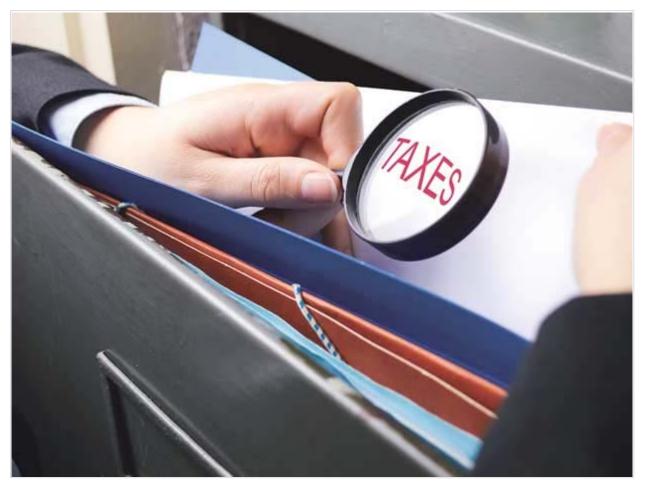
Business Standard

Five areas that will be impacted by Mauritius Protocol

The treaty between India and Mauritius was inked in 1983, but assumed significance a decade later, when foreign institutional investors were allowed to invest in Indian shares

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The government has inked a pact with its counterpart in Mauritius that gives it the right to tax capital gains arising in that country from sale of shares acquired on or after April 1, 2017, in Indian companies. There will be a transition period of two years for this change to a three-decade-old double taxation avoidance agreement (DTAA). During the transition, the tax will be limited to half the Indian tax rate. The full rate will apply FY 20. The earlier treaty was signed in 1983 and but became significant a decade later, when foreign institutional investors were allowed to invest in Indian shares.

A 2012 position paper on undisclosed money made references to these Mauritius vehicles as conduits for "round-tripping" of unaccounted money back into India. This evoked a strong rebuttal from Mauritius. It had expressed hope that a joint working group would come out with a structure where the interests of both countries would be safeguarded. Four years later, with the signing of the pact, investors would hope that such a structure is finally in place, ending the uncertainty and upsetting of stock markets that came with mention of the M-name.

In a note on the development, law firm Nishith Desai Associates analysed the impact of the change on various stakeholders. Here are five key areas, which could see some action in the coming days:

Article 6 of the protocol to the India-Singapore DTAA says the benefits in respect of capital gains arising to Singapore residents from sale of shares of an Indian company shall only remain in force till the analogous provisions under the India-Mauritius DTAA continue to provide the benefit.

The latter provisions have now been amended. And, while the new DTAA has a grandfathering provision which protects investments made before April 1, 2017, the concern is that it might not be possible to extend such protection to investments made under the India-Singapore DTAA. And, so, alienation of shares of an Indian company acquired by a Singapore resident after April 2017 might not necessarily be able to obtain, for instance, the benefits of the existing provision on capital gains, as the beneficial provisions under the DTAA would have terminated on such date.

Private equity funds and holding companies:

Investments made through hybrid instruments such as compulsory convertible debentures may still be eligible to claim residence-based taxation. For, the official statement only refers to allocation of taxation rights in respect of shares and the protocol could restrict the shift to source-based taxation on such transactions. Clarity shall only be available once the protocol's text is issued, the Nishith Desai note said.

Private equity funds which are raising money now and to start deploying this in the next financial year would also be required to first decide on and communicate to investors on the route they'd take.

Foreign Portfolio Investors (FPIs):

Under the income tax law, shares of listed Indian companies held by FPIs are deemed to be capital assets, irrespective of the holding period or the frequency of trading equity by the entity concerned. Income from sale of shares results in capital gains and at present, FPIs enjoy the benefits of the provisions in this regard under the Mauritius DTAA. Such investments will also be impacted by the amendment and by the protocol, shall be subject to tax in India after April 1, 2017. There is a zero per cent rate applicable on gains arising out of shares that are listed and sold on a

recognised stock exchange if these are held for more than 12 months; if held for less than this, capital gains on these are subject to a tax rate of 15 per cent (exclusive of applicable surcharge and cess). During the transition period, and subject to the satisfaction of the limitation of benefits clause, this rate may be reduced to 7.5 per cent.

P-Note issuers:

Issuers of participatory notes (P-Notes) might be adversely affected, as the cost of taxation arising out of the changed position would have to be built into such arrangements. This would make these costlier and less lucrative for investors seeking synthetic exposure to Indian securities. As the FPI entity is issuing the P-Note which will be subject to tax in India, issues could arise with respect to the tax amounts they will be able to pass on to the P-Note holders, due to a timing mismatch with the taxability of the FPI entity. It will have to be seen whether P-Notes can still be attractive for investors.

F&O transactions:

Similar to the position in respect of compulsory convertible debentures, Mauritius-based entities that enter futures and options contract in India might still be able to claim the benefits of residence-based taxation, as such contracts relate to capital assets other than shares. However, complete clarity on this position shall only be available after the text of the Protocol is released.

Lawyers feel existing structures will have to be re-examined once the fine print is out and complete overhaul or restructuring might be required in case of some instruments such as P-notes.

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