TR 85

Facts

Company A, holding a Category 1 GBL licence, has acquired USD 200m bonds having a maturity period of 24 months and bearing interest at the rate of 10% p.a payable quarterly from a resident of the People's Republic of China (The Issuer). It has invested in the bond as a mechanism to acquire shares in the Initial Public Offer (IPO) vehicle at a more advantageous price. Obtaining the shares was the sole objective of making the investment in the bonds. The other salient facts and terms of the bonds are thus:

- Company A funded the purchase by issuing equity of USD 5m and an overseas loan of USD 195m from one of its shareholders at 9.5% p.a interest payable quarterly.
- The issuer will repay the bond by cash or by the transfer of shares in another overseas company (Company B/The IPO Vehicle) in which the issuer has substantial interests.
- If the obligations are extinguished as above, Company A will derive a premium depending on the timing of the transfer.
- The purpose of the premium is an inducement to Company A to commit early to the investment in the form of bonds and allowing its name to be used in marketing the shares in the IPO vehicle to other investors.
- If Company A receives shares, it may, in due course, sell them at the prevailing price, which may result in a profit.
- Company A may also sell the bonds at market price, resulting in a profit or loss.
- In line with IAS 39, Company A will record the bond as a non-current asset in its Balance Sheet and will periodically recognize mark-to-market adjustments in its financial accounts to reflect the fair value of the stocks.

Points at Issue

- Whether interest paid by Company A on the USD 195m loan will be deductible against income received and whether the interest margin of 0.5% will be considered to be compliant with the arm's length principle?
- Whether the premium/gain derived by Company A on exchange of shares in Company B is exempt from income taxation in Mauritius?
- Whether, the premium paid by the Issuer on retirement of the bonds to Company A will be exempt from taxation in Mauritius, if the bonds are repaid in cash?
- Whether gains derived by Company A from sale of the Company B shares shortly after conversion will be exempt from taxation in Mauritius?
- Whether gains derived by Company A from sale of bonds prior to their maturity or early redemption, will be exempt from income taxation in Mauritius?

- Whether the mark to market adjustments that will be recognised under IAS 39 in Company A's accounts will be considered capital in nature and thus not subject to taxation?

Ruling

a) Any expenditure incurred on interest in respect of capital employed exclusively in the production of gross income specified in Section 10(1)(b), (c) or (d), of the Income Tax Act as the case may be will be allowed as a deduction in accordance with Section 19 of the Act.

   Regarding the issue of arm's length, MRA will not rely solely on interest margin to decide whether the arm's length principle is being adhered to. Other factors as laid down in Section 75 of the Act will also be considered in the application of the arm's length test to arrive at a reasonable amount of net income that would normally be expected from this type of activity undertaken by Company A.

b) (b)&(c) On the basis of the facts provided, and having regard to the risk taken by Company A, the rate of interest applicable on the bonds considered as a reasonable commercial interest rate under the current economic environment and the fact that Company A is acting as a force of attraction for other prospective investors, it is ruled that premium/gain derived by Company A either on exchange of shares in Company B or paid in cash is of a capital nature and not subject to tax.

c) Gains derived by Company A from the sale of shares are exempt from income tax by vitue of Item 8 of Sub-part C of Part II of the Second Schedule to the Income Tax Act.

d) Gains derived by Company A from the sale of bonds prior to their maturity or early redemption is exempt from income tax as in (d) above.

e) The mark to market adjustments under IAS 39 will not be subject to taxation as in (d) above inasmuch as the gain is not yet realised.