India plugs capital gains exemption loophole under tax treaty with Mauritius

After nearly a decade of negotiations, on 10 May 2016, India and Mauritius signed a protocol to amend the existing tax treaty that dates back to 1982. The most significant of the changes made by the protocol is a phased-in elimination of the residence-based taxation of certain capital gains, which will close off what commonly is known as the “Mauritius route” for investment into India. Specifically, the protocol will allow source-state taxation of capital gains from the sale of shares, which effectively will grant India taxing rights over gains derived by a Mauritius company from the sale of shares in an Indian company.

The current version of the India-Mauritius tax treaty provides that capital gains derived by an entity are taxable only in the state of residence of the seller; thus, gains derived by a Mauritius company from the sale of shares in an Indian company are not taxable in India under the treaty. Such gains are not taxable in Mauritius either, because Mauritius does not tax capital gains under its domestic law. As a result, capital gains from the sale of shares in an Indian company by a Mauritius company currently are exempt from tax in both India and Mauritius. This feature (known as the “Mauritius route”) has made the Mauritius treaty immensely popular among investors in India, with almost one-third of foreign investment coming from Mauritius at one point. The treaty is used by various types of investors, including corporations, private equity funds and institutional funds that invest in the Indian stock market.

The Indian tax authorities have made several attempts to deny benefits under the Mauritius tax treaty on the grounds that the treaty is being abused by “shell” companies set up in Mauritius by Indian resident investors (and multinational companies) to route funds into India without having to pay Indian capital gains tax on their investments. The authorities have challenged exemption claims by Mauritius-based companies and have tried to deny treaty benefits on the grounds that the Mauritius company is not the beneficial owner of the shares, but rather a mere conduit. However, the Supreme Court of India (in the Azadi Bachao Andolan and Ors case) upheld the Mauritius treaty benefits, provided the person deriving the capital gains is in possession of a valid tax residence certificate issued by the Mauritius government. The court observed that neither the Mauritius treaty nor Indian domestic law included any anti-abuse provisions. The Supreme Court decision has been followed by various high courts and tribunals in subsequent rulings.

Over the past few years, the Indian and Mauritius governments have maintained an ongoing dialogue to renegotiate the treaty and put a stop to double nontaxation because the Indian government felt it was losing significant tax revenue. There also has been a perception that Mauritius was being used to “round trip” Indian money back into the country as foreign investment. The recent OECD base erosion and profit shifting (BEPS) project gave further impetus to this dialogue, which ultimately resulted in the signing of the protocol.

It is important to note that the Indian government remains committed to providing a stable and predictable tax structure and chose to avoid making any retroactive changes through the protocol by allowing the “grandfathering” of all investments made on or before 31 March 2017 and providing for a lower tax rate on capital gains during the two transition years ending on 31 March 2019. However, at the same time, the government has acknowledged the need to tackle
treaty abuse and the round tripping of funds, prevent double nontaxation and encourage the flow of information between the two countries.

**Source-based taxation of capital gains on share sales**

Under the protocol, India will have the right to tax capital gains derived by a Mauritius company from the sale of shares of an Indian company acquired on or after 1 April 2017. However, grandfathering rules will provide protection to investments in shares acquired on or before 31 March 2017, that is, gains from the sale of such shares will be exempt from Indian tax.

The protocol also provides for a transition period before India will have the right to fully tax gains – gains arising during the period from 1 April 2017 to 31 March 2019 (in respect of shares acquired after 31 March 2017) will be taxed at 50% of the Indian domestic tax rate, subject to the fulfillment of conditions in the “limitation of benefits” (LOB) article (discussed below). As from 1 April 2019, capital gains from the sale of shares in an Indian company may be taxed in India at the full domestic tax rate.

The tax treatment of capital gains under the protocol is summarized in the following table:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Taxable in India</th>
<th>Rate of tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares acquired on or before 31 March 2017 and sold thereafter</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>Shares acquired on or after 1 April 2017 and sold on or before 31 March 2019</td>
<td>Yes</td>
<td>50% of the domestic tax rate, subject to fulfillment of the LOB conditions</td>
</tr>
<tr>
<td>Shares acquired after 1 April 2019 and sold thereafter</td>
<td>Yes</td>
<td>Domestic tax rate</td>
</tr>
</tbody>
</table>

**Introduction of LOB article**

The protocol includes a new LOB article that will operate to deny a resident of Mauritius (including a shell/conduit company) the benefit of the 50% reduction in the tax rate on gains from a sale of shares of an Indian company during the transition period if the Mauritius company’s affairs are arranged with the primary purpose of taking advantage of the benefits of the reduced tax rate in the transition rules.

A shell/conduit company will include any legal entity that falls within the definition of a “resident” under the treaty, but that has negligible or nil business operations or that carries out no real and continuous business activities in the contracting state. The protocol states that a resident will not be deemed to be shell/conduit company if (a) the company is listed on a recognized stock exchange of Mauritius; or (b) its total expenditure on operations in Mauritius is equal to or exceeds INR 2.7 million or MUR 1.5 million in the immediately preceding 12 months from the date the gains arise.

It is interesting to note that the protocol does not incorporate the “main purpose test” or “bona fide business test” mentioned in the 10 May 2016 press release issued by the Indian government to announce the signing of the protocol. The “primary purpose test” appears to be a subjective test, and no criteria to be fulfilled have been set forth.
Other source-based taxation changes

**Interest income earned by banks:** Interest that is derived and beneficially owned by a bank carrying on a bona fide banking business and that is a resident of the other contracting state currently is exempt from tax in the contracting state in which the interest arose (i.e. the source state). However, interest earned by other lenders is subject to withholding tax at the normal rates under domestic law.

The protocol will amend the interest article to set a maximum source-country withholding tax rate of 7.5% on gross interest payments to a resident of the other contracting state, including interest payments that are derived and beneficially owned by a bank carrying on a bona fide banking business. However, the protocol will “grandfather” interest payments to such a bank arising from loans or debt claims existing on or before 31 March 2017; in other words, interest arising in India and paid to a Mauritius resident bank will be subject to a 7.5% withholding tax rate in India if the relevant loan was concluded after 31 March 2017, and exempt from withholding tax in India if the loan was concluded on or before this date.

**“Other income” article:** Currently, “other income” derived by a resident of a contracting state is subject to tax only in the country of residence of the recipient. The protocol will amend the other income article to provide for source-based taxation, so that a Mauritius resident deriving other income from India (e.g. other income arising on the receipt of shares of an Indian company for inadequate consideration) will be subject to tax in India.

**New article on fees for technical services (FTS)**

The protocol will add an FTS article to the treaty to cover managerial, technical and consultancy services. The absence of an FTS article in the existing treaty, coupled with the fact that the “other income” article provides for residence-based taxation (unless the recipient has a permanent establishment (PE) or fixed base in the source state), has allowed companies to argue that services provided by a Mauritius company to an Indian company should not be subject to tax in India. With the introduction of FTS article, such services will be subject to a maximum withholding tax rate of 10% in India.

**Expansion of scope of PE**

The protocol will broaden the scope of the PE article by introducing a clause on service PEs, which will include consultancy services. A service PE will be deemed to be created for a foreign company where an employee of the foreign company carries on activities in India (for the same or a connected project) for more than 90 days in any 12-month period. Interestingly, the article does not specifically provide that a PE will be created only to the extent services are provided in India, which is in line with India’s reservations to the OECD model commentary.

The introduction of the service PE provision, coupled with the new rules for FTS (discussed above), should prevent foreign companies deriving FTS from India from arguing that they should not be subject to tax in India because the treaty does not provide for such taxation – such companies will be liable to tax on the income attributable to the service PE in India or on the FTS.
Revised exchange of information (EOI) article

The protocol will amend the existing EOI article to bring it in line with international standards and to enhance the flow of information between the tax authorities of India and Mauritius. An interesting aspect of the protocol is that it will allow either of the countries to disclose information obtained under the EOI article in public court proceedings or in judicial decisions. The protocol also provides for the use of information for any other purpose, provided the use is consistent under the laws of both states and the competent authority of the state supplying the information authorizes the use.

New article for assistance in collection of taxes

The protocol will add a new article relating to assistance in the collection of taxes, under which the contracting states will lend assistance to each other in the collection of revenue claims. The term “revenue claim” will mean an amount owed in respect of taxes of any kind imposed by the contracting states (or their political subdivisions or local authorities), as long as the taxation is not contrary to the treaty or any other instrument to which the contracting states are parties, as well as interest, administrative penalties and costs of collection related to the amount owed. This article will enable one contracting state to collect taxes with the help of the other state if the first state is unable to collect the taxes on its own.

Impact of the protocol

The protocol to the India-Mauritius tax treaty clearly aims to address long-standing issues of treaty abuse and the round tripping of funds. The protocol, combined with India’s general anti-avoidance rule that will become effective on 1 April 2017, will give more ammunition to the Indian tax authorities – it is possible that the Indian authorities increasingly may challenge Mauritius structures and attempt to deny treaty benefits, even during the transition period.

The changes to the capital gains article also will have ramifications for investments into India from Singapore, since the existing India-Singapore tax treaty links the benefits of residence-based taxation of capital gains on the sale of shares to the relevant article in the India-Mauritius treaty. According to recent press reports, it is understood that India will be renegotiating its tax treaty with Singapore (as well as the treaties with Cyprus and the Netherlands, both of which also restrict India’s taxing rights on capital gains).

While the protocol focuses on gains derived from the sale of shares of Indian companies, it does not deal with other instruments such as debt, investments in an Indian LLP, derivatives, bonds, offshore securities etc. These types of instruments could be used more frequently by taxpayers to claim beneficial treatment of capital gains under the Mauritius treaty. To be more conservative, investors also could consider converting hybrid instruments into shares before 1 April 2017 to take advantage of the benefit of the grandfathering provisions.

Overall, the amendments made in the protocol are in line with India’s commitment to the BEPS initiative (specifically, action 6 (preventing treaty abuse)) and the government’s commitment to curbing the potential for double nontaxation. The prospective applicability of the provisions and the grandfathering of past investments are welcome moves, and will provide certainty to investors with existing investments in India.
The protocol will enter into force once both governments notify each other that the relevant procedures required under their domestic laws have been completed.

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