India & Mauritius sign Protocol amending the provisions of India-Mauritius Tax Treaty

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In a significant development on 10th May 2016, the Government of India announced the signing of a Protocol amending the provisions of more than the three decade old India-Mauritius Tax Treaty.

Under this Protocol, India will get the right to tax capital gains arising on alienation of shares acquired on or after 1 April 2017. For shares acquired and transferred between 1 April 2017 and 31 March 2019, the tax rate will be limited to 50% of the Indian tax rate subject to fulfilment of conditions specified under Limitation of Benefits (LoB) Article. The Protocol among others also seeks to make changes to the taxation of interest income article, Permanent Establishment ('PE') definition, exchange of information and assistance in collection of taxes.

A brief analysis of the key amendments is set out below:

Capital Gains

- The Protocol amends the Capital Gains Article by giving India the right to tax capital gains arising on alienation of shares acquired on or after 1 April 2017. The current exemption from Capital Gains taxation in India will be withdrawn in a phased out manner as under:

Gains from alienation of shares of Indian company	Taxability in India
Acquired on or before 31 March 2017	Not taxable as per the India-Mauritius Tax Treaty

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Gains from alienation of shares of Indian company	Taxability in India
Acquired on or after 1 April 2017 and transferred before 31 March 2019	Limited to 50% of the Indian tax rate subject to fulfilment of conditions mentioned in *Limitation of Benefits (LoB)* Article
Acquired on or after 1 April 2017 and transferred after 31 March 2019	Taxable in India at the full applicable rate of tax

Limitation of Benefits

- The Protocol to India-Mauritius Tax Treaty has also introduced a LoB Article which provides that the benefit of reduced rate of tax on capital gains (i.e. 50% of normal tax rate) will not be available in the following cases:

  a) If the affairs are arranged with the primary purpose to take benefit of provision granting reduced rate of tax; or

  b) The company claiming the aforesaid benefit is a *'shell or a conduit company'*.

- A 'shell or a conduit company' is defined to mean any legal entity with negligible/nil business operations or carrying on no real and continuous business activities.

- Further, a resident is deemed to not be a shell/conduit company, if its expenditure on operations in its home country is equal to or exceeds INR 2.7 million in the immediately preceding 12-month period from the date the capital gains arise or if it is listed in a recognized stock exchange of the Contracting State.

Interest income

- The Protocol to India-Mauritius Tax Treaty has also amended Article 11 to provide that exemption from tax on interest income arising in a source country (say India) to a bank of a resident country (say Mauritius) carrying on *bona fide* banking business, shall be applicable only on interest income arising on outstanding/existing debt claims on or before 31 March 2017.

- In all other cases, interest income will be taxable in the source country at the rate of 7.5% provided the recipient is a beneficial owner of such interest income.

- It is also pertinent to note that the conditions mentioned in the LoB Article do not apply to Article 11 dealing with taxation of interest income.

Other amendments

Insertion of Service PE clause

- The Protocol also seeks to amend the definition of PE by providing that furnishing of services through employees and other personnel for a period of more than 90 days in any 12-month period shall constitute a PE.

Fees for technical services ('FTS')

- The existing India-Mauritius Tax Treaty does not have a separate Article dealing with taxation of FTS. As a result, such fees are considered as falling under the 'Business Profits' article and accordingly taxable in the source country only if the recipient entity has a PE in the source country.

- The Protocol provides for a separate Article for taxation of FTS according to which FTS arising in source country is taxable in that country at the rate of 10% (on a gross basis).

- FTS is defined to include consideration for managerial, technical or consultancy services, including the provision of services of technical or other personnel.

Other income

- The existing India-Mauritius Tax Treaty provides that all items of income (which are not expressly dealt with in earlier provisions of the Tax Treaty) shall be taxable only in the country of residence irrespective of where the income arises.

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- The Protocol grants a right of taxation to the source country if such 'other income' arises in that country.

Exchange of Information

- Provisions pertaining to "Exchange of Information" are further strengthened to, inter-alia provide that the countries shall use their information gathering measures to obtain the requested information, even though such country may not need that information for its own tax purposes.

- The Protocol also provides that a country cannot decline to supply information merely because such information is held by a bank or financial institution in a fiduciary capacity, etc.

Assistance in collection of taxes

- The Protocol inserts a new Article in the Tax Treaty to provide that both the countries shall lend assistance to each other in collection of revenue claims/taxes.

Entry into force

- India as well as Mauritius will notify each other post completion of their respective legal procedures to bring this Protocol into force. It is provided that the Protocol shall enter into force on the date of the later of these notifications.

- As far as Capital Gains Article is concerned, it is stated that the same shall have effect from Assessment Year 2018-19 and onwards.

Impact Analysis

Foreign Portfolio Investors (FPIs)/Foreign Institutional Investors (FIIs)

Long term capital gains arising on transfer of listed shares is currently exempt in India under domestic law. As far as FPIs are concerned, it has been clarified in this year's Budget, that Minimum Alternative Tax ('MAT') will also not apply to them so long as they do not have a PE/place of business in India. This position remains unaffected by the Protocol.

Short-term capital gains arising on transfer of listed shares sold on the stock exchange are however subject to a tax of 15% (excluding surcharge and cess) under domestic law. The Protocol will impact FPIs resident in Mauritius who were claiming relief under the treaty in respect of such gains. These gains will be taxable in India going forward (subject to the grandfathering in respect of shares acquired on or before 31 March 2017, and the two-year transition period with 50% taxability referred to above).

Private Equity Funds/Holding companies

Private Equity funds/holding companies who have invested in shares of unlisted companies in India are currently taxed at the rate of 10% (excluding surcharge and cess) on long term gains. Short term gains are taxed at the full rate of 40% (excluding surcharge and cess).

The withdrawal of the capital gains exemption under the Protocol will affect investments made in India by Mauritius based funds/holding companies. However, there are two recent changes which will ameliorate this position somewhat:

a) The period of holding for long-term treatment for unlisted shares is reduced from three years to two years as part of this year's Budget;

b) It has been clarified that the reduced rate of 10% on transfer of unlisted securities will apply to private company shares as well.

Here again, the grandfathering and transition provisions will provide relief. However, it may be useful to note that the transition provisions (which provide for a 50% reduction from the applicable domestic tax rate) may not practically be available in respect of long-term gains arising on transfer of unlisted shares. This is because the two year holding period required for long-term characterisation cannot be met within the two-year window contemplated under the transition provisions.

Indirect transfer cases

The Protocol grants source country taxation only as regards capital gains arising from the transfer of shares of a company resident in the source country. This may be contrasted with the provisions of the

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Capital Gains article under the India-US and India-UK treaty, which simply state that all capital gains taxation will be in accordance with the domestic law of the Contracting States.

Thus, under the Protocol, India will have the right to tax capital gains only when a Mauritius seller transfers shares of a company which is a resident of India. Gains arising from the transfer of shares of a foreign company (which is not resident in India) may continue to be taxable only in Mauritius. This is notwithstanding that the shares of such a foreign company may be deemed to be situated in India by virtue of the fiction contained in Explanation 5 to section 9(1)(i) of the Income-tax Act, 1961 (i.e. the indirect transfer provisions). This is because the indirect transfer provisions under the Act only seek to deem the situs of the foreign company's shares to be in India and do not have the effect of deeming such foreign company as a tax resident of India.

Convertible Debentures/Debt instruments

The Protocol provides for a tax rate of 7.5% on interest income, which is possibly the lowest in India's treaty network. Additionally, the Protocol extends India's source based taxing rights only to gains on transfer of *shares* of companies resident in India. Gains on transfer of capital assets such as convertible or non-convertible debentures held by a Mauritius resident should continue to be governed by the residuary Article i.e. Article 13(4) and ought to be taxable only in Mauritius.

Although compulsorily convertible debentures are equated with equity for Indian regulatory purposes, from a legal perspective, they continue to remain debt instruments until conversion. As such, any gains arising on their transfer before conversion, may not be subject to source country taxation under the Protocol.

The applicability of the grandfathering provisions to such convertible instruments could also pose challenges. For e.g., if the debentures are acquired prior to 31 March 2017 and converted into shares post that date, an issue may arise as to whether such converted shares will be grandfathered under the Protocol. Unless clarified, these could lead to uncertainty and potential litigation.

Bonus shares

Similarly, in the case of bonus shares, issues could arise as to whether their date of acquisition (for the purposes of grandfathering) should be determined from the date of issue of the bonus shares or from the date of acquisition of the original shares. This issue may need further clarity.

General Anti-Avoidance Rule ('GAAR')

It is also relevant to note that the provisions of GAAR are stated to come into force under the Act on 1 April 2017. The Finance Minister in his Budget Speech of 2015 had stated that GAAR would apply prospectively and that pre-2017 investments would be grandfathered. This indicates that pre-April 2017 investments from Mauritius could be grandfathered both under the treaty as well as from GAAR.

As far as the investments acquired post 1 April 2017 are concerned, these would not likely be grandfathered under GAAR, even though they could qualify for the two-year transition period referred to in the Protocol above (i.e. if the shares are acquired and sold before 31 March 2019). Having said this, since these investments are subject to a specific anti-avoidance rule under the LoB Article in the Protocol, one would expect that GAAR ought not to be invoked in such cases. However, further clarity on this may be warranted.

Other beneficial provisions under the treaty, including specifically the 7.5% tax rate on interest income, could also be potentially subject to scrutiny under GAAR, considering that the provisions of GAAR will prevail over tax treaties.

Other treaties

Another area where further clarity is needed is with regard to the position under the India-Singapore Tax Treaty. The Singapore Tax Treaty provides for a capital gains exemption, which is co-terminus with the capital gains exemption under the India-Mauritius Tax Treaty. Given the proposed grandfathering of pre-2017 investments from Mauritius and the two-year transition period, there is a need to address the issue of whether these concessions will be extended to investments from Singapore as well. Recent statements issued by Government officials suggest that changes to the

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India-Singapore treaty are also likely in the near future.

Policy Trends – some takeaways

The approach adopted by the Government in re-negotiating the India-Mauritius Tax Treaty appears to be mature and pragmatic. Specifically, the provision regarding grandfathering of existing investments and the reasonable transition period provided, are steps in the right direction and point to an increased recognition within the Government of the need to avoid abrupt policy shifts. This will go a long way in providing significant re-assurance to investors and provide a clear roadmap for taxation of future investments.

Having said this, there may perhaps be a need for a larger policy debate in India as to the overall level of tax rates. While the proposed reduction in corporate tax rates to 25% in a phased manner is certainly welcome, this should ideally form part of a wider discussion on whether India's strong preference for source-based taxation is leading to high tax costs overall. Specifically, as a capital importing country, there may be a need to consider the combined effect of (a) a corporate tax rate of around 30%, (b) taxes on profit repatriation (dividend distribution tax/ share buyback tax) of approximately 20%; and (c) capital gains on exit. This may go a long way in the evolution of a robust tax policy that serves India's long term investment and growth needs.

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