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TAX FLASH NEWS

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Capital gain of a Mauritian company on the sale of shares of an Indian company is not taxable under the pre-amended India-Mauritius tax treaty

Executive summary

Availment of capital gain related benefit under the India-Mauritius tax treaty (the tax treaty) has been a matter of debate from a long time. The tax department had been rejecting the benefit of the tax treaty due to several reasons like lack of commercial rationale, substance test, beneficial ownership, etc. The Supreme Court, in the case of Azadi Bachao Andolan[1], dealt with this issue and provided the benefit of the tax treaty to the taxpayer. After the Supreme Court decision, some of the Courts/Tribunal have granted the benefit under the tax treaty. However, in a few cases, the Courts/Tribunal have not granted the tax treaty benefit by applying anti-avoidance measures like substance test, etc.

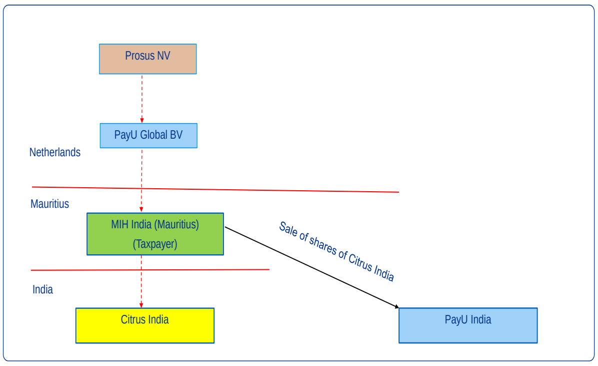
Recently, the Delhi Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of MIH India (Mauritius) Ltd[2] (the taxpayer) dealt with the issue of taxability of capital gains on the sale of shares of an Indian company under the pre-amended tax treaty. The Tribunal held that the capital gains earned by a Mauritian company on the sale of shares of an Indian company were not taxable in India as per the pre-amended Article 13(4)[3] of the tax treaty. The taxpayer was not a conduit company. The Assessing Officer (AO) made a desperate and unacceptable attempt to overcome the ratio laid down by the Supreme Court in the case of Azadi Bachao Andolan[4] by anticipating a futuristic event of ratification of a Multilateral Instrument (MLI). Assuming that the beneficial owner was the Dutch company, such capital gains were not taxable even under Article 13(4) of the India-Netherlands tax treaty.

Facts of the case

- The taxpayer, a Mauritius-based entity, was holding equity shares and cumulative preference shares of Citrus India since 2016. The holding company of the taxpayer is PayU Global B.V which in turn is owned by Prosus NV, both incorporated in the Netherlands.

- In 2017, all equity shares and cumulative preference shares of Citrus India were sold to PayU India. The taxpayer claimed that the short-term capital gain from the sale of such shares was exempt under Article 13(4) of the India-Mauritius tax treaty.

- The transaction is depicted in the following diagram:



[1] UOI v. Azadi Bachao Andolan [2002] 125 Taxman 826 (SC)
[2] MIH India (Mauritius) Ltd v. ACIT (ITA No.1023/Del/2022) – Taxsutra.com
[3] The amended India-Mauritius tax treaty provides taxation rights on capital gains arising from the alienation of shares of the company situated in the source country acquired on or after 1 April 2017 to the source country
[4] UOI v. Azadi Bachao Andolan [2002] 125 Taxman 826 (SC)

- The Assessing Officer (AO) held that the taxpayer was not entitled to the tax treaty benefit due to the following reasons:

  - The taxpayer lacks commercial and economic substance.

  - It had no financial strength to invest in the shares of the Indian company and the entire fund was routed through the taxpayer by the Dutch holding company.

  - The effective control and management of the taxpayer were with the holding company. The taxpayer was merely used as a conduit to get the benefit of the tax treaty.

  - Since India had ratified the MLI, there will be a significant change in the legal position established in the Supreme Court's decision in the case of Azadi Bachao Andolan, as the MLI preamble specifically provides for the prevention of opportunities for tax avoidance through treaty shopping.

- The AO also observed that since the effective control and management of the taxpayer was with the Dutch holding company, the provisions of the India-Netherlands tax treaty would apply to the transaction.

Tribunal's decision

Position under the India-Mauritius tax treaty

- Since the shares resulting in capital gain were acquired prior to 1 April 2017, they will not be covered under the amended Article 13 of the tax treaty. The transaction would be governed under the pre-amended Article 13 of the tax treaty and thus entitled to avail the benefit on the strength of TRC.

- The taxpayer was not a conduit company as:

  - It was incorporated in Mauritius in the year 2006 and had a valid TRC.

  - It was carrying on investment activity in India as well as other places.

  - Audited financial statements indicated that it had made substantial investments in India and it also proposed to make additional investments.

  - Shares of Citrus India sold to PayU India are still held by PayU India and have not been sold.

  - Merely because the taxpayer availed loans from its holding company to invest in shares of Citrus India cannot be a reason to treat the taxpayer as a conduit company.

- CBDT Circular No. 789[5] stated that if TRC is issued by the Mauritian tax authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as the beneficial ownership for applying the provisions of the tax treaty. The Circular was upheld by the Supreme Court in the case of Azadi Bachao Andolan. The Tribunal observed that the Supreme Court accepted the contention of the taxpayer that the motives with which the residents have been incorporated in Mauritius are wholly irrelevant and cannot in any way affect the legality of the transaction.

- The AO made a desperate and unacceptable attempt to overcome the ratio laid down by the Supreme Court in the case of Azadi Bachao Andolan by anticipating a futuristic event of ratification of MLI.

- Accordingly, the gain derived by the taxpayer on the sale of shares of Citrus India to PayU India was not taxable in India as per the pre-amended tax treaty.

Position under India-Netherlands tax treaty

- As per Article 13(4) of the India-Netherlands tax treaty, the source state has the authority to tax the capital gain only if the value of shares sold is derived principally from immovable property situated in the source state, other than property in which the business of the company whose shares were sold was carried out.

- Such allegations were not made by the AO in the assessment order before invoking Article 13(4) of the India-Netherlands tax treaty. Further, during the course of the proceeding before DRP or even before the Tribunal, no material was brought on record by the tax department to demonstrate that the condition of Article 13(4) of the India-Netherlands tax treaty was satisfied.

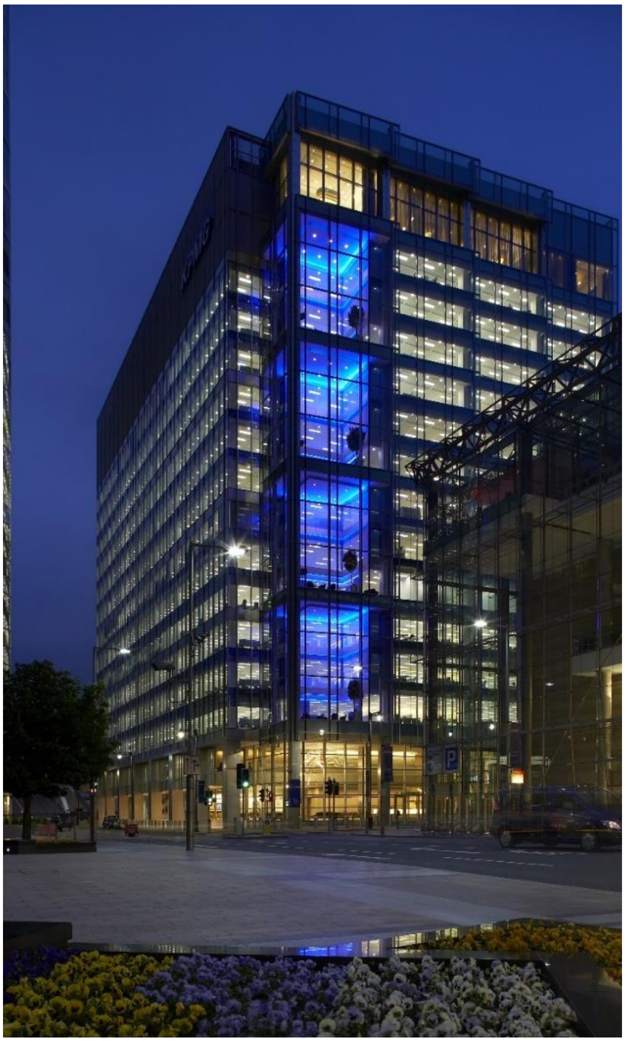
- The short-term capital gain will not be taxable even under Article 13(4) of the India-Netherlands tax treaty.

[5] Circular No. 789, dated 13 April 2009

Our comments

The Tribunal, in the instant case, has reiterated the importance of Circular No. 789 and relied on the Supreme Court decision in the case of Azadi Bachao Andolan to provide the benefit of the pre-amended India-Mauritius tax treaty. Reliance of the tax department on the future event of MLI to deny the tax treaty benefit has been rejected by the Tribunal. This decision can be helpful to argue against the tax department's overly reliance on the MLI in such cases.

The Mumbai Tribunal, in the case of Blackstone FP Capital Partners Mauritius Ltd[6], dealt with the applicability of beneficial ownership provisions to the Capital Gains Article under the India-Mauritius tax treaty. The Tribunal observed that unlike in the dividend or interest Article, which specifically provides for beneficial ownership to claim a treaty protection, there is no such provision in the capital gains article. Therefore, the concept of beneficial ownership is not relevant in the context of the capital gains article.



[6] Blackstone FP Capital Partners Mauritius Ltd [2022] 138 taxmann.com 328 (Mum)

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