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EY Tax Alert

AAR ruling on taxation of capital gains arising from sale of shares of Indian company under India-Mauritius DTAA



Executive summary

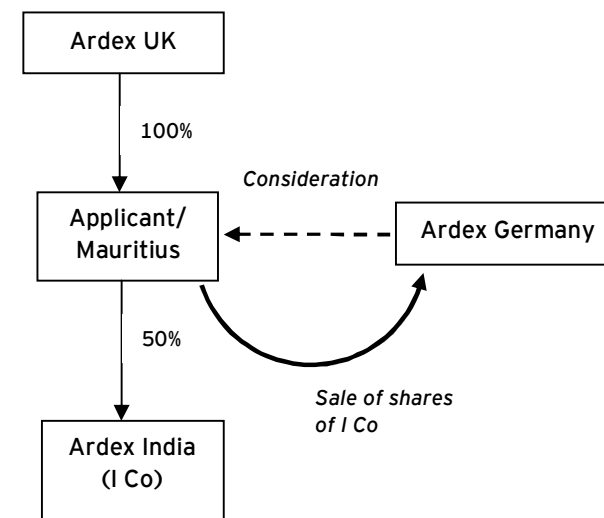
This Tax Alert summarizes a recent ruling of the Authority for Advance Rulings (AAR) in the case of Ardex Investments Mauritius Ltd. (Applicant) [AAR No. 866 of 2010] on the taxation of capital gains arising from the proposed transfer of shares held in an Indian company by the Applicant, which is the wholly-owned subsidiary of a UK company. In light of the earlier Supreme Court (SC) decision in the case of Azadi Bachao Andolan^[1], the AAR held that gains arising to the Applicant from sale of shares of the Indian company will not be taxable in India in view of provisions of the India-Mauritius Double Taxation Avoidance Agreement (Mauritius DTAA). The AAR also held that the Applicant would be entitled to receive sale proceeds, without deduction of tax at source, but would be required to file its return of income in India in respect of the proposed transaction.

Background

- ▶ Gains on sale of shares of an Indian company are taxable as capital gains in India, under the Indian Tax laws (ITL). Under the Capital Gains article of the Mauritius DTAA, gains on alienation of shares are taxable only in the country where the alienator is a resident. Hence, capital gains arising to a Mauritian tax resident on alienation of shares of an Indian company are taxed only in Mauritius.

- ▶ The above position is confirmed by an administrative circular^[2] and the SC ruling in the case of Azadi Bachao Andolan (*supra*). Furthermore, the circular states that a Tax Residency Certificate (TRC) issued by the Mauritius Tax Authority constitutes sufficient evidence for accepting the status of residence, as well as beneficial ownership, for invoking DTAA provisions. This was also upheld by the SC in the case of Azadi Bachao Andolan.
- ▶ The Applicant is a company incorporated in Mauritius, holding a TRC issued by the Mauritius Tax Authority. The Applicant is a wholly-owned subsidiary of its UK parent company, Ardex Holdings UK Ltd. The Applicant held 50% shares in Ardex Endura (India) Pvt. Ltd. (Ardex India), which is proposed to be sold to its German group company (Ardex Germany), at fair market value prevailing at the time of the proposed sale.
- ▶ The Applicant was originally created in 1998 by another UK holding company (an unrelated party to Ardex Group) and the Applicant had made substantial investments in the Indian company (now Ardex India). In November 2001, the Ardex Group took a decision to acquire the Applicant with a view to expand its business.

The transaction is pictorially depicted below:



Issues for consideration

- ▶ Whether the capital gains on the proposed sale of shares of Ardex India by the Applicant would be chargeable to tax in India in the hands of the Applicant under the Mauritius DTAA.
- ▶ Whether the Applicant would be entitled to receive the sale proceeds of shares of Ardex India without deduction of tax at source.
- ▶ Whether the Applicant would be required to file a return of income in India in respect of the proposed transfer of shares of Ardex India.

^[1] [263 ITR 706]

^[2] CBDT Circular No. 789 dated 13 April 2000

Tax Authority's contentions

- ▶ The Applicant is a wholly-owned subsidiary of Ardex UK. The Applicant had no income and its only asset was the investment in Ardex India.
- ▶ The source of all the funds of the Applicant was Ardex UK and the beneficial ownership of the shares vested in Ardex UK.
- ▶ The decision to sell the shares in Ardex India was taken by Ardex UK and the Applicant had to follow the decision in full.
- ▶ Ardex UK intended to take advantage of the beneficial capital gains provisions under the Mauritius DTAA by creating a subsidiary in Mauritius, a façade, to hold and sell the shares held in Ardex India.
- ▶ Under these circumstances, the corporate veil may be lifted. On so piercing the corporate veil, it is clear that it is Ardex UK that had invested funds in the purchase of Ardex India shares and, hence, gains on the proposed transfer of the shares accrued to Ardex UK. Consequently, UK DTAA, and not Mauritius DTAA would be applicable.

Applicant's contentions

- ▶ The allegation that the Applicant was created by the Ardex Group is not correct and justified. This

is because the Applicant was created in 1998 by another UK holding company and the Applicant had made substantial investments in the Indian company. Only in November 2001, the Ardex Group took a decision to acquire the Applicant with a view to expand its business.

- ▶ The decision to transfer the shares held by the Applicant to Ardex Germany was taken by the Board of Directors of the Applicant, and not by Ardex UK.
- ▶ It was the Applicant that made the investment in Ardex India, and not its UK holding company. The Applicant owned the shares of Ardex India, which was evident from the share certificates furnished. The investment in India was made legally and by following the relevant procedure.
- ▶ The Applicant was a separate legal entity and the beneficial ownership of the shares vested in its hands. Accordingly, there was no justification to lift the corporate veil.
- ▶ The Applicant is a tax resident of Mauritius and the Mauritius DTAA would be applicable in the present case. The TRC constituted a valid and sufficient evidence of residential status under the Mauritius DTAA. Reliance in this regard was placed on the SC decision in the case of Azadi Bachao Andolan, as well as the ruling given by the AAR in the case of E*Trade Mauritius^[3].

^[3] [324 ITR 1]

Ruling of the AAR

- ▶ It is true that the funds for acquisition of shares in Ardex India were provided by the principal, a UK company^[4]. However, the shareholding arrangement has not come about all of a sudden. The shares were first purchased in the year 2000 and the shareholding was steadily increased in 2001, 2002 and 2009. This is not an arrangement which has come into existence all of a sudden. It is not clear how far the theory of beneficial ownership may be invoked to come to the conclusion that the holder of shares in Ardex India is the UK company.
- ▶ Formation of the Mauritius subsidiary and the selling of shares held in the Indian company may be an arrangement to take advantage of the Mauritius DTAA. But this, by itself, cannot be viewed or characterized as objectionable treaty shopping. In view of the decision in the case of Azadi Bachao Andolan, treaty shopping, itself, is not taboo and, furthermore, this decision would stand in the way of further probe on this issue. Furthermore, the SC decision in the case of McDowell^[5] did not deal with treaty shopping, only the SC, in Azadi Bachao Andolan, provided guidance in this behalf.
- ▶ The AAR may have little leeway in considering whether such a transaction is designed to avoid

^[4] The AAR provides reference only to the 'UK company' in the ruling. It may be inferred that the reference is to the original UK parent company and also to Ardex UK, subsequent to the acquisition in November 2001.

^[5] [154 ITR 148]

tax. The transaction under consideration is that of sale of shares. It may be possible to take note of the steps taken to bring about the present transaction to ascertain whether there was a scheme devised to avoid tax. However, in this case where the shares were held for a considerable length of time, (i.e., more than 10 years), before they are sought to be sold by way of a regular commercial transaction, it may not be possible to go into an inquiry as to who made the original investment for the acquisition of the shares and the consequences arising therefrom.

- ▶ Even if it is a case of treaty shopping, still, in light of the SC decision in Azadi Bachao Andolan, no further inquiry on the question of treaty shopping is warranted or justified on the aspect of eligibility of the beneficial capital gains provisions under the Mauritius DTAA.
- ▶ This is not a case of so called gift or transfer without consideration of shares that is contemplated, but a sale at market rate.
- ▶ Thus, the capital gains arising on the proposed sale of shares by the Applicant to Ardex Germany is not chargeable to tax in India, in view of the provisions under the applicable Mauritius DTAA.
- ▶ The Applicant would be entitled to receive the sale proceeds without the deduction of tax at source, but is, however, required to file its return of income in India in respect of the proposed transfer of shares. Reliance in this regard was placed on the AAR ruling in the case of VNU International ^[6].

[6] [53 DTR (AAR) 189]

Comments

The use of the Mauritius DTAA for structuring acquisitions has been subject to controversy over the last several years. While certain rulings have provided comfort on the eligibility of benefits under the DTAA based on a TRC and the SC decision in the case of Azadi Bachao Andolan, there have been instances in the recent past where this has become a vexed issue, subject to scrutiny by the Tax Authority and the Courts. In such situations, attempts have been made to determine the underlying nature of the transaction by lifting the corporate veil, to establish the beneficial owner of the shares.

The present AAR ruling, upholding the non-taxability of the gains in India under the Mauritius DTAA, is based on the SC decision in the case of Azadi Bachao Andolan and affirms that applicability of a DTAA cannot be ignored even if the transaction involves treaty shopping. It would be pertinent to analyze the impending decision of the SC in the case of Vodafone to determine the impact the judgment may have on treaty shopping and other related issues.

The present ruling also clarifies that taxpayers would still need to consider complying with a tax return filing obligation even if the gains are not taxable under the DTAA.

A ruling by the AAR is binding only on the applicant, in respect of transaction in relation to which the ruling is sought and on the Tax Authority, in respect of the applicant and the said transaction. However, it does have persuasive value and the Courts in India, the Tax Authority and the appellate authorities do recognize

the principles and ratio laid down by the AAR, while deciding similar cases.

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