

Tax Hotline

March 27, 2001

CAPITAL GAINS EARNED BY PRIVATE EQUITY FUNDS TO BE TAXED AS BUSINESS PROFITS

The Indian Authority for Advance Rulings (**AAR**), in a recent ruling, has held that gains on sale of shares, earned by a Mauritius based private equity fund (**the Fund**) will be regarded as business profits. According to the AAR, private equity funds are carrying on a systematic business of buying and selling shares and hence gains arising on sale of shares should be taxed as Business Profits as per Article 7 of the India-Mauritius Tax Treaty and not under Article 13 on Capital Gains.

The AAR in this landmark judgement has considered all the aspects of a private equity fund structure and ruled that neither the Investment Adviser in India, nor the custodian can constitute a Permanent Establishment (**PE**) of the Fund in India. Hence, in absence of a PE, the entire business profits of the Fund will be taxable only in Mauritius and not be taxable in India.

The AAR has once again accepted the 'resident' status of a Mauritius based Fund on the basis of the tax residency certificate issued by the Mauritius Offshore Business Activity Authority. The AAR has distinguished the present case from its earlier ruling in the case of Cyril Pereira wherein the UAE resident was denied the treaty benefits on the ground that he was not liable to tax in UAE. In case of Mauritius, the AAR has held that the Mauritius Income Tax Act does provide for a basic charge to capital gains and business profits, even though currently, all the taxes may not be levied.

At this stage, when the writ petition questioning the tax residency of Mauritius based companies is pending in the Delhi High Court, this ruling would prove to be positive step towards re-establishing Mauritius route for investments into India.

Advance rulings are private and binding only on the applicant and tax authorities, in respect of the applicant. However, they do have some persuasive value.

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