cyril amarchand mangaldas

advocates & solicitors

TAX ALERT

May 13, 2016

Amendments to Indo Mauritius DTAA || End of the road for Mauritius based investments?

After pursuing years of prolonged negotiations and suspense, India and Mauritius have finally signed a protocol ("**Protocol**") amending the agreement for avoidance of double taxation between India and Mauritius ("**DTAA**"). The Protocol contemplates tightening of tax laws to enable collection of tax from investments routed through Mauritius, which amounts to nearly one-third of the total foreign investment into India. Followed by the Press Release ("**Press Release**") issued by the Government on May 10, 2016 encapsulating the major amendments to be made through the Protocol, the fine print of the Protocol itself has only been recently made available.

In continuation to our earlier Interim Tax Alert dated May 11, 2016, wherein we covered the key issues emanating from the Press Release, we now bring to you a comprehensive analysis of the key amendments and the issues arising therefrom the Protocol itself which has provided more clarity in respect of certain aspects and has also included few other significant amendments.

AMENDMENTS:

1. Capital Gains

One of the most significant amendments made by the Protocol is the amendment of existing provisions pertaining to capital gains in the DTAA. Capital gains derived from the sale of a capital asset situated in India by a tax resident of Mauritius are not liable to tax in India as per Article 13(4) of the DTAA. Accordingly, capital gains arising to a Mauritius entity from transfer of shares of an Indian company are exempt from tax in India. This issue has been examined on numerous occasions by the Indian judiciary and on the basis of available jurisprudence, it was an established position that so long as the Mauritius entity holds a Tax Residency Certificate and establishes that it is entitled to claim the benefits available under the DTAA, its entitlement to such benefits cannot be denied.

The Protocol has reversed the position and has now granted the right of taxation to India. Accordingly, capital gains arising from alienation of shares of an Indian company acquired on or after April 1, 2017 shall be subject to tax in India.

However, in order to facilitate smooth transition and to provide investors adequate advance notice, the following intermediary mechanisms have been proposed:-

a. ***Grandfathering of investments made till March 31, 2017***

The amendment shall be applicable only in respect of investments made in the shares of an Indian company on or after April 1, 2017. In other words, all investments made on or before March 31, 2017 shall not be impacted by the Protocol and any capital gains arising to the Mauritius entity from the sale of such investments, irrespective of the date of exit, will continue to be entitled to the benefits available under Article 13(4) of the DTAA.

b. Transit Period

In addition to the grandfathering of existing investments, the Protocol also provides a concessional tax regime in respect of capital gains earned by Mauritius entities during the period from April 1, 2017 to March 31, 2019 ("**Transition Period"**) subject to the satisfaction of certain conditions. During the Transition Period, Mauritius entities shall be liable to pay tax at 50% of the applicable tax rate under the Indian Income-tax Act subject to the satisfaction of Limitation of Benefit ("**LOB**") provision discussed hereinbelow.

c. LOB

As stated above, the concessional tax regime shall be available to a Mauritius entity during the Transition Period is subject to the LOB clause. The LOB clause restricts the concessional tax regime in following cases -

- In cases where the affairs are arranged with a primary purpose to take advantage of the said benefits;
- In cases where the seller is shell/ conduit company which has been defined as a legal entity with negligible or nil business operations or with no real and continuous business activities carried out in the other state;
- An entity is deemed to be a shell/conduit company if its total expenditure on operations in Mauritius is less than Indian Rupees 2,700,000 or Mauritian Rupees 1,500,000 (which will be equivalent to USD 40,000) in the immediately preceding 12 months.

It may be noted that LOB clause does not impact grandfathering provisions i.e., the shares acquired before April 01, 2017.

2. Interest

Prior to the execution of the Protocol, in respect of interest income, Mauritius banks were exempt from tax in India and Mauritius entities (other than banks) were taxable as per the domestic tax laws in India.

The Protocol provides that all Mauritius entities including banks earning interest income from Indian sources will now be required to pay tax at a rate of not more than 7.5% of the gross amount of interest provided the Mauritius entities are the beneficial owners of such interest income. However, Mauritius banks carrying on bona fide banking business would continue to be exempt from tax on interest earned from debt claims existing as on March 31, 2017.

The Press Release was unclear as to whether the rate of 7.5% would be applicable to all Mauritius lending entities who are otherwise liable to be tax at a much higher rate. However, the Protocol provides that even non-banking Mauritius entities shall be entitled to pay tax at the aforementioned rate of 7.5%. Thus, while exemption has been withdrawn for Mauritius banks, the applicable rate of tax for non-banking Mauritius entities has been reduced to 7.5%.

3. Permanent Establishment ("PE"):

Prior to the execution of the Protocol, the definition of PE as per the DTAA included Fixed Place PE, Agency PE and Installation PE but did not include Service PE which was enshrined in most of other DTAAs signed by India, such as DTAAs with the USA, the UK, Singapore, etc.

The Protocol provides that the definition of PE would now include Service PE which would be constituted if the employees and other personnel of an entity belonging to one contracting state render services including consultancy services in the other contracting state for a period of more than 90 days within a 12 month period.

Therefore, if the employees of a Mauritius entity visit India and furnish services to an Indian entity for a period exceeding 90 days, the Mauritius entity would constitute a Service PE in India and the income attributable to the said Service PE would become taxable in India.

4. Fees for Technical Service ("FTS")

Another significant amendment made by virtue of the Protocol is the inclusion of FTS clause within the DTAA. The DTAA with Mauritius was one of the very few DTAAs which did not have an FTS clause due to which any payment made to a Mauritius entity for rendition of any managerial or technical or consultancy service could not be brought to tax in India.

The Protocol has changed this beneficial regime and sought to tax the payments made for rendition of FTS at the rate of 10%. The definition of FTS is very broad, similar to that provided under the Indian Income-tax Act which means consideration for managerial or technical or consultancy services including provision of services of technical or other personnel.

5. Other Income

The Protocol has also ploughed the 'other income' loop hole by adding a paragraph to Article 22 of the DTAA which states that items of income which are not expressly covered in the DTAA could also be taxed in the source state (i.e. India).

Earlier, the DTAA provided for taxation of the other income only in the state of residence i.e. Mauritius, except in cases where the entity had established a PE in the other contracting state or in case of income from immovable property situated in other contracting state.

Thus, certain income (such as deemed dividend, receipt of shares of closely-held company without consideration, etc.) which are taxable in India under the Indian Income-tax Act but were not taxable in the hands of Mauritius entities, would now become liable to tax in India.

6. Exchange of Information and Assistance in Collection of Taxes

The Protocol has included a clause in the DTAA to facilitate Exchange of Information ("EOI") in respect of which the competent authorities shall exchange information in respect of anything so long as such exchange is not contrary to the provisions of the DTAA. While there are certain exceptions under which a contracting state is not under an obligation to share the information, it has been specifically provided that such exceptions cannot be construed to permit a contracting state to decline the supply of information merely because it has no domestic interest in such information or that the information is held by a bank or other financial institution.

The Protocol has also provided for lending assistance in the collection of revenue claims. Revenue claims has been defined to include taxes of every kind and description. It enables one contracting state to collect taxes on behalf of other contracting state and remit back the same.

IMPACT ON INVESTORS:

1. Impact on Foreign Direct Investments ("FDI")

Strategic FDI

Whilst strategic investors making foreign investments pursuant to a merger or acquisition, joint venture or a strategic minority position may have to pay more tax on account of the changes made in the Protocol; it is unlikely to have a significant impact on such strategic FDI investments. It is pertinent to note that in respect of strategic investments, while tax is one of the important considerations, it is usually not the determinative factor for structuring the investment. Other factors like availability of financing, the local corporate regulations including flexibility in issuance of different instruments to meet the business exigencies, ability to return income and capital, etc. play a more important role in the choice of jurisdiction.

Private Equity ("PE") and Venture Capital ("VC") investments

Due to the very nature of investments made by PE and VC funds, which are predominantly in unlisted securities and quite often exits have to be made while the securities continue to remain unlisted, PE and VC investments might be impacted. It is because most of the PE and VC investments are financial in nature and any development that affects the internal rate of return for the investors is going to influence the choice of jurisdiction for such entities. Tax often plays a very important role (at times a determinative one) in the choice of jurisdiction in devising the investment structure.

Convertible instruments

In case of existing convertible debentures, shares acquired pursuant to their conversion prior to April 1, 2017 can be said to be covered by the grandfathering provisions since conversion of debentures is a tax transparent transaction. Even in cases where the conversion (with respect to an instrument that was acquired before April 1, 2017) takes place after April 1, 2017, the same benefit should be available, especially in cases where the conversion itself is a tax neutral transaction as per Indian domestic laws.

In respect of direct sale of convertible instruments, it can be contended that capital gains derived on such securities are not taxable in India as the language of the Protocol is restricted to 'shares'. It is pertinent to note that senior revenue authorities have clarified through various press interviews that while the Protocol specifically talks only about shares, the intention was to cover capital gains accruing or arising to a Mauritius entity from the transfer of all types of capital assets.

2. Impact on FPI investments

Benefits enjoyed by Foreign Portfolio Investors ("**FPIs**") in respect of capital gains arising on sale of listed shares, futures and options, Participatory Notes ("**P Notes**"), etc. may also get impacted by the Protocol as discussed below:

Listed Shares

Long term holdings: FPIs typically invest in listed shares and capital gains on sale of listed shares are exempt from tax if the same are held for a period of more than 12 months subject to payment of securities transaction tax. Therefore, such investments would not be impacted by the Protocol.

Short term holdings: However, capital gains arising on sale of listed shares held for a period of less than 12 months are taxable at the rate of 15% under the Indian Income-tax Act which was not taxable under the DTAA prior to the signing of the Protocol. Such short term capital gains earned by FPIs from the transfer of listed shares would be subject to tax in India as provided in the Protocol.

P Notes

Issuers of P Notes typically transfer all taxes payable by them to the P Note holders. Thus, holders of P Notes issued by Mauritius based FPIs may also get adversely impacted because the FPIs may pass on the taxes payable by them to the P Note holders.

Futures and Options ("F&O")

In case of Mauritius entities making investments in F&Os of Indian companies, the impact would depend on whether the income arising therefrom was being offered by FPI either as business income or capital gains. In cases where the income was characterised as business income, the concerned FPI would have contended that it had no PE in India and, therefore, income earned by it from F&O transactions was not taxable in India. The same argument should be available even after the execution of the Protocol.

However, if the said income was characterised as capital gains, then the exemption available for capital gains earned from F&O transactions would no longer be available and tax may have to be paid in India on such income.

3. Impact on debt instruments

It is pertinent to note that the Protocol provides for a concessional tax treatment in respect of interest income accruing to Mauritius entities provided they are the beneficial owners of such income. While concessional tax treatment for interest income has been provided by India in a number of other tax treaties, the rate of taxation for interest income has never been lower than 10%. However, in case of Mauritius, the Protocol tries to tax interest income at the rate of 7.5%.

It is important to note that interest income accruing to a Mauritius entity was liable to tax in India at 40% (plus applicable surcharge and education cess) in respect of certain instruments including convertible debentures as per the provisions of the erstwhile DTAA. This is a very significant concession and may encourage a number of Mauritius entities / lenders to provide loans to Indian companies provided they are able to meet the beneficial owner test.

4. Relevance of India-Singapore DTAA

The protocol to the India-Singapore DTAA specifically provides that the benefits in respect of capital gains arising to Singapore residents from sale of shares of an Indian Company shall only remain in force so long as the analogous provisions under the India-Mauritius DTAA continue to provide similar benefits.

Recent news reports suggest that the Indian Government is already looking to rework the India-Singapore DTAA to align it with the Protocol. While it is widely expected that DTAA with Singapore shall be revised to bring it at par with Mauritius, the exact nature and manner in which the amendments would be brought about would depend on the negotiations between the two countries.

5. Other tax treaties

One needs to wait and watch if India will attempt to revise DTAAs with other countries like the Netherlands, Cyprus, etc. which also provide preferential tax treatments to capital gains.

It is apt to recall here that Cyprus has been already blacklisted by the Indian Government unilaterally for lack of effective exchange of information by invoking Section 94A of the Income-tax Act and thus, Cyprus is no longer considered favourably by the investors to invest into India.

Assuming India-Netherlands DTAA is not renegotiated in a manner similar to the DTAA, one may see a surge in the investments through Netherlands.

Be that as it may, it is evident that India wants to eventually phase out the preferential tax treatments given under various tax treaties so as to encourage investments coming directly from the investors' home jurisdiction and also to alleviate routing of investments through intermediary tax friendly jurisdictions.

SIGNIFICANT TAKEWAYS:

While it is definitely a step in right direction taken by the Government of India to provide clarity on the issues in respect of beneficial tax treatment provided in the DTAA, it is also laudable that adequate notice has been given to the tax payers to come to terms with the amendments and give much needed certainty and clarity to the foreign investors. The amendments on the taxation of interest could again encourage investors investing through debt instruments to prefer Mauritius as the favourable jurisdiction.

It may be noted that the Protocol provides that the concessional tax treatment during the Transition Period be availed only upon satisfaction of the conditions provided under the LOB clause. However, LOB clause uses phrases like 'Primary Purpose' and 'Bonafide Business Activities' which have been left undefined and the same could lead to avoidable litigation. One hopes that clarity is provided by the Government on this aspect.

Further, with the General Anti Avoidance Rules ("**GAAR**") coming into effect from April 1, 2017 (which empower the tax authorities to deny treaty benefits), the interplay between GAAR provisions and LOB provisions shall have to be carefully examined.

In any case, it seems that the Protocol has just nailed the coffin shut for investors who, without having any substantive presence in Mauritius, seek to route their investments through Mauritius.

DISCLAIMER

All information given in this newsletter has been compiled from credible, reliable sources. Although reasonable care has been taken to ensure that the information contained in this newsletter is true and accurate, such information is provided 'as is', without any warranty, express or implied as to the accuracy or completeness of any such information.

Cyril Amarchand Mangaldas shall not be liable for any losses incurred by any person from any use of this publication or its contents. This newsletter does not constitute legal or any other form of advice from Cyril Amarchand Mangaldas.

Should you have any queries in relation to any of the issues set out herein or on other areas of law, please feel free to contact us at the following coordinates:

Cyril Shroff
Managing Partner
Email : cyril.shroff@cyrilshroff.com

S R Patnaik
Partner
Email : sr.patnaik@cyrilshroff.com