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Article

India-Mauritius Treaty – The long awaited overhaul and its underlying consequences

By **S.Sriram**

The Double Taxation Avoidance Agreement ('DTAA') entered into by India with Mauritius on 24th August, 1982 and made effective from 1st April, 1983 was the first of its kind wherein the right to tax the capital gains arising to a resident of Mauritius from transfer of shares of an Indian company was completely allocated to Mauritius. Tax on dividend received by a resident of Mauritius from an Indian company was also taxable only at 5% under the DTAA which was otherwise taxable at 25% under Section 115A of the Income-tax Act, 1961 ('the Act'). These beneficial treaty clauses enabled the flow of more than USD 90 Billion (which accounted for one third of total investments in India) within a short span of 15 years, into India as Foreign Direct Investment ('FDI') from Mauritius.

Sensing the highly beneficial provisions of the Indo Mauritius DTAA, many entities which were actually being controlled and managed from countries other than Mauritius started setting up shell entities (what are called as 'letter box' companies) in Mauritius, and routed investments into India, though such shell entities. As queries were raised by Revenue Authorities on the eligibility of investment companies to the DTAA, the Central Board of Direct Taxes ('CBDT') vide Circular No 682 of 1994[1] clarified that production of Tax Residency Certificate ('TRC') from the Mauritian Revenue Authorities would suffice entitlement of a Mauritian entity to the DTAA. This Circular was quashed by the Delhi High Court in *Shiva Kant Jha* v. *Union of India*[2] as being ultra vires the Act, but was upheld by the Supreme Court in *Union of India* v. *Azadi Bachao Andolan*[3] as being issued well within the powers of CBDT and also binding on all Revenue Authorities. The Supreme Court laid great emphasis on the need to follow the provisions of a DTAA especially when two governments have consciously agreed to certain terms and extended certain tax benefits keeping in mind the economic necessities prevailing at that time. Any attempt to ignore or override the provisions of a DTAA was held not to be permissible unless there was a bilateral agreement to modify the agreed terms. The Indo-Mauritius DTAA stands modified, with both the Government of India and the Government of Mauritius entering into a Protocol to this effect on 10th May, 2016. This article deals with a few practical implications of the protocol.

a. Gains from transfer of CCDs, options and other structured products would still be taxable in Mauritius only

The protocol, amends Article 13 of the DTAA dealing with 'Capital Gains'. According

1 Circular 682/ 1994 dated 30th March, 1994

2 [2002] 256 ITR 563 (Delhi)

3 [2003] 263 ITR 706 (SC)

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to the amendment, gains from alienation of shares acquired on or after 1st April, 2017 in an Indian company in India is liable to tax in India from 1st April, 2017.

In order to provide a smooth transition, it has been provided that the rate of tax applicable to any gains from sale of shares from 1st April 2017 to 31st March 2019 shall not exceed 50% of the domestic tax rate prevailing in India.

This amendment however does not affect the 'residuary clause' of Article 13. The gains from alienation of movable assets 'other than shares' (and ships/ aircrafts), like compulsory convertible debentures CCDs), call and put options and other structured products qualifying as 'securities' under the Securities Contract (Regulations) Act, 1956, though deriving their value form the underlying shares of an Indian company, would also continue to be tax free in India.

It can be noted that the amendment to Section 9(1)(i) of the Act post the judgment of Supreme Court in *Vodafone International Holdings BV* v. *Union of India*[4] deems any asset in the form of 'any interest' in a foreign company to be regarded as located in India if interest derives, directly or indirectly, its value substantially from assets located in India. However, the Protocol to Mauritius DTAA in so far as providing taxing rights to India only covers gains from alienation of 'shares in a company resident of India'. Shares and other assets that derive their value from shares are clearly distinct assets. Hence, though the transfer of other assets that derive their value from shares located in India can be taxed in India under the Act, even under the amended Mauritius DTAA, such other assets would be taxable only in Mauritius.

This would evolve newer hybrid securities being introduced in the financial market to continue investments in Indian companies while not being hit by the amended provisions of DTAA.

b. Transfer of hybrid instruments converted into shares post 2017 liable to tax in India – earning stripping still an option

While transfer of a hybrid instrument *per se* would not be taxable in India, the transfer of shares allotted upon the instrument's conversion (either compulsorily or voluntarily), would be subject to tax in India.

Section 49(2A) of the Income Tax Act clarifies that for computing capital gains on sale of shares received on conversion of debentures, cost of acquisition of shares shall be cost of convertible debentures. The Punjab and Haryana High Court in *CIT* v. *Naveen Bhatia* [2015] 62 taxmann.com 87 (P&H) has held that the period of holding of such converted shares for computing capital gain tax shall be reckoned from the date of acquisition of convertible instrument. A hybrid instrument would earn interest till the time it is treated as debt and would also reduce the tax liability on transfer of shares allotted on its conversion. A prudent investor can thus take a conscious call to be taxed under the DTAA

4 [2012] 341 ITR 1 (SC)

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so as to adopt an earning stripping to reduce his overall tax liability.

For example, 9% Optionally Convertible Debentures (OCD) of Rs.100 Million is issued in 2010 for being converted into equity in 2020. In 2020, if the underlying value of shares as well as market value of OCD is Rs 225 Million, should the OCD be sold off as such or should they be converted into shares and then transferred? It would appear to an accountant that the OCD holder would be better off selling the OCD at Rs 225 Million instead of receiving shares in lieu of the OCD and then be subject to capital gain tax in India. However, a closer look at the mode of computation of capital gains would show that, if the OCD is converted into shares and then transferred, the transaction would result in a capital loss of Rs 6.15 Million(as computed under Income tax Act) as the cost of acquisition would be computed at Rs 231.15 Million[5]. This tax loss can be used to set off tax liability that may arise from other transactions.

c. Singapore v Mauritius – Mauritius still wins

The DTAA between India and Singapore concluded on 24th January, 1994 provided that the gains derived by a resident of Singapore from alienation of shares of an Indian company would be taxable in India also. Subsequently, to attract more investments from Singapore, the DTAA with Singapore was amended vide protocol dated 29th June, 2005 to provide that the gains derived by a resident of Singapore from alienation of shares of an Indian company would be taxable only in Singapore. The protocol however provided that the benefit extended by India to investments from Singapore would be extended only till the time similar benefit is extended by India to Mauritius. The relevant provision of protocol reads as under;

> *Articles 1, 2, 3 and 5 of this Protocol shall remain in force so long as any Convention or Agreement for the Avoidance of Double Taxation between the Government of the Republic of India and the Government of Mauritius provides that any gains from the alienation of shares in any company which is a resident of a Contracting State shall be taxable only in the Contracting State in which the alienator is a resident.*

Now, with the DTAA with Mauritius being amended with effect from 1st April, 2017, there is possibility to contend that the Protocol between India and Singapore dated 29th June, 2005 would become inapplicable and the provisions of the DTAA signed on 24th January, 1994 would get revived. In any case, it is understood that India is re-negotiating its pact with Singapore to bring the taxing rights amongst the countries as originally agreed in 1994. Even assuming that the 1994 Singapore DTAA is retrieved, Mauritius would still stand a bar above Singapore for the following reasons

(a) The gains derived by a resident of Mauritius from the transfer of shares of

[5] Considering Cost Inflation Index of 711 for 2010 and 1644 for 2020 (estimated based on the fluctuation between 2010 and 2015)

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an Indian company would be taxable in India only if the shares were acquired after 1st April, 2017. In other words, transfer of any shares of an Indian company acquired by a resident of Mauritius on or before 31st March, 2017 would not be subject to tax even if the transfer is executed after 1st April, 2017. On the other hand, transfer of shares of an Indian company by a resident of Singapore would be taxable in India if the transfer is executed on or after 1st April, 2017, irrespective of the date on which the shares were acquired.

(b) The Protocol to DTAA between India and Mauritius provides for a window between 2017 and 2019 for a concessional tax rate of 50% of the applicable tax rate. No such benefit is available under the Singapore DTAA.

(c) Further, capital gain from transfer of movable property other than shares (and ships and aircrafts) by a resident of Mauritius would be taxable only in Mauritius, while such transfer by a resident of Singapore would be taxable in India also.

(d) The Limitation of Benefit clause in the DTAA with Mauritius is less stringent than the DTAA with Singapore.

d. Amendments to other DTAAs in pipeline

Mauritius has been the source of more than one third of all investments made in India. The tax exemption provided by India to the investors from Mauritius for over 30 years has been successfully been renegotiated. This would open the doors for renegotiation for withdrawal of capital gain tax exemption to investors from other countries like Cyprus, Netherland, etc. The relationship that India had developed with Mauritius for over 30 years has ensured that the investments made prior to 2017 are grandfathered with the benefits conferred on them when the investments were made. However, considering the unpleasant environment with other countries like Cyprus, it would be doubtful as to whether the investments made in the past would be protected if the DTAA is amended to tax the gains from such investments in India. Investors should be aware that DTAA with other countries like Cyprus can be amended to tax any gain on transfer of their investments, though such investments were made at a time when no tax was contemplated in India on the transfer of their investment.

e. Taxation of other income under Mauritius DTAA

Apart from the amendment to taxation of capital gains, the DTAA with Mauritius has also been amended to bring in provisions relating to Service Permanent Establishment and for taxation of income from rendering of managerial, technical or consultancy services.

In addition, the Article on 'Other Income' has also been amended to provide that the income arising in India of a nature not dealt with in the other articles would be taxable in India also. Such income was earlier taxable only in Mauritius.

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Thus, income as specified in section 56(2)(viia) of the Act, like income in the nature of gifts etc. would become taxable in India.

f. Introduction of taxation of FTS and Service PE

The Mauritius DTAA was originally based on OECD Model, without providing for taxation of Fee for Technical Services ('FTS') or for Service Permanent Establishment ('Service PE'). In line with international development post signing in 1983, the DTAA has been amended to allocate to India, taxing rights on FTS arising from India and rendition of services through a PE in India.

Every person resident of Mauritius and having any business transaction with India as well as every person resident of India transacting with a person resident of Mauritius should relook at the tax implications on all their transactions *de-novo*, in light of the new protocol between India and Mauritius as well as the recent amendment to the Act.

[The author is a Principal Associate, Direct Tax Practice, Lakshmikumaran & Sridharan, Mumbai]

Notifications and Circulars

Income Declaration Scheme, 2016 - Rules notified

CBDT has issued Notification No. 33/2016 dated 19-5-2016 notifying Income Declaration Scheme Rules, 2016 and also Circular No. 17/2016 dated 20-5-2016 to clarify certain issues on scope of the scheme and procedure to be followed. As per the notification, the Rules will come into effect on 1-6-2016 and provide method of calculating Fair Market Value (FMV) for various assets as also value of interest of a person in a partnership firm. Where investment in any asset is partly from an income which has been subject to tax prior to assessment year 2017-18, the FMV shall be reduced by an amount which bears to the value of the asset as on the 1st day of June, 2016, the same proportion as the assessed income bears to the total cost of the asset. The form for declaration of income or income in form of investment, acknowledgement and intimation of payment of tax, surcharge and penalty have also been provided. Declaration has to be made to the concerned Principal Commissioner or the Commissioner who has the jurisdiction over the declarant and an acknowledgement in Form-2 to the declarant within fifteen days from the end of the month in which the declaration under Section 183 has been furnished.

The Circular issued in this regard clarifies that, in future the declarant will be liable for capital gains under the Income-tax Act on sale of the investment (asset) declared under the Scheme. Also where a search/ survey operation was conducted and the assessment has been completed but certain income was neither disclosed nor assessed, then such unassessed income can be declared under Scheme.

Penalty under Section 271(1)(c) not a disqualification to apply for non-deduction of TDS

A non-resident receiving any sum including interest can make an application to the

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Assessing Officer u/s 195(3) of Income Tax Act, 1961 to grant a certificate authorizing it to receive such sum without deduction of tax at source under Section 195(1). The manner of application has been provided in Rule 29B of Income Tax Rules, 1962. As per clause (iii) of sub-rule (2) of Rule 29B, a non-resident who has been subject to penalty under Section 271(1)(c) was not eligible for making application to the Assessing officer under Section 195(3). By Notification Number 31/2016 dated 5-5-2016, this clause has been deleted.

Commencement of Limitation for Penalty Proceedings u/s 271D and 271E of Income Tax Act, 1961 clarified

In light of the fact that there are conflicting interpretations of various High Courts on the issue as to whether the limitation for imposition of penalty under Section 271D and 271E of the Income Tax Act, 1961 commences at the level of Assessing Officer (below the rank of Joint Commissioner of Income Tax) or at the level of Joint Commissioner of Income Tax, CBDT has issued the circular to clarify the 'Departmental View'. It has been clarified by Circular No. 09/2016 dated 26-4-2016that the penalty has to be initiated at the level of Joint Commissioner and the initiation of penalty by an officer below the rank of Joint Commissioner is inconsequential. CBDT has thereby directed Assessing Officers (below the rank of Joint Commissioner of Income Tax) to intimate the contravention of provisions of Section 296SS and 269T to the Range Head who will issue the notice for initiation of penalty proceedings and will complete the penalty proceedings. It has also been clarified that the circular represents 'Departmental View' and the circular would not be operative in a jurisdiction where the jurisdictional High Court has taken a stand contrary to that of the Circular.

Payment of interest on refund of excess TDS deposited under Section 195 – Clarification issued

Circular No. 11/2016 dated 26-4-2016 advises field formation to not file appeals regarding eligibility of interest on refund of excess TDS. This is based on the order of the Apex Court dated 26-2-2014 in *TATA Chemical Limited*, Civil Appeal No. 6301/2011 in which the Apex Court held that refund is debt owed by the Revenue and obligation to refund money received and retained without right carries with it a right to interest. Thus, if a resident deductor is entitled for the refund of tax deposited under Section 195 of the Income Tax Act, 1961 then it has to be refunded with interest under Section 244A of Act, from the date of payment of tax.

Business of printing, printing and publishing – Additional depreciation allowable

Accepting the position that the business of printing or printing and publishing amounts to manufacture or production of an article or things, the CBDT has issued Circular No. 15/2016 dated 19-5-2016 stating that such assessee will be eligible to claim additional depreciation under Section 32 (1)(iia).

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Ratio decidendi

Term loan borrowed for purchasing capital asset, when waived by a bank would constitute business income of the borrower

The taxpayer had borrowed certain sums for acquiring capital assets, part of which was waived due by the lender bank, considering the financial position of the taxpayer. On the question of whether the amount written off by the lender can constitute income of the taxpayer, the High Court observed that waiving of repayment of loan, even if the loan is not used in the course of trading activity, would constitute a benefit or perquisite to the business of the taxpayer. The High Court accordingly held that the amount of term loan waived under a rehabilitation scheme would constitute business income of the taxpayer borrower. [*CIT* v. *Ramaniyam Homes (P.) Ltd*, Tax Case (Appeal) No. 278 OF 2014, decision dated 22-4-2016, Madras High Court]

Retrospective increase in rent does not mean that there was escapement of income in earlier years

The taxpayer had let out its property to the Government of India. The rent receivable was enhanced retrospectively under a supplementary agreement. On the question of whether this would result in enhanced rent becoming taxable in the earlier years, the Supreme Court observed that, as no right to receive the rent accrued to the taxpayer at any point of time during the earlier years inasmuch as such enhancement, though with retrospective effect, was made subsequent, no income accrued in the earlier years. The Supreme Court accordingly held that the amount of rent enhanced with retrospective effect would accrue only in the year in which the agreement of enhanced rent is entered into and reassessment of earlier years is not permissible. [*P.G. & W. Sawoo (P.) Ltd.* v. *ACIT*, Civil Appeal No. 4091 of 2016, decision dated 19-4-2016, Supreme Court]

Payment for downloading copyrighted photograph is not royalty

The taxpayer, engaged in the business of publishing magazines, paid certain sums for procuring images and figures to be published in its magazines in India. The Revenue Authority held that the payment was in the nature of royalty and hence the taxpayer to be an assessee in default for not deducting tax on the payment. The Tribunal observed that the transactions of downloading of photographs for exclusive one time use, without the right to edit or make copies or to be used elsewhere, cannot be regarded as royalty. The Tribunal further held that, in any case, the payment for downloading the photograph can only be regarded as a payment to acquire a copyrighted article and not a payment for right to use a copyright, and hence, the payment cannot be regarded as royalty with the meaning of the Act. [*DCIT* v. *VJM Media (P.) Ltd* , ITA No. 1216/Mum/2011, decision dated 13-4-2016), ITAT Mumbai]

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Transaction between two foreign parties cannot constitute a comparable uncontrolled transaction for determining transfer price

The taxpayer had imported certain goods from its Associated Enterprise ('AE'), which had been procured by the AE from third party manufacturers. On the question of whether the transaction price between the third party and the AE can be regarded as ALP for determination of transfer price between the taxpayer and the AE, the Tribunal held that geographical difference, wherein both the buyer and seller are foreign parties, cannot constitute a 'comparable' uncontrolled transaction, to determine transfer price in India. The Tribunal further held that an external comparable uncontrolled transaction will exist only when similar goods are purchased by some another Indian party from a non-AE. The Tribunal further observed that submissions made by an importer to the Customs Authorities while determining valuation of goods for payment of Customs Duty would be crucial in determining transfer price under the Income-tax Act. [*DCIT* v. *Rayban Sun Optics India Ltd*, ITA No 4203/ Del/2010, decision dated 19-4-2016, ITAT Delhi]

Advance Pricing Agreements would have persuasive value in determining transfer price for years prior to the agreement being made applicable

The taxpayer had entered into an Advance Pricing Agreement ('APA') in relation to certain transactions for a specified period, which terms, it sought to apply for earlier years wherein the transfer price was in challenge before the Tribunal. The Tribunal held that provisions for comparability analysis in APA will have immense persuasive value and can be 'rolled back' for past years even though the APA signed had no 'rollback provisions'. The Tribunal however held that this can be done only if the international transactions in both the years are the same and availability of data for the past year is also on similar lines as suggested in the APA. [*Ranbaxy Laboratories Ltd.* v. *ACIT*, ITA 196/Del/2013, decision dated 25-4-2016, ITAT Delhi]

Foreign exchange fluctuation loss on outstanding foreign currency loan is a revenue expenditure

The taxpayer acquired certain capital assets out of sums borrowed in Indian rupee. It had subsequently converted these loans into foreign currency loans to take benefit of lower rate of interest on such foreign currency loans. The taxpayer had incurred loss due to rate fluctuation on foreign currency while repaying the loan. On the question of whether the loss incurred in repayment of loan due to fluctuation in foreign currency can be allowed as a revenue expenditure, the Tribunal held that loss bears no nexus or relation to the capital asset acquired by the taxpayer and that the action of the taxpayer is linked to its underlying objective of saving interest costs which is undoubtedly on revenue account. The Tribunal thus held that the loss incurred bears the character of revenue expenditure. [*Cooper Corporation (P.) Ltd* v. *DCIT*, ITA 866/ PN/ 2014, decision dated 29-4-2016, ITAT Pune]

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NEW DELHI
5 Link Road, Jangpura Extension,
Opp. Jangpura Metro Station,
New Delhi 110014
Phone : +91-11-4129 9811

B-6/10, Safdarjung Enclave
New Delhi - 110 029
Phone : +91-11-4129 9900
E-mail : lsdel@lakshmisri.com

MUMBAI
2nd floor, B&C Wing,
Cnergy IT Park,
Appa Saheb Marathe Marg,
(Near Century Bazar)Prabhadevi,
Mumbai - 400025.
Phone : +91-22-24392500
E-mail : lsbom@lakshmisri.com

CHENNAI
2, Wallace Garden, 2nd Street
Chennai - 600 006
Phone : +91-44-2833 4700
E-mail : lsmds@lakshmisri.com

BENGALURU
4th floor, World Trade Center
Brigade Gateway Campus
26/1, Dr. Rajkumar Road,
Malleswaram West, Bangalore-560 055.
Ph: +91(80) 49331800
Fax:+91(80) 49331899
E-mail : lsblr@lakshmisri.com

HYDERABAD
'Hastigiri', 5-9-163, Chapel Road
Opp. Methodist Church,
Nampally
Hyderabad - 500 001
Phone : +91-40-2323 4924
E-mail : lshyd@lakshmisri.com

AHMEDABAD
B-334, SAKAR-VII,
Nehru Bridge Corner,
Ashram Road,
Ahmedabad - 380 009
Phone : +91-79-4001 4500
E-mail : lsahd@lakshmisri.com

PUNE
607-609, Nucleus, 1 Church Road,
Camp, Pune – 411 001.
Phone : +91-20-6680 1900
E-mail : lspune@lakshmisri.com

KOLKATA
2nd Floor, Kanak Building
41, Chowringhee Road,
Kolkatta-700071
Phone : +91-33-4005 5570
E-mail : lskolkata@lakshmisri.com

CHANDIGARH
1st Floor, SCO No. 59,
Sector 26,
Chandigarh - 160026
Phone : +91-172-4921700
E-mail : lschd@lakshmisri.com

GURGAON
OS2 & OS3, 5th floor,
Corporate Office Tower,
Ambience Island,
Sector 25-A,
Gurgaon- 122001
Phone: +91- 0124 – 477 1300
Email: lsgurgaon@lakshmisri.com

INTERNATIONAL OFFICES :

LONDON
Lakshmikumaran & Sridharan Attorneys (U.K.) LLP
Octagon Point,
St. Paul's,
London EC2V 6AA
Phone : +44 20 3823 2165
E-mail : lslondon@lakshmisri.com

GENEVA
Lakshmikumaran & Sridharan SARL
35-37, Giuseppe Motta
1202 Geneva
Phone : +41-22-919-04-30
Fax: +41-22-919-04-31
E-mail : lsgeneva@lakshmisri.com

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