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India-Mauritius tax treaty re-negotiated: what it means for international business

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In what appears to be one of the most significant tax changes in recent Indian history, the India-Mauritius tax treaty has been re-negotiated. And, with talks of the Indian government following suit with other Indian tax treaties, like those with Singapore and Netherlands, this really has begun a new chapter for foreign investments into India.

Historically, Mauritius has been a preferred jurisdiction for investors, especially pooling vehicles looking to invest in Indian markets. The main attraction is the exemption from Indian tax under the India-Mauritius tax treaty on capital gains arising to a Mauritius resident from sale of shares/securities. Such gains are only taxable in Mauritius. And, since Mauritius does not levy capital gains tax, such transactions could result in a zero capital gains tax liability for the investor. Understandably, Mauritius has consistently been one of the top sources of foreign investment into India.

On May 10, though, the governments of India and Mauritius signed a protocol to their tax treaty, allocating taxing rights over such capital gains to India in case of a sale of shares of an Indian company by a Mauritius resident. In order to ensure tax certainty, the Indian government has gone on to provide certain grandfathering and limited limitation of benefits provisions as well. At the same time, withholding taxes on interest have been lowered to a 7.5% tax rate. Therefore, while equity investments may need to factor in additional Indian tax costs, debt investments will likely get a boost from the treaty amendments.

While the text of the protocol has been released by the Indian government, an official notification of the same is awaited (and expected in the next couple of months), for the protocol to come into force.

Amendments to the treaty

Taxation of capital gains: Under the amended treaty, capital gains arising from the sale or transfer of shares of an Indian company by a Mauritius resident which have been acquired on or after April 1, 2017, shall be taxable in India.

Consequently, investment in shares before April 1, 2017, shall be grandfathered and taxed as per the unamended provisions of the treaty, even if these shares are alienated after April 1, 2017.

As far as share investments made after April 1, 2017, are concerned, a lower tax rate may be applied if the alienation of shares occurs between April 1, 2017, and April 1, 2019. The amendment provides that during this transition period, the tax rate on any such gains shall not exceed 50% of the domestic tax rate in India. However, to use this benefit, Mauritius investors would need to fulfill the 'Limitation of Benefits' clause, which provides two conjunctive tests – (a) the Mauritius company should not be a shell or conduit company; and (b) it satisfies the bona fide business/main purpose test.

A minimum expenditure requirement has been prescribed, and failure to meet such requirement would result in the Mauritius resident deemed to be a shell or conduit. This would occur when the total expenditure on operations in Mauritius is less than INR 27 Lakhs (approx. USD 40,000) in the 12 months immediately preceding the share transfer.

Taxation of interest: A positive change as a result of the negotiation is the introduction of a lower withholding tax of 7.5% for interest payments made by an Indian resident to a Mauritius investor. The existing treaty does not provide for a beneficial rate of tax, and the domestic interest withholding tax rates apply – which range from 5% to 40%. This amendment comes as a welcome move in the private debt space.

Other changes: Apart from the significant changes discussed above, others include (1) amendments to the 'permanent establishment' (PE) article to include the concept of service PE, i.e., based on the presence of employees or personnel; (2) introduction of a specific article dealing with taxation of fees for technical services; and (3) provisions relating to cross collection of revenue claims.

The protocol also amends a unique feature of the existing India-Mauritius treaty which accords the right to tax 'other income' to the resident state. Under the amended provision, the source country shall have the right to tax 'other income.' Under Indian domestic tax laws, notional income such as receipt of shares below fair value is taxed as 'other income' in the hands of the recipient on the difference between the consideration paid and fair value of the shares. These transactions,

which enjoy protection under the treaty when shares were sold to a Mauritius buyer, could now have tax exposure in India.

Impact on foreign investments

A direct result of the change to the India-Mauritius treaty would be the loss of capital gains tax exemption available under the India-Singapore tax treaty. This is because the India-Singapore tax treaty contains a specific provision which automatically terminates the capital gains tax exemption under the treaty if the India-Mauritius tax treaty gives India capital gains taxing rights in respect of gains arising to a Mauritius resident from sale of Indian shares.

Unfortunately, it is not clear whether grandfathering of pre-2017 investments will be possible under the India-Singapore treaty. Press reports suggest that lawmakers are in talks to re-negotiate the India-Singapore treaty to ensure tax certainty for earlier investments, in line with the promise of the Modi government to end 'tax terrorism."

Another interesting conclusion is the extent to which the amendments provide India with taxing rights for the alienation of 'shares.' Securities, such as convertible and non-convertible debentures and other debt instruments, should not fall under the purview of 'shares.' As a result, sale of debt securities should continue to enjoy the Indian capital gains tax exemptions. This is an added incentive for debt investments. Coupled with a lower withholding tax rate, a tax friendly exit would certainly make debt investments and mezzanine debt a lucrative option for foreign investors.

Overall, equity investments, especially hedge funds that generally adopt short term strategies, would be most affected by the amendment, as short term capital gains taxes on the sale of listed securities over the stock exchange is subject to a 15% tax rate.

Investment funds having long term strategies in listed securities should still be able to benefit from the domestic tax exemption for capital gains on shares held for more than 12 months. Private equity and venture capital investors, which typically invest in the unlisted space, would also be adversely impacted, and would need to factor in such incremental Indian tax costs.

While the government has maintained that it is moving towards a "tax certain" environment, there continue to be unanswered questions and unintended consequences.

For example, Indian domestic laws provide for deeming fictions in case of determining holding periods of capital assets – arising from corporate reorganizations such as mergers, demergers, and even liquidations and gift of

shares. It is yet to be seen whether such deeming fictions under Indian domestic law can be extended to claim the grandfathering benefits.

Another key issue is whether investments originally made in the form of convertible debt (prior to 2017) that are converted into equity (post 2017), may still qualify for grandfathering, considering the instrument is not a share investment. Moreover, it will be difficult for long term private equity/venture capital investors to actually benefit from grandfathering it since the investment has to be acquired and exited within a two year window. And, exiting within two years results in a short term capital gain in such investments so, to that extent, one can only reduce the exposure from say 40% to 20%.

Working group

It is anticipated that these amendments will impact a large chunk of foreign investors, particularly since, in some cases, Indian tax costs could be as high as 40%. While on one hand, Indian sectors are continuously being opened or liberalized to attract foreign investment, the additional cost of Indian taxes will surely cause foreign investors to pause and reconsider their strategy and structures.

The Indian government has shown cognizance to the industry's concerns, and has very recently constituted a working group to consider the issues arising from the amendments. All those interested should submit their comments and suggestions by July 4. The working group is expected to provide a report in three months.

The working group is being headed by the joint secretary of the Indian Central Board of Direct Taxes, and comprises of revenue officers and representatives of SEBI, custodians, brokerage firms and fund managers. Representation of industry players, and not just government officials, should help in providing the industry perspective as the working group discusses the issues.

This is definitely a positive effort by the Indian government, although given that the treaty was amended after years of negotiations, any changes or concessions will likely be only in Indian domestic law. It will be interesting to see what changes will be recommended by the working group and actually be brought about by the Indian government.

That said, press reports suggest that the Indian government is looking to re-negotiate tax treaties providing similar benefits – such as those with Singapore, Netherlands, and Cyprus. One would still need to wait and watch on the nitty-gritties, although the message is clear, namely, the government intends to transition to source-based taxation for foreign investors making Indian investments.

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