Tax Snippets

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A DECADE YOUNG, A CENTURY STRONG

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Investment in Equity Oriented Mutual Funds from Mauritius – Tax Exempt

Mauritius has been a popular gateway for foreign investments into India. This was primarily due to the Double Taxation Avoidance Agreement ('DTAA') entered between India and Mauritius in 1983. The DTAA provided that capital gains arising out of sale of shares of an Indian company by an entity resident in Mauritius would not be taxed in India. Since Mauritius did not levy any capital gains tax, there was a tax arbitrage by routing Foreign Direct Investment into India via Mauritius.

India renegotiated its tax treaty with Mauritius in 2016. The revised protocol, effective from 1 April 2017, gave India the right to tax capital gains arising to a Mauritius resident from sale of shares of an Indian company. However, to safeguard the interest of existing investors, the following grandfathering provision were introduced:

- Shares acquired under the old regime (pre-2017) would continue to enjoy the exemption from capital gains.
- Shares acquired between 2017 and 2019 would be taxed at a concessional rate (which was 50% of the prevalent domestic tax rates).
- All other shares were subject to tax as per domestic tax law of India.

Recently, in the case of Emerging India Focus Funds v. ACIT, the Delhi Tribunal has examined whether the term "shares" used in Article 13 of the DTAA would also covered equity oriented mutual funds[1].

Facts

The taxpayer, a Mauritian company, carried investment activities in India by way of investments in shares and debentures. It was registered as a Foreign Institutional Investor with SEBI, and pooled funds from investors around the world, which was in turn invested in India.

For the Assessment Year ("AY") 2022-23 (tax year 2021-22), the fund reported capital gains of approximately INR 5,93.48 Crores (USD 69.8 million) from the sale of equity oriented mutual funds and claimed exemption under Article 13(4) of the DTAA[2]. The Tax Officer, however, held that since these mutual funds derived their value from underlying assets, namely equity shares in India, it would be taxable under Article 13(3A)[3]. Accordingly, as the investment was in equity oriented mutual funds where 65% of the proceeds are invested in equity shares of domestic companies listed on a recognized stock exchange, the Tax Officer attributed tax on 65% of the total Capital Gains (being the minimum threshold for qualifying as an "equity-oriented fund").

When the draft assessment order was referred to the Dispute Resolution Panel[4], the DRP agreed with the views of the tax officer. The DRP relied on the 'Doctrine of Purposive Construction' which provides that a transaction must be considered in the sense in which the legislature intended it to be done on the basis that: -

- Section 10(38) of the Income Tax Act, 1961 ("the Act") exempts income arising from the transfer of equity shares in a company. Such section also exempts the income arising from the transfer of unit of an equity-oriented fund also.
- Section 112A of the Act exempts long term capital gains arising from the transfer of equity shares of a company. Such a section also exempts capital gains arising from a unit of an equity-oriented fund.

Thus, the intent of Income Tax Law is very clear to treat the units

1 *'Equity oriented fund" inter alia means a fund set up under a scheme of a mutual fund specified under clause (23D) of section 10 where a minimum of 65% of the total proceeds of such fund is invested in the equity shares of domestic companies listed on a recognized stock exchange.*

2 *Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 3A shall be taxable only in the Contracting State of which the alienator is a resident.*

3 *Gains from the alienation of shares acquired on or after 1st April 2017 in a company which is resident of a Contracting State may be taxed in that State.*

4 A fast-track mechanism for resolving disputes in cases involving foreign companies.

of equity- oriented mutual funds as equity shares. The DRP also noted that in case of equity oriented mutual funds, a major composition of the funds is invested in the equity shares of the domestic companies and hence, the units of such mutual funds partake in the characteristics of shares. Furthermore, in addition to DRP's agreement with tax officer, the DRP also held that once the equity oriented mutual funds are treated as equity shares, the entire capital gains (not just 65%) were subject to capital gains tax in India as per Article 13(3A) of the DTAA. Aggrieved by the order of the DRP, the taxpayer filed appeal to the Tribunal.

Tribunal's Findings

- The Tribunal emphasized that DTAAs should be interpreted in which the reasonable meaning of words and phrases is preferred. As the term "shares" is not defined under the DTAA, their interpretation should be derived from Indian domestic law. The Companies Act, 2013 and the Securities Contracts (Regulation) Act, 1956, for instance, had a very clear demarcation between shares and mutual funds.
- Under Indian laws, shares and mutual funds were distinct forms of securities. While shares represent ownership in a company with attendant rights and liabilities, mutual fund units represent a beneficial interest in a trust. The regulatory framework, rights of investors, and nature of returns differ significantly.
- Various courts and tribunals have in the past explicitly held that units are not akin to shares
- The amendment brought about in the 2016 protocol via Article 13(3A) carved the exception only for shares. When mutual funds were not explicitly included, they would be governed by Article 13(4) which allocated the taxing rights to the residence state i.e. Mauritius.

Basis the aforesaid, the Tribunal held that gains from the sale of equity-oriented mutual funds did not constitute 'alienation of shares' under Article 13(3A) of the India-Mauritius DTAA. Therefore, such gains are exempt from Indian tax under Article 13(4), and the Mauritius resident is entitled to treaty benefits.

Key Takeaways

- The ruling provides clarity and certainty for foreign investors using the Mauritius route for investments in Indian mutual funds, both pre and post April 2017. The decision reinforces the importance of interpretation of words and phrases under DTAA.
- Article 3(2) of the DTAA provides that any term not defined in DTAA, unless the context otherwise requires, have the meaning which it has under the laws in force of that Contracting State "relating to the areas which are the subject of this Convention". Thus, if a term is not defined under the DTAA, the meaning of such term can be interpreted as defined under the Act (as it relates to subject of taxes).
- Further, Section 90(3) of the Act provides that any term used but not defined in this Act or in DTAA shall, unless the context otherwise requires, and is not inconsistent with the provisions of this Act or the DTAA, have the same meaning as assigned to it in the notification issued by the Central Government in the Official Gazette in this behalf.
- Thus, while the Tribunal has drawn interpretation of the meaning of the term 'share' from other domestic laws of India, neither the DTAA nor the Act explicitly allows drawing interpretation of undefined terms from domestic laws of India other than the Act.
- In order to bring certainty with respect to interpretation of DTAA, the Draft Income Tax Bill 2025 explicitly provides that *"If any term is used in DTAA and is not defined in DTAA or in the Bill or in any notification, it will have the meaning given in any Act of the Central Government relating to taxes, or in its absence, in any other law of the Central Government, and such meaning will be applicable from the date of the agreement."*

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