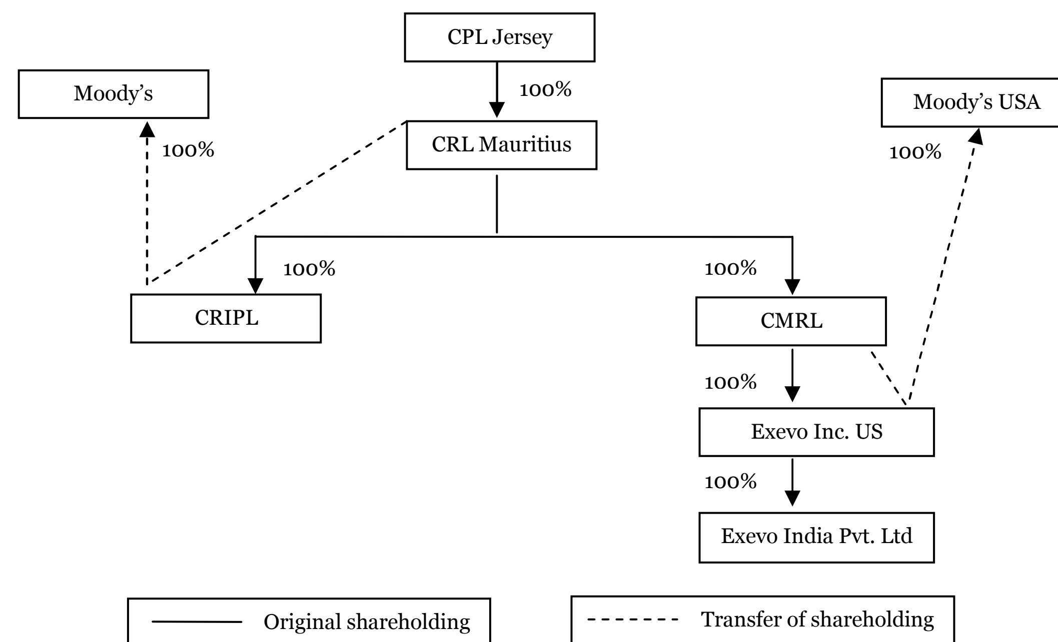
- CRL Mauritius also held 100% of shares in Copal Market Research Ltd., a company incorporated in Mauritius (CMRL Mauritius). CMRL Mauritius, in-turn, held 100% shares in Exevo Inc. US, a company governed by the laws of United States of America. Exevo Inc. US held 100% of the shares in Exevo India Pvt. Ltd., a company incorporated in India [See pictorial presentation of holding structure].

- Both CRL Mauritius and CMRL Mauritius held tax residency certificates (TRCs) issued by the Mauritius revenue authorities for various years since their incorporation.

- The transactions undertaken were as follows-

  - Sale of shares of CRIPL by CRL Mauritius to Moody's Group Cyprus Ltd. (Moody's Cyprus); and

  - Sale of shares of Exevo Inc. US by CMRL Mauritius to another US company – Moody's Analytics, Inc (Moody's USA)



- An individual, a resident of United Kingdom, was the Chief Executive Officer of CPL Jersey and was also a common director of Exevo Inc. US and CRIPL. This individual had also entered into a business advisory agreement with CRL Mauritius *vide* which he was appointed as a consultant to advise the group on mergers, acquisitions, sale of subsidiaries, etc., as may be required.

- An advance ruling was sought in respect of (a) Levy of income-tax in India on gains arising from the above transactions, and (b) consequently, tax withholding obligation of the acquirer under section 195 of the Income-tax Act, 1961 (the Act).

Issues before the AAR

With respect to capital gains from the above-mentioned transactions, the key questions before the AAR were as follows:

- Whether the transferor is justified in taking a view that capital gains should not be chargeable to tax in India, as per the provisions of Article 13(4) India-Mauritius tax treaty?

- Whether the transferor is justified in taking a view that earn-out consideration would be a part of the full value of consideration?

- Whether the acquirer of shares is required to withhold tax under section 195 of the Act on the income chargeable to tax in India, in the hands of CRL Mauritius and CMRL Mauritius from the sale of shares?

Revenue's contentions

The Revenue contended the following:

- The transactions have been arranged and devised so as to avoid the transactions being taxed in India by invoking the India-Mauritius tax treaty.

- The beneficial owner of shares was CPL Jersey (since shares in Indian companies were held through wholly-owned subsidiaries of CPL Jersey). Given that there was no Double Taxation Avoidance Agreement between India and Jersey, capital gains arising from the above mentioned transactions were taxable in India under the provisions of the Act.

- TRC is not conclusive, though it is *prima facie* to be accepted. The position adopted by the Supreme Court in the case of Azadi Bachao Andolan[2] has been modified to an extent by Vodafone International Holdings BV[3].

- If the tax residence of the companies is to be determined on the basis of its place of management, then the effective place of management of the two Mauritius transferors would be the place of residence of individual who was authorised to take care of the details of the transactions under consideration (i.e. United Kingdom).

- Capital gains arising by transfer of assets in India should suffer tax in one jurisdiction or the other. Since capital gains is not actually taxed in Mauritius and is liable to tax only in India, one cannot rely on the India-Mauritius tax treaty to evade tax.

- The Revenue did not specifically deal with the position or contradict the stand that earn-out is part of full value of consideration.

Applicants' contentions

The Applicants contended the following-

- The transactions undertaken were legally permissible between legal entities. The amount invested in CRIPL was not sourced from shareholders of

[2] UOI *v.* Azadi Bachao Andolan [2003] 263 ITR 706 (SC)
[3] Vodafone International Holdings BV *v.* UOI [2012] 341 ITR 1 (SC)

CRL Mauritius and was funded from operational income of CRL Mauritius. Therefore, it was not a case of round tripping. Even if the funds were made available by investors, the Mauritian shareholder, being a company, cannot be deprived of ownership of shares.

- The two Mauritius transferors were entitled to claim benefit under the India-Mauritius tax treaty by virtue of section 90(2) of the Act. Even in respect of capital gains arising from sale of shares, which derive substantial value from assets located in India, tax treaty benefits can be availed of. (It may be noted that transfer of such assets is taxable in India, by virtue of amendment made by the Finance Act, 2012, retrospectively effective from 1 April 1961.)

- In light of the observations of the Supreme Court in the decision of Azadi Bachao Andolan (above)-
  - TRC of the seller entities should be accepted.
  - Even if no capital gains is actually taxed or is chargeable to tax in Mauritius, as per the provisions of the India-Mauritius tax treaty, the jurisdiction to tax capital gains arising in the present case, would still be with Mauritius.

- The fact that capital gains are not taxed in Mauritius cannot be a reason for holding that the sale of shares by Mauritius companies involves a scheme of avoidance of tax.

- The control and management of the transferor companies was vested with the Board of Directors in Mauritius. Authority delegated to an individual for taking care of the details of the sale transaction and his role did not amount to control and management of the companies.

- The test of beneficial ownership should not be applied in the given circumstances and that the legal ownership of the shares vested in the company that held it. Every corporation is an independent legal entity. The fact that the owner company was a 100% subsidiary of another company will not alter the legal ownership.

- Earn-out consideration was a part of the sale consideration and hence, it will form part of the capital gains. Accordingly, the rules of taxing capital gains shall apply to the earn-out consideration.

Ruling by the AAR

The AAR ruled as follows in favour of the Applicants:

- Relying on the Supreme Court decision in the case of Azadi Bachao Andolan (above), the AAR held that what is relevant in the context of the tax treaty is not whether the income is actually taxed in Mauritius, but whether in terms of the tax treaty, it can be taxed in Mauritius. The AAR is bound by the decision of the Supreme Court and the contention raised by the Revenue in this regard cannot be entertained by the AAR.

- Effective management of the companies is from the place where the Board of Directors function. Normally, the management of the company vests in its Board of Directors. There was nothing on record to show that the management of the companies in Mauritius, in general, was not with the Board of Directors of the companies in Mauritius. The role of the individual functioning under the business advisory agreement did not appear to be in connection with running the business of the companies concerned. As a result, on an application of the place of management test, the AAR ruled in favour of the Applicants, that the transferor companies were tax residents of Mauritius.

- In case of a company which is an independent legal entity, the theory of beneficial ownership does not prevail over the apparent legal ownership. Company law also recognises the recorded owner of the shares and not the person on whose behalf it may have been held.

- Earn-out would be a part of the full value of consideration receivable.
- In view of the above, CRL Mauritius and CMRL Mauritius can claim the benefits of India-Mauritius tax treaty. Therefore, the capital gains arising on sale of shares should be taxable only in Mauritius by virtue of Article 13(4) of the tax treaty.
- Since the two transferor Mauritius companies are not chargeable to tax in India, the buyer was not liable to withhold tax under section 195 of the Act.

Conclusion

From the ruling, it may be inferred that-

- In case of a corporate assessee, the legal ownership of the asset cannot be ignored, to look into the beneficial ownership, for the purpose of capital gains taxation under the India-Mauritius tax treaty.
- The place of management test of the company is normally to be applied based on the jurisdiction from where the Board of Directors functions, unless there is evidence to the contrary.
- Given the provisions of the India-Mauritius tax treaty, tax cannot be levied in India on capital gains, even if the same is not taxed in Mauritius.
- The tax treaty benefits should be granted in respect of transfer of shares of an offshore company, deriving value from Indian assets. It may be noted that this is the first Ruling, after the Finance Act, 2012 came into force, where the tax treaty benefits in respect of such transfers were claimed.
- Earn-out consideration is a part of the sale consideration and hence, it will form part of the capital gains and the rules of taxing capital gains shall apply to the earn-out consideration.

It may be noted that advance rulings are binding on the Revenue and the applicant only in respect of the transaction under consideration and in regard to the questions on which the ruling is pronounced. However, these may have persuasive value. Further, it would be important to note that recently Supreme Court in the case of Columbia Sportswear Company[4] has held that earlier decisions of the AAR on a particular issue are binding on the AAR in future.

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[4] Columbia Sportswear Company *v*. DIT [TS-549-SC-2012] [PwC News Alert dated 7 August 2012. [http://www.pwc.com/in/services/tax/news_alert/2012/pdf/pwc_news_alert_7_august_2012_columbia_sportswear_company.pdf]]

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