Paper 9

AAR Ruling: income derived by a Mauritius fund from units of a mutual fund will not be taxable in India ©

DLJMBs case

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Synopsis:

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A. Introduction

India's Authority for Advance Rulings (AAR), in its ruling dated July 16, 1997 has held that any income, earned by a Mauritius resident company, which is not expressly covered by any other Article in the Indo-Mauritius tax treaty (treaty), will be taxed in Mauritius only. Thus, if a Mauritius resident company derives income from units of a mutual fund, this income as per the ruling, will not be taxed in India [1]. Mauritius is a very popular jurisdiction for routing funds for investments into India, owing to a favorable tax regime, besides being a low cost jurisdiction. This ruling, is likely to have a favorable bearing on all funds which cater to their offshore investors by investing in a special mutual fund scheme in India for down-line investments. A ruling by the AAR, is binding only on the applicant and the tax authorities in relation to the questions raised before the Authority. However, if the broad facts remain the same, other Mauritius resident entities can also obtain a favorable ruling, on making an application.

B. Facts

The Applicant, DLJMB Mauritius Investment Company (DLJMB Mauritius), proposed to make investments in Indian shares, debentures and other debt instruments to the tune of US $ 100 million. To enable it to make such investments various DLJ affiliated entities[2] agreed to be its shareholders. The shareholding in DLJMB Mauritius, was proposed to be broad-based comprising of several entities, mainly companies or partnerships, organized in the United States (US) and the Netherlands Antilles. In turn, various US and non-US investors had invested in these entities, which were all managed by DLJ Inc.

C. Rulings Requested

DLJMB Mauritius requested rulings from the AAR on the following issues:

- whether it would be entitled to be the benefits of the Indo-Mauritian Tax Treaty (Treaty)
- whether capital gains arising in its hands from the transfer of securities it holds in Indian companies would be exempt from tax in India, owing to the provisions of the Treaty
- whether interest received by it pursuant to a loan agreement in respect of debentures and/or any other debt claims issued subsequent to the approval of the Reserve Bank of India (RBI) / Government of India would be exempt from tax under the Treaty
- whether any other income, not being in the nature of dividends, interest, capital gains, business income or any other income which is not expressly covered by any other article under the Treaty, for example: income from units of a mutual fund in India, will be taxed in Mauritius only and not in India

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[1] AAR Number 315 of 1997

[2] Donaldson Lufkin & Jemerette, Inc (DLJ Inc) is a leading investment and merchant bank, which conducts its business through various subsidiaries

D. Commercial Justification

The AAR had to determine whether the US entities which desired to invest in India, set up a Mauritius based nominee company, merely to obtain better tax advantages. If a transaction is designed prima facie for avoidance of tax within the meaning of Clause (c) of the proviso to section 245R(2) of the Income tax Act, 1961, the AAR is entitled to reject an application and deny a ruling in respect of such a transaction. While rejection of a ruling does not automatically imply that the benefits of the tax treaty will not be available (the normal recourse to appeals within the tax department is always available), the tax authorities could take cognizance of the remarks made by the AAR on rejecting the ruling.

DLJMB Mauritius, the Applicant however established commercial justification for setting up base in Mauritius. Its justification were based on several facts *viz::*

- routing investments in India, through a single entity will avoid multiple applications to the RBI or the Foreign Investment Promotion Board (FIPB) on behalf of all investors
- the guidelines for setting up venture capital funds or companies in India are very restrictive, so it was decided not to invest through an entity organized in India
- Mauritius is preferred by off-shore investors in view of its low-cost financial service sector and its favorable treaty with India

As there were several factors in favor of setting up an entity in Mauritius, besides a favorable tax regime, the application was not rejected and a ruling was granted.

E. Treaty Benefits

In order to determine, whether DLJMB Mauritius was entitled to the benefits under the Treaty, including exemption of a capital gains tax in India arising out of transfer of Indian securities, the AAR had to determine the residential status of the applicant. The AAR accepted the contention of the applicant that its place of effective management is only in Mauritius and not in the US or anywhere else.

The AAR noted that a Mauritius tax residency certificate is obtained only on compliance with certain specific conditions. Moreover, the applicant was also regulated by the Mauritius Offshore Business Activities Authority (MOBAA). Besides, satisfying several other criteria, DLJMB Mauritius had to appoint at least two Mauritius resident directors and its company secretary was to be a resident in Mauritius. Its directors meetings were also to be held in Mauritius. In addition it had to maintain its accounting records in Mauritius, have a bank account in Mauritius, make appropriate disclosures to MOBAA and submit periodical reports to it. As the place of effective management was held to be Mauritius, the applicant was treated as a resident of Mauritius, within the meaning of Article 4 for the purpose of the Treaty. It was thus entitled to the benefits which flow under the treaty.

F. Interest

The applicant did not get a favorable ruling regarding exemption of interest income arising to it from debentures or debt claims, approved of by the RBI or the GOI under the provisions of Article 11 of the Treaty. However, the observations made by the AAR are very interesting.
Article 11(4) states that: Interest arising in a Contracting State shall be exempt from tax in that Contracting State `to the extent' approved by the Government of that State, if it is derived and beneficially owned by any person (other than a person referred to in paragraph 3) who is a resident of the other Contracting State provided that the transaction giving rise to the debt-claim has been approved of `in this regard' by the Government of the first mentioned Contracting State.

In this case, the applicant would be the beneficial owner of the interest income and this fact was not disputed. Thus the entire scope of the argument revolved around the fact whether: the exemption would extend to the entirety of the interest paid to the Mauritius resident (in this case the applicant) or whether it would extend to only that portion of it, which is exempt under the Indian Income tax Law.

It was contended on behalf of DLJMB Mauritius, that if the quantum of interest is already exempt under the tax laws there would be no necessity of providing for an exemption under the Treaty. But, the AAR held that the conditions `to the extent approved of' and `in this regard' would have to be read harmoniously and any interest received in respect of a debt transaction will be exempt only if it is paid under a transaction that has been approved by the Government and only subject to such limits of exemption as may be provided for in respect of such payments under the Indian Income-tax laws.

G. Income derived from units

Article 22(1) of the Treaty provides that: Subject to the provisions of paragraph 2 of this Article, items of income of a resident of a Contracting State, wherever arising, which are not expressly dealt with in the foregoing Articles of this Treaty, shall be taxable only in that Contracting State.

In other words, if a Mauritius resident derives any item of income which does not fall within the provisions of any other article of the Treaty, it will be taxable only in Mauritius and not in India.

The AAR noted that mutual funds in India, are set up either as trusts or as companies. Dividends declared by an Indian company after June 1, 1997 are exempt in the hands of shareholders, so the issue of such dividend falling within Article 12 of the Treaty and being taxed accordingly does not arise. If the income distribution is by a mutual fund set up as a trust, the income will not fall within the definition of dividend as provided in Article 12 of the Treaty.

It will also not fall under any of the categories specified in Article 7 (Business Profits), Article 11 (Interest), Article 12 (Royalties) and Article 13(Capital Gains). Thus, it can only fall under the residuary provisions of Article 22.
Consequently, in this case, it was held that income from units of a mutual fund in India arising in the hands of DLJMB Mauritius, will be taxed in Mauritius only and not in India.

H. Conclusion

For the first time, in the context of the Indo-Mauritius Treaty, the AAR conceded that income from units of a mutual fund would be covered under the provisions of Article 22 of the Treaty. Thus, such income would not be subject to tax in India, but would be taxable only in Mauritius. The AAR adopted a divergent view from the one taken by it earlier in the case of *Dr Rajnikant R. Bhatt*[3]. In this case, income arising from mutual funds specified in Section 10(23D) [4] of the Indian Income-tax Act, 1961 and from the Unit Trust of India (UTI) [5]were held to be dividends covered by Article 10 of the Treaty. Under this provision, a Mauritius resident who is the beneficial owner of the dividend is be subject to tax in India, at 5% per cent if holds 10% or more of the equity stake of the capital of the company paying dividends. In other cases, the rate of tax in India on dividend income is 15%.

As mentioned earlier, dividend distributed by an Indian company is now exempt from tax in the hands of the shareholders. Earlier, The UTI Act was regarded as a company for tax purposes. The Unit Trust of India Act, 1963 however has now been amended. Section 32(3) of this Act which defined income distribution by the UTI as dividend and deemed the UTI as a company, has now been deleted. The AAR in the case of DLJMB Mauritius has held that even income arising to a Mauritius resident from the units of the UTI would fall within Article 22 and will not be subject to tax in India.

The contents of this paper should not be construed as legal opinion or professional advice.

[3] AAR Number 268 of 1996
[4] Section 10(23D) exempts specified mutual funds and the Unit Trust of India from tax liability in respect of any income earned by them.
[5] The Unit Trust of India, is India's largest mutual fund, set up under the Unit Trust of India Act, 1963