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AAR holds that capital gains arising from transfer of shares held by a Mauritian company in an Indian company is not liable to tax in India

The Authority for Advance Ruling ("AAR") has delivered a landmark ruling on taxability of capital gains arising on the transfer of shares of an Indian Company held by a Mauritian Company. The AAR has ruled that such gains will be liable to tax only in Mauritius as per the Tax Treaty between India and Mauritius.

Facts of the case

- E*Trade Mauritius Limited ("E*Trade Mauritius") is a tax resident of Mauritius holding a valid Tax Residency Certificate ("TRC"). E*Trade Mauritius was a subsidiary of Converging Arrows Inc USA, which was in turn a subsidiary of E*Trade Financial Corporation ("E*Trade US").

- E*Trade Mauritius held 43.85 percent of the equity share capital of Infrastructure Leasing and Financial Services Investmart Ltd ("ILFS Investmart"), a listed company in India. It sold its entire holding in ILFS Investmart to HSBC Violet Investments (Mauritius) Limited ("HSBC Mauritius") under a private arrangement. E*Trade Mauritius did not have any Permanent Establishment in India.

- E*Trade Mauritius made an application under section 197 of the Income-tax Act, 1961 ("the Act") for a Nil withholding certificate from the Assistant Director of Income-tax ("ADIT") for sale of shares of ILFS Investmart to HSBC Mauritius. However, the ADIT rejected the application and held that the capital gains was liable to tax in India at the rate of 21 percent on the basis that E*Trade Mauritius was a mere shell company and the real owner of the shares was E*Trade US.

Upcoming Events

- Transfer Pricing Documentation and Dispute Resolution: Making or Breaking the Corporate Tax
- Workshop on 'Successful EPC Contracting in India – Addressing Fiscal and Legal Challenges', May 13-15, 2010, New Delhi, India

Awards & Recognitions

- BMR Advisors ranked second most active transaction advisor (Private Equity) in 2009, Venture Intelligence League Table
- BMR ranked Tier 1 Tax Transactional Firm, International Tax Review's online poll, 2010
- BMR is Transfer Pricing Firm of the Year and wins India Case of the Year award, International Tax Review Asia Awards, 2009

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- E*Trade Mauritius filed a writ petition before the Bombay High Court against the order of the ADIT. However, the High Court referred the case back to the Revenue Authorities (“RA”) and also ordered HSBC Mauritius to deposit the entire tax on the capital gains. E*Trade Mauritius filed a petition for revising the order of the RA before the Director of Income-tax (International taxation) (“DIT”) under section 264 of the Act. However, the DIT rejected the contentions of E*Trade Mauritius and held in favour of the RA. Thereafter, the Court allowed the RA to draw the capital gains tax deposited by HSBC Mauritius.

- In this background, E*Trade Mauritius applied to the AAR seeking a ruling on whether the capital gains arising from transfer of shares of ILFS Investmart by E*Trade Mauritius to HSBC Mauritius would be liable to tax in India.

Main issue before the AAR

- Whether capital gains on sale of shares of Indian Company by E*Trade Mauritus are liable to tax in India?

- If the capital gain was liable to tax in India, whether the applicant was liable to pay tax at the rate of 10 percent as per proviso to section 112(1) of the Act?

Applicant’s contentions

- The Central Board of Direct Taxes (“CBDT”) had clarified in its Circular No 682 dated March 30, 1994 that capital gains arising to a resident of Mauritius on transfer of shares in an Indian company would be liable to tax only in Mauritius. Further, the CBDT clarified in its circular No 789 dated April 13, 2000 directing the RA to accept the Tax Residency Certificate (“TRC”) issued by the Mauritius authorities as a conclusive proof of residence and beneficial ownership of the shares.

- The Supreme Court in the Azadi Bachao Andolan ruling has analysed all relevant issues relating to the applicability of the Circular for the purpose of claiming the tax benefit under the provisions of the Tax Treaty between India and Mauritius and upheld the validity of the circular issued by the CBDT.

- Enquiry on beneficial ownership would be an unnecessary exercise in view of the above CBDT circular, which were binding on the RA as held by the Supreme Court ruling in the case of *Azadi Bachao Andolan*.

Revenue’s contentions

- The Revenue contended that beneficial ownership vests with E*Trade US while

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the legal ownership was with E*Trade Mauritius and hence, capital gain from the transaction would arise for E*Trade US.

- The DIT had, in the revision order, taken a prima facie view that capital gains would be taxable in the hands of E*Trade US and that DIT has concluded that further enquiries would be required for conclusively determining that E*trade US was the beneficial owner. The Revenue further contended that it would be inappropriate to give a ruling on the issue at this stage as the RA have not arrived at a definite conclusion.

- The Revenue contended that term 'beneficial ownership' referred in the CBDT Circular was only with respect to the Article in the Tax Treaty dealing with dividends and that it cannot be extended for capital gains.

- The Revenue contended that Share Purchase Agreement was not signed by an employee or director of E*Trade Mauritius and that E*Trade US had negotiated the sale of shares of ILFS Investmart.

- The Revenue further observed that the funds for investments in shares originated from E*Trade US and that the dividend amount received from ILFS Investmart was remitted to E*Trade US as a reimbursement of excess funds. Based on this, it contended that the transaction should be regarded as sham, despite the ruling in *Azadi Bachao Andholan*.

Ruling of the AAR

- The term 'beneficial ownership' used in the CBDT Circular applies to dividends and capital gains.

- The shares were registered in the name of E*Trade Mauritius and ILFS Investmart has recognized it as a shareholder. E*Trade Mauritius also received dividends and it has, through it secretary, entered into a Share Purchase Agreement with HSBC Mauritius. Therefore, E*Trade Mauritius should be regarded as the legal owner of the shares.

- The AAR observed that the E*Trade Mauritius received funds for the purchase of the shares of its parent company by way of capital contributions and loans, and did not draw any adverse inference based on this fact.

- The AAR observed that treaty shopping and the underlying objective of tax avoidance/mitigation cannot be apparently equated to a colourable device. The AAR further observed that a transaction entered into by a conduit entity in order to take advantage of the tax relief which is available in the Treaty between the

conduit entity and the company with which transactions has been entered into cannot be declared invalid. The AAR further observed that the motive behind the setting up of a conduit entity is not material to judge the validity of the transaction.

- The fact that source of funds is traced to the holding company or that the holding company had negotiated the sale transaction or the fact that the consideration ultimately goes to the parent company in the form of dividends or by capital reduction does not lead to an inference that the holding company should be regarded as the owner of shares.

- The fact that E*Trade US exercises control over E*Trade Mauritius does not dilute the separate legal status of E*Trade Mauritius.

- The AAR relied on the Azadi Bacho Andholan ruling and the CBDT Circular and held that capital gains arising from transfer of shares by E*Trade Mauritius to HSBC Mauritius is not liable to tax in India.

- The AAR also held that it did not have the authority to restrain the RA from enquiring from E*Trade US, but observed that inquiry should be within the legal position laid down in its ruling and in that of the Supreme Court.

BMR comments and analysis

This is a significant ruling where the AAR has reiterated the principles laid down by the Supreme Court in Azadi Bachao Andholan ruling. The Supreme Court had also ruled that the issue of "Treaty Shopping" should be left to the discretion of the Executive as it is dependent upon several economic and political considerations and that the Courts cannot judge the legality or otherwise of treaty shopping. The AAR has also concurred with this principle.

This ruling should bring relief to the companies with Mauritius holding structure. Despite a comprehensive ruling by the Supreme Court, the Revenue continues to be aggressive in its approach on denying the Tax Treaty benefit for capital gains arising from sale of shares by a Mauritius company. Apart from E*Trade's case, the Revenue had adopted similar approach on several high profile cases.

While the ruling of the AAR is binding only for the applicant, it would encourage several other companies to apply to the AAR to secure a ruling in their cases as well.

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