Tax Hotline

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ITAT'S EARLY HOLIDAY GIFT – DECIDES TIMING ISSUES CONCERNING GRANDFATHERING CLAUSE OF THE INDIA-MAURITIUS TAX TREATY FOR TAXPAYER

BACKGROUND

The Mauritius-India tax treaty was amongst the few India tax treaties which allocated exclusive residence taxing rights over capital gains from the alienation of shares of a company which was a resident of the other contracting state. In other words, capital gains from the transfer of shares of a company which is a resident of India by a resident of Mauritius were exempt in India. This changed in 2016 when the tax treaty was amended. Gains from the alienation of shares of a company which is a resident of India – *acquired* on or after 1 April 2017 – may now be taxed in India. However, future gains from shares *acquired* prior to 1 April 2017 have been "grandfathered" and remain exempt in India under the tax treaty.

TIMING ISSUES

But when are equity shares which come into existence upon the conversion of convertible equity shares "acquired"? In a recent case[1] the New Delhi Bench of the Income Tax Appellate Tribunal was faced, inter alia, with the question of when equity shares which come into existence after 1 April 2017, but upon the conversion of cumulatively convertible preference shares which were acquired prior to that date were "acquired". The tribunal decided that the date of acquisition of such equity shares should be determined with reference to the date on which the preference shares were "acquired", and not the date on which the preference shares were "converted". Therefore, capital gains from the transfer of such equity shares would be exempt from tax in India.

The conversion of the preference shares into equity shares, the tribunal reasoned, resulted only in a qualitative change in the taxpayer's rights in the investee company, without affecting any of its voting rights. The tribunal considered that there were no material differences between the preference and equity shares. It also observed that the tax treaty used the term "shares", which included equity as well as preference shares. Therefore, it opined that the conversion after the grandfathering deadline would not change the taxpayer's access to the treaty exemption.

NDA ANALYSIS

The tribunal's decision raises some very interesting issues insofar as how one might reconcile the domestic law concepts of "transfer", "period of holding", "cost of acquisition" with the treaty terms "alienation" and the date on which shares are "acquired".

A key term used in the tax treaty is "alienation". Unlike the OECD and UN Models, which do not define it, Article 13(5) of the Mauritius-India tax treaty defines "alienation" exhaustively to mean "the sale, exchange, or relinquishment of the property or extinguishment of rights therein or the compulsory acquisition thereof under any law in force in the respective Contracting States". This definition is a partial reproduction of the inclusive definition of the term "transfer" found in Section 2(47) of the Indian Income-tax Act, 1961.

The conversion of preference shares to equity shares involves not only the form of the asset, but also the nature of rights held by its owner. A preference share entitles its holders to a certain rate of return in terms of annual dividends to the extent the company be profitable. Equity shares do not carry any such rights. Therefore, the conversion involves the relinquishment of rights, which is included in the definition of "alienation" of the treaty. The conversion could also be regarded simply as an exchange of assets.

Therefore, the convertible shares should be seen as having been alienated at the moment they are converted for the purpose of Article 13(4). Gains from *this* alienation, given that the preference shares were acquired before 1 April 2017, were grandfathered. The grandfathering would not have much import on the taxation on capital gains arising from the conversion, because Section 47(*xb*) of the Income-tax Act, 1961 excludes the application of the taxes on capital gains to such transfers. However, the question remains to be answered: when were the equity shares received in exchange of the preference shares acquired?

It could be argued that the transfer of an asset by the transferor and the date of its acquisition by the acquirer are coincidental – that they are two sides of the same coin – unless it can be shown that the law requires the two concepts to be delineated. Does the law require such a delineation in the case of a conversion of preference shares to equity shares?

The exemption under Section 47(*xb*) is accompanied with two corresponding provisions in Section 2(42A)(*hf*) and Section 49(2AE). The former accounts for the period for which preference shares were held by a taxpayer for determining the period for which the (converted) equity shares have been held by a taxpayer. The latter attributes the cost of acquisition of the preference shares to the (converted) equity shares.

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A close reading of these provisions leaves room for two alternative views with respect to when, in the context of the grandfathering provisions if Article 13 of the Mauritius-India tax treaty. First, it could be argued that the fictions with respect to the period of holding and the cost of acquisition should be construed to impute the date of acquisition of the preference shares to the converted equity shares. Alternatively, it could be argued that the deeming fictions contained in Section 2(42A)(*hf*) and Section 42(2AE) have been made only to protect the tax base, which would otherwise have been lost on account of Section 47(*xb*).

The former approach would imply that indeed the entire capital gain from the alienation of the equity shares are grandfathered under the tax treaty. The latter interpretation, however, would imply that the equity shares were "acquired" on the date of conversion of the preference shares. Therefore, it is arguable that capital gains from the transfer of the equity shares, should only be partially grandfathered. In other words, only that part of the capital gains which had accrued up to the time of conversion to equity shares would be entitled to the grandfathering benefit under the tax treaty. If indeed this argument were upheld, the cost of acquisition of the equity shares should be determined by their market value on the date of conversion, and not the acquisition of the preference shares. This should provide a step up in the cost of acquisition, and only those capital gains which have accrued since the conversion should be taxable in India.

CONCLUSION

The facts of this case, and the law about the taxation on capital gains in India raise a number of timing issues with respect to tax treaty application. Unfortunately, the tribunal does not address these issues. It may well be possible that it has come to a justifiable outcome. However, its reasoning appears to be specious, and susceptible to challenge before the High Court.

– Morvi Chaturvedi, Ipsita Agarwalla & Dr. Dhruv Janssen-Sanghavi

You can direct your queries or comments to the authors.

[1]Sarva Capital LLC vs. ACIT [ITA No. 2289/Del/2022]

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