



Capital gain arising on transfer of shares of an Indian company is not taxable under the India-Mauritius tax treaty, control and management is held to be outside India

Background

Recently, the Authority for Advance Ruling (AAR) in the case of Mahindra-BT Investment Company (Mauritius) Limited¹ (the applicant) held that the capital gains arising from the transfer of shares are not taxable in India in view of Article 13(4) of the India-Mauritius tax treaty (tax treaty). The AAR while agreeing with the commercial rationale of the holding structure held that there is nothing wrong in the applicant holding the shares of an Indian company and eventually transferring the same to another company which fulfills conditions stipulated in the Option Agreement. The AAR examined the minutes of the Board meetings held in Mauritius where key financial decisions were taken and held that the control and management of the applicant was not wholly in India as contemplated in Section 6(3) of the Income-tax Act, 1961 (the Act).

Facts of the case

- The applicant's shares are held by Mahindra Overseas Investment Co.(Mauritius) Limited, a company incorporated in Mauritius and BT Holding Limited, a company incorporated in the United Kingdom in the ratio of 57:43.
- The applicants Board of Directors comprises of three directors resident in Mauritius, one director resident in the United Kingdom and one director resident in India. The control and management of affairs of the applicant is exercised by the board of directors whose meetings were conducted in and chaired in Mauritius.
- Mahindra & Mahindra Ltd. (M&M), a company incorporated in India and British Telecommunication PLC (BT), a company incorporated in England entered into a joint venture agreement to form Mahindra British Telecom Ltd. (now known as Tech Mahindra Limited (TML) on 19 August 1986. The shares of TML were held by M&M and BT in the proportion of 57:43.
- TML and SBC Services (now known as AT&T) entered into a commercial agreement on 28 December 2004.
- The applicant was incorporated in Mauritius on 9 May 2005. The applicant had acquired 8 per cent holding in TML which is listed on Bombay Stock Exchange and National Stock Exchange in India. The shares were acquired in two tranches in financial years 2005-06 and 2006-07.
- An agreement was entered between TML and the applicant on 23 June 2005 wherein the applicant agreed to subscribe and invest in TML on a partly paid basis. The applicant agreed to subscribe 99,31,638 equity shares at a price of INR67 per share.
- A multiparty agreement named as 'Option Agreement' was executed between AT&T, M&M, BT, TML and the applicant on 10 May 2005. As per the Option Agreement, AT&T will be granted options over the shares representing 8 per cent of the enlarged fully diluted shares of TML upon achieving certain specified milestones.

¹ Mahindra-BT Investment Company (Mauritius) Limited [AAR. No 991 of 2010] - taxsutra.com

- AT&T achieved the milestones and decided to exercise the option. The applicant consequently transferred 98,70,912 shares of TML to AT&T at USD3.5022 per share and realised long-term capital gain of INR900 million (approximately).
- In the instant case, earlier the AAR had held² that it is not bound to give a ruling on the said transactions intended to circumvent SEBI guidelines issued in public interest.
- The matter was taken to the Bombay High Court by the applicant. The High Court noted that the agreement entered into in 2004 between TML and AT&T was not acted upon due to commercial reasons and that the draft prospectus filed with the Securities Exchange Board of India (SEBI) in 2006 had disclosed the agreement entered into by the applicant with AT&T. The High Court restored the questions to the AAR for a ruling holding that there had been no breach of SEBI guidelines and SEBI had not issued any show cause notice or adjudication order for contravention of its guidelines.
- The real transaction was between TML and AT&T, and the incidence of tax on the sale of shares by TML was transferred through a holding structure and series of agreements to the applicant to take advantage of the tax treaty whereas the control and management of the affairs of the applicant remained in India.
- By virtue of provisions of Section 6(3) of the Act, the applicant is a resident of India since the control and management of the affairs of the applicant is situated only in India.

Applicant's contentions

- The applicant is a tax resident of Mauritius, holding a tax residency certificate issued by the Mauritian tax authorities and the control and management of its affairs is situated in Mauritius. To this effect, reliance was placed upon the decision of *Azadi Bachao*³ wherein the validity of Circular 789⁴ was upheld by the Supreme Court.

Issue before the AAR

- Whether the applicant, a tax resident of Mauritius, is not chargeable to capital gains tax in India under Article 13(4) of the India-Mauritius DTAA in respect of transfer of shares of an Indian company to AT&T?

Tax department's contentions

- The applicant is a nominee of the founder companies M&M and BT and its only activity is acquisition of shares of TML and holding the same for transferring to AT&T as per the Option Agreement.
- The incorporation of the applicant was without any economic substance and with a sole purpose to hold the shares to facilitate a tax neutral transfer of shares.
- The shareholder agreement states that the applicant will cease to exist on the execution of the transfer of shares to AT&T. Further, the financial statements of the applicant show no business activity other than holding investment in TML.
- The applicant was set up for a commercial purpose, and there is nothing in the law that prohibits incorporating a company for a special purpose. Even if it is considered to be a special purpose vehicle, it will not make a company wholly controlled and managed from India.
- Mere doing business in one jurisdiction cannot constitute having controlling and directing power in that jurisdiction.
- The applicant even today continues to hold 2,42,904 shares of TML without any obligation to transfer them to AT&T or anyone else.
- The control and management of the applicant was situated outside India since majority of the directors of the applicant were resident outside India, all meetings of the board of directors have been conducted outside India, the statutory books of account and records have been maintained and kept at the registered office in Mauritius.

² Mahindra-BT Investment Company (Mauritius) Ltd. [2012] 24 taxmann.com 296 (AAR)

³ Union of India vs Azadi Bachao Andolan (2003) 263 ITR 706 (SC)

⁴ Circular 789 of 2000 dated 13 April 2000

- All decisions of financial matters, approval of financial budgets and statements, decision on declaration of dividends, buy-back of shares were taken in Mauritius. Also, decision in respect of Option Agreement were taken in Mauritius by the board of directors which included representatives of BT, which held 43 per cent of the applicant's share capital.

AAR Ruling

- Tax department's emphasis on the fact that the applicant was not set up for a commercial purpose and was holding shares only for ultimately transferring the same to AT&T is misplaced.
- With an objective to motivate AT&T to give business to TML, it was agreed commercially between the applicant, TML and AT&T that AT&T would be offered an opportunity to become a shareholder of TML only when it had given a certain level of business to TML for which certain milestones were set. It was only after such milestones were achieved that the option was exercised. There is nothing unusual or abnormal about such conditions in an Option Agreement.
- On perusal of minutes of the board meetings held in Mauritius relating to buy-back of shares, final closing for sale of shares held in TML, appointment of tax advisor, approval of financial statements, dividend declaration and distribution, etc. indicate that the control and management of the affairs of the company particularly all financial affairs were situated only in Mauritius.
- The Supreme Court in the case of VVRNM Subbayya Chettiar⁵ held that the term affairs must mean affairs which are relevant for the purpose of the Act and which have some relation to income. There is no substantial evidence to show that any important affairs of the applicant relevant for the purpose of the Act were being controlled from India.

- AAR placed reliance on the decision of Nandlal Gandhalal⁶ wherein the Supreme Court held that the expression 'control and management' means *de facto* control and management and not merely the right or power to control and manage.
- There is no force in the argument that since the real transaction was between TML and AT&T, the control and management of the applicant should be treated as in India.

Our comments

Applicability of benefit under the India-Mauritius tax treaty vis-à-vis direct or indirect transfer of shares of an Indian company has been a subject matter of litigation before the courts. The AAR in the instant case has held that the applicant is not liable to tax in India in respect of transfer of shares of the Indian company (TML) to a U.S. company (AT&T) by virtue of beneficial provisions of Article 13(4) of the India-Mauritius treaty.

In May 2016, India and Mauritius signed a protocol amending the tax treaty to provide rights to India to tax transfer of shares acquired on or after 1 April 2017. The protocol provides relaxation (tax rate at 50 per cent of domestic tax rate in India) in respect of capital gains arising to Mauritius residents from alienation of shares between 1 April 2017 and 31 March 2019. However, such benefits shall not be available to Mauritius resident who is a shell/conduit company and does not satisfy the business purpose test. The protocol also provides how to consider a company as a conduit or a shell company.

In the present ruling, AAR has also dealt with the issue of residential status of the company on the basis of control and management of the company. The Finance Act, 2015 amended the provisions of Section 6(3)⁷ of the Act to provide that a company is said to be resident in India in any previous year if it is an Indian company or its place of effective management (POEM) in that year is in India. POEM has been defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole, are in

⁵ V.VR.N.M. Subbayya Chettiar v. CIT [1951] 19 ITR 168 (SC)

⁶ CIT vs Nandlal Gandhalal [1960] 40 ITR 1 (SC)

⁷ The Finance Act, 2015 amended the provisions of Section 6(3) w.e.f. 1 April 2016. This amendment has been deferred till 1 April 2017 by the Finance Act, 2016.

substance, made. The Central Board of Direct Taxes has also issued draft guiding principles for determination of POEM of a company.

Even though the ruling of the AAR is binding only on the parties involved in a particular case, the ruling would have a persuasive value in similar matters before the income tax authorities and courts of law.



Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida

6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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