Tax Hotline

January 03, 2017

INDIA AND SINGAPORE SIGN PROTOCOL REVISING TAX TREATY

- India and Singapore sign a protocol amending the agreement for avoidance of double taxation with Singapore.
- India shall have the right to tax capital gains arising from alienation of shares acquired on or after April 01, 2017 by a Singapore resident.
- Investments in shares made before April 01, 2017 have been grandfathered and will continue to enjoy the benefits of the erstwhile provisions of the India-Singapore tax treaty. Capital gains arising from the alienation of such investments will not be subject to capital gains tax in India, subject to a revised Limitation of Benefits clause provided for under the protocol.
- Capital gains arising out of the alienation of instruments other than shares (convertible debentures, bonds etc.) held by Singapore residents should continue to be entitled to benefits of taxation only in Singapore.
- The protocol provides for domestic anti-avoidance measures to override treaty provisions.

OVERVIEW OF THE PROTOCOL

In a press note dated December 30, 2016 ("**Press Note**"), the Indian government announced the signing of the third protocol ("**Protocol**") to amend the double tax avoidance arrangement between India and Singapore ("**Singapore Treaty**"). The amendments introduced by the Protocol are largely along the lines of those introduced by the protocol amending the double tax avoidance arrangement between India and Mauritius ("**Mauritius Protocol**"), which India and Mauritius recently entered into. While the Indian government is yet to release the text of the Protocol, the same has been made available on the website of the Inland Revenue Authority of Singapore.[1]

The Protocol amends the prevailing residence based tax regime under the Singapore Treaty and gives India a source based right to tax capital gains which arise from the alienation of shares of an Indian resident company owned by a Singapore tax resident. It provides for (i) the grandfathering of investments made on or before March 31, 2017, (ii) a revised limitation of benefits ("**Revised LOB**") clause, the conditions of which need to be fulfilled in order to obtain the benefit of the capital gains provisions, (iii) a transitory period from April 01, 2017 to March 31, 2019 during which a reduced rate of tax should be applicable on capital gains arising on the alienation of shares acquired on or after April 1, 2017, and (iv) explicit language allowing treaty provisions to be overridden by domestic anti-avoidance measures such as the General Anti-Avoidance Rule ("**GAAR**"), which is slated to come into effect from April 1, 2017.

BACKGROUND

India and Singapore signed the Singapore Treaty on January 24, 1994. Since then the Singapore Treaty has been amended twice by protocols dated June 29, 2005 ("**2005 Protocol**") and June 24, 2011 ("**2011 Protocol**").

Under the Singapore Treaty as it stands today (i.e., after its amendment by the 2005 Protocol), capital gains arising from the alienation of shares of an Indian company by a tax resident of Singapore are taxable only in Singapore. This position is in line with that under the India-Mauritius Tax Treaty ("**Mauritius Treaty**") as it stood before amendments introduced by the Mauritius Protocol.

However additionally, the 2005 Protocol provides that the capital gains tax benefit should be available subject to a 'limitations of benefit' (LOB) clause, which provides that a Singapore tax resident would not be entitled to the capital gains tax benefit if (i) its affairs are arranged with the primary purpose of taking advantage of the benefits provided under the Singapore Treaty, or (ii) it is a shell / conduit company. A shell/conduit company is defined to mean 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 Singapore. The LOB clause provided that in order for a Singapore entity not to be deemed a shell / conduit company (thereby making such entity eligible to claim the capital gains tax benefit), such entity would have to either (a) be listed on a recognized stock exchange in Singapore or (b) incur total annual expenditure of SGD 200,000 on operations in Singapore in the 24 months immediately preceding the date on which the gains arise.

Further, Article 6 of the 2005 Protocol provides that the benefits with respect to capital gains which were made available under the 2005 Protocol would be co-terminus with the benefits made available under the Mauritius Treaty. Consequently the beneficial regime available under the Singapore Treaty is slated to fall away on March 31, 2017, when the Mauritius Protocol is to come into effect. Clouds of uncertainty have hung over the Singapore Treaty, especially regarding whether it would be revised to confer similar benefits to investments made by Singapore based entities as will be available under the revised Mauritius Treaty. This uncertainty has now been addressed by the signing of the Protocol.

AMENDMENTS INTRODUCED BY THE PROTOCOL

(i) Taxation of capital gains on shares

Research Papers

Handbook on New Labour Codes
April 29, 2024

Compendium of Research Papers
April 11, 2024

Third-Party Funding for Dispute Resolution in India
April 02, 2024

Research Articles

Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy
January 25, 2024

Private Equity and M&A in India: What to Expect in 2024?
January 23, 2024

Emerging Legal Issues with use of Generative AI
October 27, 2023

Audio

Third-Party Funding: India & the World
April 27, 2024

IBC allows automatic release of ED attachments: Bombay HC reaffirms
April 15, 2024

The Midnight Clause
February 29, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Q&A 2024 Protocol to the Mauritius India Tax Treaty
April 22, 2024

Boost to India's Space Potential: India Liberalizes Foreign Direct

By virtue of the 2005 Protocol, capital gains derived by a Singapore resident from the alienation of shares of a company resident in India ("**Indian Company**") were taxable in Singapore alone, subject to fulfilment of the LOB clause. However, the Protocol marks a shift from residence-based taxation to source-based taxation. Consequently, capital gains arising on or after April 01, 2017 from alienation of shares of a company resident in India shall be subject to tax in India. The aforementioned change is subject to the following qualifications:-

(a) *Grandfathering of investments made before April 01, 2017*

The Protocol states that capital gains arising out of sale of shares of an Indian Company that have been acquired before April 01, 2017 shall not be affected by the Protocol. Such investments shall continue to enjoy the treatment available to them under the erstwhile provisions of the Singapore Treaty. However, investors will need to fulfil the requirements of the Revised LOB clause instead of the LOB clause under the 2005 Protocol.

(b) *Transition period*

The Protocol provides for a relaxation in respect of capital gains arising to Singapore residents from alienation of shares acquired after April 1, 2017 but alienated before March 31, 2019 ("**Transition Period"**). The tax rate on any such gains shall not exceed 50% of the domestic tax rate in India ("**Reduced Tax Rate**"). However, this benefit will also be subject the Revised LOB provided under the Protocol.

(c) *Limitation of benefits*

The Protocol provides that grandfathered investments i.e. shares acquired on or before 1 April 2017 which are not subject to the provisions of the Protocol will still be subject a Revised LOB in order to avail of the capital gains tax benefit under the Singapore Treaty, which provides that:

- The benefit will not be available if the affairs of the Singapore resident entity were arranged with the primary purpose to take advantage of such benefit;
- The benefit will not be available to a shell or conduit company, being a legal entity with negligible or nil business operations or with no real and continuous business activities.

An entity is deemed to be a shell or conduit company in case its annual expenditure in Singapore is less than SGD 200,000 in Singapore, during each block of 12 months in the immediately preceding period of 24 months from the date on which the capital gain arise ("**Expenditure Test**"). A company is deemed not to be a shell/conduit company if it is listed on recognized stock exchange of the country or it meets the Expenditure Test. This is in line with the existing LOB that is in place under the 2005 Protocol.

With respect to availing the benefit of the Reduced Tax Rate during the Transition Period, the Revised LOB will still apply with one exception: the Expenditure Test will need to be fulfilled only in the immediately preceding period of 12 months from the date on which the capital gain arises. This is a departure from the earlier LOB clause under the 2005 Protocol, which required expenditure of SGD 200,000 on operations in Singapore in the 24 months immediately preceding the alienation of shares.

(ii) Interest Withholding Rate Remains at 15%

The Protocol has not introduced any changes to the rate of withholding tax on interest payments prescribed under the Singapore Treaty. This may place Singapore at a disadvantage to Mauritius as an ideal jurisdiction to structure debt investments into India, though it should be noted that unlike in the case of Mauritius, the domestic tax rate in Singapore is 17%, meaning that a lower withholding tax rate would not necessarily result in any significant benefit for Singapore in relation to Mauritius. Of course, for funds which enjoy exemptions under the Singapore fund regime or in cases where there is leverage in the Singapore company, the 15% withholding tax rate can end up being a cost or, alternatively such funds or companies may have relied on the lower withholding tax rates for certain types of interest prescribed under the Indian domestic tax regime; in such scenarios, there may have been the expectation that if the Protocol introduced capital gains tax benefits on the lines of those introduced by the Mauritius Protocol, the lower withholding tax rate for interest payments available under Mauritius Protocol would have also been adopted for the Singapore Treaty.

More importantly, gains arising from the alienation of instruments other than shares (such as convertible debentures, bonds etc.) should remain taxable only in Singapore. Investors based in Singapore for other reasons may prefer to invest via debentures, as investments via equity/preference shares may no longer be viable. This would however be subject to application of domestic general anti avoidance rules.

Further, gains arising from the transfer of other capital assets such as interests in Limited Liability Partnerships (LLPs) may also continue to be taxed only in Singapore. Given the recent liberalization of foreign direct investment in LLPs, this is another tax efficient investment avenue that may be explored going forward.

(iii) Enabling language for GAAR

The Protocol has inserted Article 28A to the Singapore Treaty which reads:

"This Agreement shall not prevent a Contracting State from applying its domestic law and measures concerning the prevention of tax avoidance or tax evasion."

The language of the newly inserted Article 28A makes it clear that the Indian government's sees the GAAR as being applicable even to situations where a specific anti-avoidance provision (such as an LOB clause) may already exist in a tax treaty. Interestingly, similar language was not introduced by the Mauritius Protocol.

Making the GAAR applicable to companies that meet the requirements of a LOB clause is likely to adversely impact investor sentiment. Under the GAAR, tax authorities may exercise wide powers (including denial of treaty benefits) if the main purpose of an arrangement is to obtain a tax benefit and if the arrangement satisfies one or more of the following: (a) non-arm's length dealings; (b) misuse or abuse of the provisions of the domestic income tax provisions; (c) lack of commercial substance; and (d) arrangement similar to that employed for non-bona fide purposes. It will be interesting to see the interplay between the Revised LOB provision and the GAAR as well as any measures that the Revenue may take to override the provisions under the treaty.

Investment
April 03, 2024

Cyber Incident Response Management
February 28, 2024

IMPACT AND ANALYSIS

(i) Impact on private equity funds and holding companies

As mentioned earlier, while investments by a Singapore resident in shares of an Indian Company made before April 01, 2017 should continue to be eligible to avail of the benefits of the erstwhile provisions of the 2005 Protocol, such benefits shall be subject to fulfilling the requirements of the Revised LOB clause. Further, shares purchased on or after April 1, 2017, and alienated during the Transition Period should be subject to tax in India at the rate of 50% of the tax rate prevailing in India. However, availing such benefits will again be subject to the Revised LOB clause. Purchase of shares after April 01, 2017 which are then alienated after the expiry of the Transition Period should be subject to regular tax as per the domestic tax rate in India.

Investments made through hybrid instruments such as compulsory convertible debentures should continue to be exempt from tax in India and Singapore should have the right to tax gains from such instruments.

The impact of the Protocol will have to be carefully considered by Indian companies looking to set up Singapore based holding structures. Quick implementation may still allow companies to avail of the benefit of the grandfathering provisions. However, with the GAAR set to come into force, and a concerted effort by the Indian authorities to introduce source based taxation in those treaties which do not already provide for it, offshore investors may also need to carefully reconsider their choice of intermediate jurisdiction and the overall value of investing through intermediate jurisdictions.

(ii) Impact on shares held by Foreign Portfolio Investors ("FPIs")

Under the Indian 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 carried out by the concerned FPI. As such, income from sale of shares results in capital gains and at present, FPIs enjoy the benefits of the capital gains provisions under the Singapore Treaty.

While the Protocol should provide some relief to FPIs based out of Singapore as regards the tax regime to be applicable to their investments after March 31, 2017, they will find themselves in a similar position to FPIs based out of Mauritius. The signing of the Protocol will no doubt result in an increase in tax costs, especially where short terms capital gains are earned. However, what appears clear from the spate of amendments to India's tax treaties in the recent years, is that the Indian government is making a concerted effort to bring the era of tax free investments in India to a close, and is consciously moving towards a source based taxation regime which factor should be considered by investors looking to invest in India.

(iii) Impact on derivatives, P-Notes etc.

The Protocol will have a significant impact on P-Notes issued against underlying shares of Indian companies. While to a large extent the changes to the treaty were expected, there was a hope that residence based taxation for portfolio investments would be extended. However, the amendments do not create a distinction and this will have an impact on P-Note investments, especially in issues relating to tax pass through to the P-Note holders on the taxes payable by the FPI. The Protocol should not adversely impact derivatives, which should also continue to enjoy exemptions from Indian capital gains taxes. The gap that is created between the tax treatment for equity shares *vis-à-vis* derivative instruments may lead to a shift in strategies that are dominated by exposure to derivative instruments as opposed to investments in equity shares.

CONCLUSION

The signing of the Protocol is welcome as it sets to rest uncertainty regarding the future taxation regime that would be applicable to investments by Singapore based entities. While the Protocol does result in increased taxation for foreign investors, this was expected, given recent trends, especially the amendment of the Mauritius and Cyprus tax treaties. While the Protocol puts Singapore at an advantage over Cyprus, in that the Protocol provides for grandfathering of existing investments and provides for a transition phase of reduced taxation, the Protocol may result in Singapore falling behind Mauritius as a preferred jurisdiction for debt investments into India. Along with the Netherlands, where a number of debt investment platforms have recently been set up, Mauritius will give Singapore some competition for being the preferred intermediate jurisdiction for investment into India. However, it is not unlikely that the Indian government will push for the tax treaty with the Netherlands to be revised. In such a scenario, existing investment structures will need to be relooked at, and preferred intermediate jurisdictions reassessed.

One troubling factor is the treaty article that provides for the GAAR override of treaty provision. GAAR confers sweeping powers on tax authorities, including the denial of treaty benefits, and investors are sure to be apprehensive about what situations the tax authorities may see as fit for applying the GAAR. The apprehension of being subject to GAAR may serve to counteract the certainty that the LOB provisions are intended to provide.

– Joachim Saldanha, Ashish Sodhani & Rajesh Simhan
You can direct your queries or comments to the authors

[1] https://www.iras.gov.sg/irashome/uploadedFiles/IRASHome/Quick_Links/Protocol%20amending%20Singapore-India%20DTA%20(Not%20in%20force)%20(31%20Dec%202016).pdf