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India, Mauritius revise tax treaty to limit abuse

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On May 10, 2016, the Indian Finance Ministry announced that a new protocol has been finalized to amend certain provisions of the Indo-Mauritius double taxation avoidance agreement. According to a press release issued by the Finance Ministry, the protocol is aimed at tackling the dual problem of treaty shopping and round tripping of funds, besides streamlining the flow of investment and stimulating the flow of exchange of information between the two countries.

In the main, the protocol vests India with the right to tax capital gains arising from the transfer of shares acquired on or after April 1, 2017, in a company resident in India from the 2017 financial year (earlier, capital gains were to be taxed by the country in which the transferor was tax resident). The protocol also grandfathers existing investments; and provides for a reduced tax rate (subject to a limitation of benefits clause) in respect of capital gains arising during April 2017 and March 2019 (transition period).

The change in the existing tax treatment of capital gains has rightly stolen the protocol's thunder, but there are other noteworthy revisions as well, including an elaborate article on exchange of information and a new article on collection of taxes. The key changes are discussed below.

Changes introduced

Capital gains tax

The protocol amends article 13 of the treaty (with effect from April 2017) by inserting two new paragraphs: paragraph 3A, which provides that gains from the alienation of shares acquired on or after April 1, 2017, in a company which is resident of a contracting state may be taxed in that state; and paragraph 3B, which provides that the rate of tax on capital gains arising between April 1, 2017, and March 31, 2019, shall not exceed 50 percent of the tax rate applicable on such gains in the state in which the target company is situated.

The protocol also adds a new article 27A on limitation of benefits. According to the article, the benefit of new paragraph 3B of the treaty (reduced tax rate) shall be denied in cases where the affairs are seen to be arranged with the "primary purpose" of taking advantage of the said paragraph. The article further provides in clause 2 that a shell or a conduit company posing as a resident of either contracting state shall not be entitled to the benefits of paragraph 3B.

The article clarifies that a shell or conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in the contracting state. A resident of a contracting state is deemed to be a shell or conduit company if its expenditure on operations in that contracting state is less than MUR1.5m or INR2.7m in the respective contracting state, as the case may be, in the immediately preceding period of 12 months from the date on which the gains arise; or if it is not listed on a recognized stock exchange of the contracting state.

Interest, PE and FTS

The protocol provides for a lower withholding tax of 7.5 percent (of the gross amount of the interest) on interest payments; and provides for a source-based taxation of interest income of Mauritian banks. The protocol expands the definition of permanent establishment to include the furnishing of services, including consultancy services, where such activities continue (for the same or connected project) for a period aggregating more than 90 days in any given 12-month period. Finally, the protocol inserts a new article 12A, on fees for technical services, to provide that such fees may be taxed in the contracting state in which they arise, but the tax cannot exceed ten percent (of the gross amount of the fees) if the beneficial owner of the fees is a resident of the other contracting state.

Mutual assistance and co-operation

The protocol replaces the existing article 26, on exchange on information, with a more elaborate one; and a new article 26A, on assistance in the collection of taxes (both articles mirroring the text contained in the OECD Model Tax Convention). The new article provides that the contracting states shall exchange such information as is “forseeably relevant” (the current article refers to information that is “necessary”) for carrying out the provisions of the tax treaty. Besides, a contracting state shall use its information gathering measures to obtain the requested information even where it does not need such information for its own tax purposes (neither can it decline to supply information solely because it does not have any domestic interest in such information).

The strict confidentiality requirement found under the current article has been retained, but an exception has been carved out to allow a contracting state to use the information received under the treaty for “other purposes” provided that such use is not only within the confines of the domestic laws but has also been authorized by the country sharing the information. Last, it has now been explicitly provided that the exchange of information is not restricted to article 1 (application to residents) or article 2 (taxes covered) of the tax treaty.

Need for the revisions (capital gains)

Those aware of the history of the treaty relationship between India and Mauritius would readily agree that the need for revising the 30-year old tax treaty was both genuine and urgent. Article 13(4) of the tax treaty, under which gains arising from the alienation of shares are taxable only in the resident country, has been long used (and, sometimes abused) by foreign companies to incorporate entities in Mauritius to get an exemption from Indian capital gains tax (since Mauritius does not levy capital gains tax, the investments go tax-free).

In the absence of any in-built anti-abuse rule, the treaty is open to abuse by shoppers and round trippers, who interpose shell companies in Mauritius to invest in India. There is no need to prove any genuine commercial activity in Mauritius and the production of a valid tax residency certificate is sufficient evidence to prove status of residency and be entitled to capital gains exemption under Article 13(4) (see Circular No.789 of April 4, 2000). In fact, the courts too have been uniform in holding that an anti-abuse rule cannot be read into the provisions of the treaty and that if Parliament were to prevent treaty abuse in general and treaty shopping in particular, adequate revisions in the treaty must be carried out (see *Azadi Bacho Andolan*; *Vodafone*; *Serco BPO Pvt Ltd*).

The changes carried out to article 13(4) are commensurate with the underlying objective of attaining an abuse-free tax treaty. The question however remains whether levying a tax on capital gains is a prerequisite to tackling the "long-pending issues of treaty abuse," given that the treaty was prone to abuse mainly because of lax residency requirements, although a favourable tax regime was admittedly a strong motivation to shop for the treaty. After all, the abuse could have been adequately tackled by putting adequate anti-abuse rules in place, in line with the OECD's final report on base erosion and profit shifting (BEPS) Action 6. It will not be out of place to mention that most of the abusive tax avoidance arrangements will any way be targeted by the Indian general anti-avoidance rule, which is due to take effect next year.

Importantly, the protocol will have a bearing on the India/Singapore tax treaty (in view of an existing agreement with Singapore) and there is a high possibility of India seeing a drastic downfall in foreign direct investments from both Mauritius and Singapore – two countries that have consistently been the go-to destination for channelling investments into India. It is yet to be seen whether the costs of a decrease in potential foreign direct investments will outweigh the assured benefits that would have been available otherwise, including through the collection of corporate tax and other forms of indirect taxes.

What's next?

The protocol as it stands today is not clear as to whether the changes will apply only to shares (as it appears from the text of the protocol) or to other forms of investments such as mutual funds, derivatives, and debt as well. This lack of certainty in taxation will see an increase in treaty disputes not only between taxpayers and tax authorities but also between tax authorities of different jurisdictions.

In a welcome move, the Indian government has created a working group of experts to examine the consequential issues arising from the amendments carried out in the tax treaty. The group will be headed by a senior CBDT official and will comprise officers from the Securities and Exchange Board of India; brokerage firms; and fund managers. The group is due to submit a report in September this year. Let us hope that the group clarifies the underlying issues (including compliance issues arising as a result of the changes) to increase investor certainty.

But with all its discontents, the protocol must be hailed as a voice from heaven, resolving one of the most significant challenges facing the tax treaty.

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