On 10 May 2016, India and Mauritius amend the India-Mauritius Double Taxation Avoidance Agreement dating 1983

In a significant development, the Government of India has entered into a protocol with the Government of Mauritius amending the agreement for the avoidance of double taxation between India and Mauritius, to the effect that India will henceforth have the right to tax capital gains income earned by Mauritian residents from the disposal of shares of Indian companies acquired by such Mauritian residents on or after 01 April 2017. We summarise below the key features of the protocol to the agreement for the avoidance of double taxation between India and Mauritius.

Article 13 of the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains between India and Mauritius ("India-Mauritius DTAA") allows Mauritius to tax capital gains earned by Mauritian residents from the disposal of shares of an Indian company. With no tax on capital gains on disposal of shares in Mauritius, this has resulted in Mauritius historically being the source of the highest amount of foreign investment inflow into India. Financial investors have favoured Mauritius as a jurisdiction through which to structure their investments into India by interposing a pooling or holding company in Mauritius prior to making investments into India. However, from time to time, the Mauritius route has come under scrutiny by Indian regulators principally due to concerns that it was being used for the purposes of tax avoidance, round tripping, and money laundering. Consequently, while Indian courts have consistently upheld the Mauritius route and granted Mauritian residents the benefits of the India-Mauritius DTAA, the Government of India has been negotiating with the Government of Mauritius over the past few years to amend the India-Mauritius DTAA.

The Government of India and the Government of Mauritius have now amended the India-Mauritius DTAA vide a protocol to the India-Mauritius DTAA dated 10 May 2016 ("the Protocol"). The key features of the Protocol are highlighted below.

Key Features of the Protocol

Source-based taxation of capital gains on disposal of shares

Income in the nature of capital gains earned by Mauritian residents from the disposal of shares of a resident Indian company acquired on or after 01 April 2017 will be taxed in India. For the period beginning 01 April 2017 and ending 31 March 2019 ("the Transition Period"), subject to such Mauritian resident fulfilling the conditions of a limitation of benefits ("LoB") clause to be inserted into the India-Mauritius DTAA, India will tax such capital gains income arising during the Transition Period at 50% of the rate prescribed under domestic tax laws in India ("Indian Tax Law"). As from 01 April 2019, however, the capital gains income earned by Mauritian residents from the disposal of shares of a resident Indian company acquired after 01 April 2017 will be taxed in India at the full rate prescribed under the Indian Tax Law.

Introduction of limitation of benefits clause

During the Transition Period, India will tax capital gains earned by Mauritian residents from the disposal of shares of an Indian company at 50% of the rate provided under the Indian Tax Law. However, the benefit of such reduced taxation during the Transition Period will be made conditional upon the concerned Mauritian resident fulfilling the requirements of an LoB clause to be inserted into the India-Mauritius DTAA. The LoB clause will specify that the Mauritian resident must pass a 'bona fide purpose' test and a 'main purpose' test, so as to demonstrate that it is not a mere shell or conduit company set up for the sole purpose of availing the beneficial tax treatment available under the India-Mauritius DTAA. It appears that the LoB clause will contain an objective threshold, along the lines of the LoB clause seen in the India-Singapore DTAA (see below), to determine whether a Mauritian resident is a shell or conduit company - a Mauritian resident claiming the benefit of the India-Mauritius DTAA will be deemed to be a shell or conduit company if its total expenditure on operations in Mauritius is less than INR 2.7 million or MUR 1.5 million (about USD 43,000) in the immediately preceding 12 months.

Grandfathering of investments made prior to 01 April 2017

Grandfathering provisions will be inserted into the India-Mauritius DTAA to provide that capital gains made by Mauritian residents on the disposal of shares of a resident Indian company acquired before 01 April 2017 will be taxable in Mauritius and not in India.

Enhanced exchange of information and other changes

It is understood that the provisions for exchange of information between India and Mauritius under the India-Mauritius DTAA will be made more robust to align them with international standards and that provisions obligating assistance in collection of taxes by Indian and Mauritian tax authorities will be introduced into the India-Mauritius DTAA. It is further understood that certain other provisions of the India-Mauritius DTAA will be amended to provide for source-based taxation rights for India, including the provisions regarding taxation of interest income made by banks resident in Mauritius.

<u>Possible Impact on the Protocol on the double taxation avoidance agreement entered into between India and Singapore ("India-Singapore DTAA")</u>

Under the India-Singapore DTAA, Singapore has the right to tax income in the nature of capital gains earned by Singapore residents from the disposal of shares of Indian companies ("Singapore Taxation Right"). As a result of (i) the Singapore Taxation Right, (ii) the low or nil tax rates and favourable regulatory climate in Singapore, and (iii) the comfort provided by the LoB clause of the India-Singapore DTAA to Indian tax authorities that the India-Singapore DTAA is not being abused to avoid payment of tax in India, Singapore has emerged in recent years as a popular jurisdiction through which to structure investments into India. However, the India-Singapore DTAA also contains a provision to the effect that the Singapore Taxation Right shall "remain in force" only so long as the India-Mauritius DTAA provides that gains earned from the disposal of shares of an Indian company by a Mauritian resident shall be taxable in Mauritius.

Given that the Protocol now provides that Mauritius will no longer have the right to tax income in the nature of capital gains earned by Mauritian residents from the disposal of shares in an Indian company, it may be reasonably concluded that the Singapore Taxation Right will also fall away. Consequently, income in the nature, inter alia, of capital gains earned by a Singapore resident from the disposal of shares of an Indian company will no longer be taxable in Singapore, and will become taxable in India.

SanFirst's comments

The above amendments to the India-Mauritius DTAA made by the Protocol formally bring to rest, though in a manner unfriendly to genuine foreign investors, a controversy that has been the subject of much litigation, legislation, and debate in India. The Protocol will allay the fears of the Government of India that the Mauritius route was being employed for round-tripping of funds, tax evasion, and money laundering. From an investor's point of view, a significant positive note is that the Protocol provides for grandfathering provisions regarding the shifting of taxation rights from Mauritius to India – therefore, financial investors have comfort that investments made (and not disposals) prior to 01 April 2017 will be taxed upon exit, in Mauritius and not in India. A negative outcome of the Protocol is that Mauritius may no longer be an attractive destination through which to structure investments into India; and other jurisdictions like the Netherlands, United Arab Emirates, etc. with which India has favourable tax treaties may become popular for structuring investments into India.

The application of the India-Mauritius DTAA's LoB clause is as yet slightly unclear. In particular, (i) the details of the 'main purpose' test and the 'bona fide purpose' test are unclear. There is a possibility that these tests may be subjective and lead to some uncertainty regarding the taxability of investments made during the Transition Period, and (ii) it is unclear whether the LoB clause will apply only to the taxation of capital gains under the India-Mauritius DTAA, or whether it would also apply for availing beneficial taxation of other kinds of income such as business income, royalties, etc.

Investors may need to secure Indian approvals (where required) and accelerate their investments into India through Mauritius with certainty, prior to 01 April 2017.

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You may contact us for the full Protocol or download it on the website of the Ministry of Finance and Economic Development: www.mof.govmu.org.

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