

For SPV controlled and managed in Mauritius, capital gains on sale of shares in Indian company held to be taxable in Mauritius only

September 9, 2016

In brief

The Authority for Advanced Ruling (AAR) held that the applicant, a tax resident of Mauritius, holding a Mauritian tax residency certificate (TRC) with entire control and management of its affairs situated in Mauritius, was entitled to benefit under Article 13(4) of the India-Mauritius Double Taxation Avoidance Agreement (tax treaty). The AAR rejected the Income-tax Department's contention that the applicant was incorporated without any "economic substance" with the sole purpose to hold shares to facilitate tax-neutral share transfer, and that control and management of its affairs was situated in India.

In detail

Facts

- The applicant¹ was incorporated in Mauritius on 9 May, 2005 and held a valid TRC issued by the Mauritian revenue authorities.
- M Ltd, a company incorporated in Mauritius, held 57% and B Ltd, UK held 43% of the applicant's shares.
- On 28 December, 2004, T Limited (then an unlisted company) and A Inc. had entered into a software and professional services agreement (agreement 1) wherein it was understood between the parties that A Inc. could become a shareholder of TML if it generated/ achieved a certain amount of business for T Limited.
- On 10 May 2005, the applicant along with A Inc., B Ltd, M Ltd and T Ltd entered into an option agreement, under which A Inc., on achieving certain milestones, was entitled to purchase up to 9,931,638 shares of T Limited from the applicant.
- Subsequent to the above, on 9 July 2005, the applicant acquired 9,931,638 shares in T Limited at a price of INR 67 per share.
- T Limited was subsequently listed on the Bombay Stock Exchange and the National Stock Exchange.
- T Limited filed a draft prospectus (for listing on stock exchange) in 2006, which mentioned that the agreement 1 was not acted upon.
- On 22 March 2010, A Inc. exercised the option to purchase the shares of T Ltd. Consequently, the applicant sold 9,870,912 T Ltd shares and earned a long-term capital gain of INR 910.1 million.
- The applicant had approached the AAR for a ruling on the taxability of the above capital gains in India. Initially, the AAR² refused to give a ruling on the ground that the arrangement of the share issue and transfer was designed to circumvent the Securities and Exchange

¹ AAR No 991 of 2010

² (2012) 24 taxmann.com 296 (AAR)

Board of India (SEBI) Guidelines,³ and thus impaired public interest. The AAR stated that it could not ignore this illegality, even if no tax avoidance motive existed. However, on a writ petition to the Bombay High Court, considering the clarification from the SEBI that there was no breach of guidelines, the High Court restored the matter to the AAR for its ruling.

Issues before the AAR

- Whether, in view of Article 13(4) of the tax treaty, the applicant, a tax resident of Mauritius, was chargeable to tax in India on capital gains arising on sale of shares in T Ltd to A Inc.?
- If the applicant was found chargeable to tax in India, would the applicable tax rate be 10% under section 112(1) of the Income-tax Act, 1961 (the Act)?

Revenue's contentions

- The applicant was a nominee of the founder-companies M Ltd and B Ltd, and its only activity was the acquisition of shares of T Ltd and holding them for transferring to A Inc. as per the option agreement.
- The incorporation of the applicant had no economic substance and had the sole purpose of holding the shares to facilitate a tax neutral transfer of shares as mandated in the option agreement.
- Further, the applicant's financial statements showed no business activity other than holding investment in T Ltd.

- On the basis of the option agreement, the following conclusions were reached:
 - i. The actual transaction occurred between T Limited and A Inc.
 - ii. The incidence of tax on the sale of shares by T Ltd to A Inc. was transferred through a holding structure and a series of agreements to enable the applicant to take advantage of the tax treaty.
 - iii. Control and management of the applicant's affairs remained in India; therefore, the applicant was a resident in India as per the Act.
 - iv. Therefore, the income earned by the applicant on the sale of shares was taxable in India.

Applicant's contentions

- According to Article 13(4) of the tax treaty, capital gains arising to a Mauritius resident from alienation of shares covered therein were liable to tax only in Mauritius.
- Based on the Circulars⁴, upheld in the Azadi Bachao Andolan⁵, as the applicant had a valid TRC, it was entitled to the benefits of the tax treaty.
- The Revenue's contention that it was incorporated merely for the purpose of transferring shares of T Ltd to A Inc. was factually incorrect as, after the sale of shares to A Inc., it continued to hold shares in T Ltd without any obligation to sell the same to anyone.
- It was incorporated for a commercial purpose, and the law did not prohibit

incorporation of a company for a special purpose.

- Based on Supreme Court judgements,⁶ a Bombay HC decision,⁷ and the following facts, it contended that the control and management of its affairs were neither wholly nor partially situated in India:
 - i. Financial statements were maintained at the registered office in Mauritius and were audited by the Statutory Auditors resident in Mauritius. Further, all corporate and legal compliances were done as per Mauritian domestic laws. Banking transactions were conducted through a bank account in Mauritius.
 - ii. Its Board of Directors comprised of three directors resident in Mauritius, one director resident in the United Kingdom and one director resident in India. All board meetings had been held and chaired in Mauritius, and decisions related to financial matters, approval of financial budgets and statements, decisions on declaration of dividends, decisions on buy-back of shares, and decisions in respect of shares in question, including the control of the option agreement, were made in such meetings held in Mauritius.
 - iii. All shareholders' meetings were held in Mauritius.

AAR's ruling

- The Revenue's contentions that the applicant was holding shares only for ultimately transferring the same to A Inc., and that the applicant

³ Clause 2.6.1 of SEBI (Disclosure and Investor Protection) Guidelines, 2000

⁴ Circular No.789 dated 13 April, 2000 and Circular No.682 dated 30 March, 1994

⁵ Union of India v. Azadi Bachao Andolan and Ors (2003) 263 ITR 706

⁶ Erin Estate v. CIT 34 ITR 1 and NM Subbayya Chettiar v. CIT 19 ITR 168

⁷ Narottam v. CIT 1953 23 ITR 454

was not set up for a commercial purpose, were misplaced.

- The option provided to A Inc. for purchasing T Ltd shares on achieving pre-determined milestones was only to motivate A Inc. to generate business for T Ltd. The AAR further commented that there was nothing unusual in such an agreement.
- The main issue to be addressed was whether the control and management of affairs of the applicant was situated wholly in India. The AAR observed the following, and concluded that the control and management of affairs of the applicant was not wholly situated in India:

i. Based on facts and judicial

precedents presented by the applicant, it could not be said that the control and management of the affairs of the applicant were wholly situated in India.

- ii. The Revenue's only argument was that the real transaction was between T Ltd and A Inc., and therefore, the control and management of the applicant should have been treated as in India. There was no force in this argument. The Department did not produce any substantial evidence to show that any important affairs of the company relevant for the purpose of the Act were being controlled from India.
- In view of the above, it ruled that Article 13(4) of the tax treaty would apply, and that the applicant would not be

chargeable to tax in India.

- Since the income in question was not taxable in India, the AAR did not rule in relation to the applicable tax rate in India.

The takeaways

- In this ruling, the AAR appears to have given sufficient weightage to the business purpose of entering into the option agreement.
- The ruling has re-iterated the basic criteria for determination of place of control and management of affairs of a company.

Let's talk

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

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

About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.

In India, PwC has offices in these cities: Ahmedabad, Bengaluru, Chennai, Delhi NCR (Gurgaon), Hyderabad, Kolkata, Mumbai and Pune. For more information about PwC India's service offerings, visit www.pwc.com/in

PwC refers to the PwC International network and/or one or more of its member firms, each of which is a separate, independent and distinct legal entity in separate lines of service. Please see www.pwc.com/structure for further details.

©2016 PwC. All rights reserved

Follow us on:



For private circulation only

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PwCPL, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. Without prior permission of PwCPL, this publication may not be quoted in whole or in part or otherwise referred to in any documents.

© 2016 PricewaterhouseCoopers Private Limited. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers Private Limited (a limited liability company in India having Corporate Identity Number or CIN : U74140WB1983PTC036093), which is a member firm of PricewaterhouseCoopers International Limited (PwCIL), each member firm of which is a separate legal entity.