India- Mauritius Tax Treaty – Amendment in the Protocol

The India-Mauritius Double Taxation Avoidance Agreement (DTAA) provided that capital gains from sale of shares can be taxed only in the country, where the holder of the share is resident. Accordingly, capital gains on sale of Indian shares by Mauritius entities are taxable only in Mauritius as per the DTAA. The agreement helped Mauritius in rising as a financial center, and becoming the source of the biggest foreign investment into India. However, from last several years, India has been trying to re-negotiate the tax pact with Mauritius to avoid round tripping and treaty abuse. Recently, the Central Board of Direct Taxes ('CBDT') has issued press release dated 10 May 2016 in relation to amendment in the protocol of the Indian Mauritius DTAA. With this press release, India gets a right to tax the capital gains arising out of the sale of shares. Read on …

CA. Vivek Raju P. and CA. Ajit Kumar Jain

(The authors are the members of the Institute. They can be reached at vivekrajup@yahoo.co.in)

India-Mauritius Tax Treaty- Journey So Far

The Indian-Mauritius tax treaty gone through various debate and discussions and travelled a long journey. The key highlights are as under:

- The Government of India entered into Double Tax Avoidance Agreement (DTAA) or treaty with Mauritius which came into effect from 1 April 1983.

- This treaty was corroborated by Circular No 682, dated 30.03.1994, which clarified that capital gains from alienation of shares in Indian companies was taxable in Mauritius only.
- The treaty has been controversial ever since, despite the fact that the treaty was most prone and became synonymous to "treaty shopping" and abuse, it always had the blessings of the government in India, as FDI was flowing into the country.
- In the year 2000, the CBDT further reassured through Circular No 789 dated 13.04.2000, which provided that Tax residency certificate issued by the Mauritius Tax Office is sufficient to claim treaty benefits. This was a defining circular which ensured that tax officials don't pierce the corporate veil and question the Mauritius entity.
- Writ petitions have been filed by in Delhi HC for challenging the validity of the circular 789 and the Delhi High Court has struck down the circular issued by CBDT.
- On further appeal the Hon'ble Supreme Court in *Union of India v Azadi Bachao Andolan (2003) 263 ITR 706 (SC)*, has overturned the ruling of the HC and held that under the constitution of India, the government had the power to enter into treaties with other countries and that judiciary has no power to judge the legality of treaty shopping merely because one section of thought considers it improper.
- The SC further noted that, if the intention of the legislature was to restrain a resident/national of a third country from enjoying the benefits of the treaty, then it would have incorporated suitable limitation of benefits clauses to arrest such abuse. Hence it ruled that the circular was good in law. This landmark ruling has laid to rest any controversy on the treaty. Subsequently many rulings have been at other fora drawing from this judgement.

Based on discussions with the authorities in Mauritius, the two governments finally entered into a protocol modifying the treaty on 10 May 2016. This protocol brings certain most needed changes to the treaty to address misuse. The government has thus addressed a long pending issue.

Based on discussions with the authorities in Mauritius, the two governments finally entered into a protocol modifying the treaty on 10 May 2016. This protocol brings certain most needed changes to the treaty to address misuse. The government has thus addressed a long pending issue.

Review of Protocol

The following are the provisions of the Protocol, as seen from the perspective of the taxability in India of the income of a resident of Mauritius:

I. Taxation of Capital Gain

The protocol addresses some of the key areas that have been left to be plugged earlier, the core issue of capital gains has been addressed for the first time. Protocol gives the source state right to tax over capital gains arising from the transfer of shares of a company resident in that source State. The intention of the government has to be lauded, wherein it has given ample time for a smooth change in a gradual and a phased manner. The key highlights of the amendments are as under:

- India will now be able to tax capital gains on investments in shares made post 1 April, 2017 from Mauritius.
- A transition window of 2 years from 1 April, 2017 to 31 March, 2019 has also been provided for, wherein the tax rate on capital gains on investment made in the intervening period would be limited to 50% of the domestic tax rate in India subject to fulfillment of conditions mentioned in the Limitation of Benefits (LoB) clause.

  The LOB specifies certain criteria for claiming the 50% abatement during the transition window. Both of which have to be satisfied for claiming the relief. There are two tests for qualifying for the benefits : 1) The affairs should not be arranged with the primary intention of availing the benefit provision granting reduced rate of tax (Main purpose test) 2) The company should not be a 'Shell or Conduit company' (Bonafide business test).
- A company is not deemed 'Shell or Conduit' if it incurred an expense of at least INR 2.7 Mn (MUR 1.5 Mn) in the immediately preceding 12 months in home country or is listed on a recognised stock exchange in the home country.
- Taxation in India at full domestic rate will be applicable for capital gains arising from 1 April, 2019 onwards.
- A new article 27A has been introduced in the treaty to provide the clauses, subject to which the residents of states can avail treaty benefits.

Briefly put, after the amendment in protocol, the taxability of capital gain on sale of shares acquired by a Mauritius resident in Indian company is as under:

Acquisition of Shares	Sale of Shares	Taxability as per treaty/protocol
Prior to 1 April, 2017	Any Time	Taxable in Mauritius
From 1 April, 2017 to 31 March, 2019	From 1 April, 2017 to 31 March, 2019	Capital Gain taxed in India at 50% of the domestic tax rate, subject to satisfaction of LOB conditions.
From 1 April, 2017 to 31 March, 2019	After 31 March, 2019	Taxable in India at normal rates.
After 31 March, 2019	Any Time	Taxable in India at normal rates.

Key observations & implications

- Going forward, there would be a tax on capital gains arising to a Mauritius company on the transfer of shares companies' resident in India.
- It should be noted that gains arising on transfer of shares of companies that are not resident in India should continue to be not taxable in India. Similarly, gains from alienation of debt instruments should also continue to be not taxable in India.
- The LOB clause incorporated in the protocol appears similar to the one in the treaty with Singapore wherein Article 24 of the India – Singapore DTAA, provides certain quantum of expenses to be incurred in a 24 month prior period. Further this limit is applicable only for the abated tax rate and not for other benefits which the treaty provides.

  Further clarity is yet to emerge on instruments like Compulsory Convertible Debentures (CCDs), Convertible Preference Shares and other hybrid instruments which are in existence and due to be converted into shares at a future date.
- An Explanation has been inserted through the protocol as per which, legal entities not having bona fide business activities shall be covered by Article 27A(1) of the Convention. It appears that the satisfaction of main purpose test may be difficult for the entities as there is no guiding principle with quantitative thresholds as to what would constitute a "Main Purpose" and hence becomes subjective and might be prone to litigation. It would be good if certain rules are framed to address the matter so as to not leave it open ended as to what may be construed as "Main Purpose".
- The government will have to also address and make appropriate changes to General Anti Avoidance Rules (GAAR) notified in 2013, which among others prescribes the cutoff date for investments that are not subject to GAAR as 31 August 2010. Though now GAAR has been deferred to 2017 and also the benefit under the treaty has now been extended to be co-terminus with the said date, a need arises to bring further clarity, to GAAR rules wherein the grandfathering date for the investments for GAAR purpose may have to be extended to April 1, 2017 to eliminate unwanted confusion and interpretation by the tax authorities which is not in the spirit of what the government wanted. There are also concerns whether protocol could be used to bring transfer of Participatory Notes under the tax net.
- Based on the Protocol, there may be an impact on the India-Singapore DTAA since the relevant provisions have been linked to the continuation of the corresponding provisions of the India Mauritius treaty. In this respect, the Indian government intends to renegotiate the treaty with Singapore to bring it on par.
- Abuse of tax treaties emerged as a global concern which is also considered in the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan 6. The Action Plan 6 provides guidance on preventing the granting of treaty benefits in inappropriate circumstances. India-Mauritius Treaty was a classic example of treaty abuse. To sum-up, the amendment is in line with India's commitment to the BEPS initiative to avoid treaty abuse and curb the double non-taxation.

II. Permanent Establishment (PE):

The protocol has also expanded the definition of PE contained in Article 5, with inclusion of service PE clause wherein deployment of personnel for a period of more than 90 days in any 12 month period shall constitute a PE. The service activity includes activity of furnishing of services, including consultancy services. Any entity earlier using this route to provide services to India will now lose this benefit.

III. Fees for Technical Services (FTS):

The existing treaty does not have an article dealing with taxation of FTS income. To this effect, FTS income is considered as Business Profits and was taxable in source country only in case of presence of a PE. The Protocol inserts a new article 12A to

provide that source country a right of taxation over such FTS at a rate of 10% (on gross basis) if the beneficial owner is a resident or the other contracting state. FTS has been defined to include consideration for managerial, technical or consultancy services, including the provision of services of technical or other personnel. The definition of FTS is made wide enough without any make available clause.

IV. Interest income

The Protocol has amended the treaty to provide exemption from tax on interest income arising in source country to a bank of a resident country carrying on bona fide banking business on outstanding/existing debt claims on or before 31 March, 2017. The debt claims existing before 31 March, 2017 have been grandfathered. In other cases such income shall be taxable in source country @ 7.5% (on gross basis), provided the recipient is the beneficial owner of such interest income without regard to LOB.

V. Other income

The existing treaty provides that other income not connected with PE and not dealt with in other articles shall be taxable in resident State. A new non obstante clause overriding the earlier provisions is now inserted to grant a right of taxation to the source state as well in case such income arises.

VI. Information exchange Amendment

The protocol amends the existing Article 26 to align the information exchange in line with the international standards of transparency. It also provides that the contracting state shall use its information gathering measures to obtain the information requested by the other contracting state even if that other state may not need the information for its tax purposes. Now India can also insist on information in respect of persons who are not residents of Mauritius, as long as such information is in the possession of Mauritius as the restrictions placed in para 3 of Article 26 are amended. It would be possible now to exchange information held by banks or financial institutions.

The amendment in treaty and the information sharing mechanism put in place, will over a period of time, take away the attractiveness of Mauritius route into India for treaty shoppers.

Overall this has been a great move by the government to promote a stable tax and predictable tax regime and attract FDI inflows. The measures will widen the tax base and will also help aligning the taxation to the BEPS initiatives.

VII. Assistance in Collection of Taxes

Article 26A is newly introduced in the treaty to provide that both the countries shall lend assistance to each other in collection of revenue claims/taxes. The aim is to ensure that states are able to collect their revenue with assistance from the other state when they are not able to do on their own. The other state (Say Mauritius) will help in collecting the same in accordance with the provisions applicable in Mauritius on enforcement and collection as if the same is a revenue claim of Mauritius.

The finance ministry has constituted a working group to examine the issues arising as a consequence of the changes in the treaty to submit a report to CBDT within three months after examining the relevant issues.

Conclusion:

Mauritius has always been the highest contributor of FDI to India, approximately a third of all the FDI flowing into India in the period 2000 – 2015 was routed through Mauritius. The amendment in treaty and the information sharing mechanism put in place will, over a period of time take away the attractiveness of Mauritius route into India for treaty shoppers.

It also address the issue of round tripping of funds from India. The incorporation of the clauses pertaining to capital gains exemption phase out reflects the alignment to the principles of BEPS initiatives and provide clarity on the tax reforms. The amendments have been proposed to be implemented prospectively and that too in a phased manner. This gives a breather to those currently invested in India as the treaty benefits based on which investments have been made, stands protected. It also acts as a guiding source to those planning to invest in India's growth story in future.

Overall this has been a great move by the government to promote a stable tax and predictable tax regime and attract FDI inflows. The measures will widen the tax base and will also help aligning the taxation to the BEPS initiatives. ■