Protocol: Amendment to India-Mauritius Double Taxation Avoidance Agreement

Tax Alert
May 11, 2016

The Government of India has on May 10, 2016 issued a press release announcing the Protocol for amendment of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains between India and Mauritius ("Tax Treaty").

The Tax Treaty has been in effect since 1983 and has been applicable from the assessment year 1983-84 onwards. The key benefit of the exemption of capital gains tax (both short term and long term capital gains) in India has been available since then. Foreign investment from Mauritius from the year 2000 to December 2015 has been 33% of the total inflows[1] into India. The Tax Treaty has led to significant revenue loss. Various disputes on eligibility of the benefit under the Tax Treaty have arisen, including before the Hon'ble Supreme Court in the case of *Union of India vs. Azadi Bachao and Another*[2]. These disputes led to the introduction of the concept of tax residency certificate, which every non-resident is required to furnish to avail the benefit under the Tax Treaty and other double taxation avoidance agreements ("DTAA"). It has been indicated that the amendments to the Tax Treaty will also be made applicable to DTAAs with Singapore and Cyprus by re-negotiating the respective DTAAs. It is understood that these amendments will impact almost 50% of the foreign investment which India received from Mauritius and Singapore.

This ELP Tax Alert summarizes the development and has our comments thereon.

KEY FEATURES OF THE PROTOCOL (Press Release)

CAPITAL GAINS

1. India now has the taxation rights on capital gains arising from the alienation of shares acquired on or after April 1, 2017 in a company resident in India with effect from financial year 2017-18.
2. Protection to investment has been granted in relation to the shares acquired before April 1, 2017.
3. The rate of taxation on the capital gains arising between the transition period of April 1, 2017 to March 31, 2019 shall be 50% of the domestic tax rate.
   a. Such reduced rate shall be subject to fulfillment of the Limitation of benefit ("LOB") Article.
4. Under the LOB Article, a resident of Mauritius, including a shell/conduit company, shall not be entitled to the benefit of 50% reduced rate of tax, if such resident fails the main purpose test or bonafide business test.
   a. A resident of Mauritius shall be deemed to be a shell/conduit entity, if its total expenditure on operations in Mauritius is less than Rs 2,700,000 (equivalent to Mauritius rupees 1,500,000) in the immediately preceding 12 months.
5. Taxation (capital gains) after the transition period will be at full rate from the financial year 2019-20 onwards.
6. The table summarizes the taxation of capital gains in case of a Mauritius resident:

Acquisition of shares (relevant date)	Capital gains taxation
Shares acquired prior to April 1, 2017 and sold any time.	Capital gains taxable in Mauritius i.e. grandfathering.
Shares acquired between April 1, 2017 to March 31, 2019, sold between these dates.	Capital gains will be taxed in India at the rate of 50% of domestic tax rate, subject to fulfillment of LOB conditions.
Shares acquired between April 1, 2017 to March 31, 2019 and sold after March 31, 2019.	Capital gains will be taxable in India at the normal domestic rate of taxation. Domestic tax rates in case of short term

[1] Source: Quarterly Fact Sheet – http://dipp.nic.in/English/Publications/FDI_Statistics/2015/FDI_FactSheet_OctoberNovemberDecember2015.pdf
[2] [2003]263ITR706(SC)

Shares acquired from financial year 2019-20 onwards and sold thereafter.	capital gains is 40% and long term capital gains is 20% (10% as per the Finance Bill, 2016 in case of non-residents). It appears that the provisions relating to LOB Article may not be relevant in this context.

INTEREST INCOME – BANKS

1. Interest income arising in India to a Mauritian resident bank, will be subject to withholding tax in India, at the rate of 7.5% in respect of debt claims or loans made after March 31, 2017.
2. Interest income arising in India to a Mauritian resident bank in respect of debt claims or loans made on or before March 31, 2017 shall be exempt from tax in India.

OTHER AMENDMENTS

1. The Protocol also provides for updation of Exchange of Information Article as per international standard, provision for assistance in collection of taxes, source based taxation of other income, etc.

ELP COMMENTS

The reason for the amendment has been mainly to prevent double non-taxation. The amendment places Indian investors on par with the foreign investors, especially *qua* short term capital gains. The amendment co-relates with the introduction of the General Anti Avoidance Rules in India, which is applicable from the Assessment Year 2018-19.

PRACTICAL IMPACT

1. The source based taxation approach will clearly impact foreign investment (from Mauritius) into India. Investments will now have to factor in the Indian capital gains tax.
2. The amendment will impact ongoing/proposed investments routed through Mauritius. Investments which will be made between the period of the amended provision and April 2017 may be seen as having been entered into mainly for the purpose of seeking the benefit under the Tax Treaty. However, the press release indicates that there is a window of investment that will enjoy the exemption from capital gains tax, drawing investments into India.
3. Entities incorporated in Mauritius solely for the purpose of investments will not be able to meet the LOB conditions, thereby being liable to tax at the normal domestic tax rates in India. Mauritius may benefit from expenditure owing to the fulfillment of the LOB conditions, however, the LOB conditions may not be relevant from April 2019 onwards which could result in establishment of shell/conduit entities in Mauritius.
4. The amendment will impact private equity funds, venture capital funds, etc proposing to invest through Mauritius.

SOME OPEN ISSUES

1. The amendment appears to leave untouched the taxation of indirect transfers. It will be debatable as to whether a transaction of indirect transfers prior to April 1, 2017 will now be taxed under the Mauritian Tax Treaty based on the benefits secured to the Mauritian resident company without seeking to look through the antecedent transaction of the indirect transfer.
2. The press release provides for taxation of capital gains arising from alienation of shares. Can it be said that it still leaves a window open for investment into instruments such as debentures? This can be clarified only with the reading of the text of the Protocol.
3. Foreign investors invest into Indian companies through convertible instruments, with the most common being compulsorily convertible debentures. If such instruments are converted after April 1, 2017, can it be said that the shares are acquired after April 1, 2017 and accordingly taxed in India. It needs to be seen whether any benefit can be obtained from the recently introduced Rule 8AA of the Income-tax Rules, 1962 (which provides that the period of holding shall include, the period for which debenture is held prior to conversion) for determining the date of acquisition of shares.
4. It is indicated that the India-Singapore DTAA is proposed to be re-negotiated to similarly reflect the Tax Treaty changes. It would be interesting to examine the changes, considering that Singapore already has LOB conditions to prevent treaty abuse.

CONCLUDING COMMENTS

Litigation on account of availability of the Mauritian Tax Treaty will reduce significantly. These amendments will bring clarity

and certainty to investment decisions. The amendment is from this perspective a welcome move, and the Government needs to be lauded for such a significant amendment.

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