The Travails of the India Mauritius Tax Treaty & the Road Ahead

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"In 1993, when I assisted structuring of the first company under the then new offshore Mauritius Offshore Business Activities Authority regime, little did I realize that Mauritius would become India's largest investment partner, facilitating approximately 44% of the total FDI into India. Since then the tax treaty between India and Mauritius has been subjected to and survived numerous attacks from the revenue authorities, the press and certain sections of public despite its legitimacy. Interestingly, the treaty has been defended by the same revenue authorities and the government at the highest political level resulting in the survival of the treaty. The end result has definitely been positive.

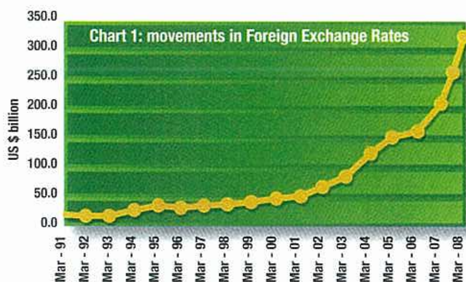
For me personally, and as a lawyer, it has been a fascinating journey holding Mauritius's hand at every point of inflection, especially before the judiciary. I had an opportunity to represent Mauritius's interest (and in turn India's too) in number of cases notably AIG India Sectoral Fund, TCW/ICICI, DLJ Private Equity and ultimately Azadi Bachao Andolan where Supreme Court of India placed its final seal of approval on the use of Mauritius entities for investment in India.

Going forward, instead of resenting the loss of tax revenue on capital gains in India, we should celebrate the increased gains in other direct taxes such as corporate, dividend and employment taxes, and indirect taxes due to increased economic activity brought about by FDI facilitated by the India - Mauritius Treaty."

Nishith Desai

Introduction

The Double Tax Avoidance Agreement ("DTAA") between India and Mauritius ("Treaty") has played a pivotal role in the India story. India embarked upon liberalization almost two decades ago at a time when the balance of payment crisis forced India to open her economy for foreign investments. India's foreign exchange reserves have grown significantly since 1991. The process of liberalization has resulted in an improved balance of payments position. Her foreign exchange reserves, which stood at a lowly US$ 5.8 billion at the end of March 1991, increased gradually to US$ 38.0 billion by the end of March 2000. Subsequently, the reserves rose to US$ 113.0 billion by the end of March 2004, and dramatically surged to US$ 309.7 billion by the end of March 2008.



Source: Reserve Bank of India

A considerable slice of credit for this turn-around goes to Mauritius, which has entered into a favorable tax treaty with India for avoidance of double taxation and encouragement of trade and investment. Over a period of time, it has become a practice amongst foreign investors to invest in India by setting up a special purpose vehicle in Mauritius.

However the history of the Treaty goes further back in time than the liberalization of the Indian economy. India and Mauritius shared a DTAA during the colonial times under the British Empire . Upon attaining independence in 1968, Mauritius severed its tax treaty relationship with India until it signed the comprehensive Treaty with India on August 24, 1982. This article seeks to trace the turbulent history of the Treaty and chart a tranquil and productive way forward for the two nations.

History of the Treaty

The Government of the Republic of India and the Government of Mauritius entered into the Treaty, which came into force in India on April 1, 1983. Indian regulations, at the time of entering into the Treaty, did not permit free trade with certain countries, especially with South Africa. India was desirous of liberalizing these trade barriers and enhance the trade relations with some of its friendly neighboring countries such as Mauritius. The preamble to the Treaty indicates that the basic purpose of entering into the agreement was not merely to avoid the incidence of double taxation and prevention of fiscal evasion, but also, importantly, to encourage mutual trade and investment. In the initial years, Indian companies which had operations in Mauritius, benefited from the Treaty as they did business with a number of African countries with which Mauritius had a preferential agreement on trade and tariffs. Further generally, as per the Treaty, capital gains earned by an entity are taxable only in the country of residence. Therefore India further benefitted through the Treaty as it had the sole right to tax the capital gains earned by the Indian companies operation through Mauritius.

Mauritius had started developing as an offshore banking jurisdiction in 1988/89, and wanted to be the platform to Africa. In 1992, when Mauritius ventured as a non-banking offshore regime, it became the road to India, because of the favorable capital gains tax provisions in the Treaty. Investors investing in India began to combine the flexibility of the favorable offshore business regime in Mauritius with the advantage of the tax-efficient Treaty. The launching of Mauritius as a non-banking offshore investment jurisdiction coincided with the liberalization of the Indian economy in 1991.

The tables had turned and almost overnight, Mauritius became the route to India and the preferred platform for the foreign investors investing in India.

Consequently, capital gains earned by a Mauritius resident on disposal of shares of an Indian company would not be chargeable to tax in India but would be chargeable to tax only in Mauritius. However, as per the taxation framework prevailing in Mauritius an offshore company does not pay capital gains tax in Mauritius. Thus, by virtue of the Treaty, an offshore company resident in Mauritius would pay no capital gains tax either in India or in Mauritius and would be liable to tax only in its home jurisdiction.

Surviving the Turbulence – Judicial Controversies

While the Treaty has served as an ideal route for offshore investments into India, it has also been a subject of many-a-controversy in India. The Indian government has, however, constantly supported the Treaty. There have been several clarifications as regards the provisions of this Treaty. The Central Board of Direct Taxes ("CBDT") issued Circular No.682, dated March 30, 1994 clarifying that, capital gains derived by a resident of Mauritius by alienating shares of Indian companies shall be taxable only in Mauritius according to Mauritius tax law.

This position was questioned in 1994 by the Indian Income Tax authorities ("Revenue Authorities") pursuant to a ruling of the Authority for Advance Rulings ("AAR"). They sought to deny the Treaty benefits to all such cases, where the beneficial ownership of the income of Mauritius companies could be linked to a single parent outside Mauritius. This ruling was overturned by the AAR in another case, where the broad-basing of investors and the commercial justification were used as a differentiating factor.

However, in early 2000, the Revenue Authorities once again sought to deny the Treaty benefits to some Mauritius resident companies. According to the tax authorities the beneficial ownership in these companies was outside Mauritius and thus the foremost purpose of investing in India via Mauritius was tax avoidance. The tax authorities alleged that Mauritius was merely being used as a conduit and thus sought to deny the Treaty benefits, despite the absence of a limitation of benefits provision in the Treaty. This led to a down-run on the stock market in India and caused panic amongst the foreign investors.

In response to this controversy, the CBDT issued a circular No. 789 dated April 13, 2000 stating that the "Mauritius Tax Residency Certificate" issued by the Mauritius Tax Office was sufficient evidence of tax residence of that company in Mauritius and that such companies were entitled to claim the Treaty benefits. As a result, the tax officers were stopped from questioning the beneficial ownership of the Mauritius resident companies and applicability of Treaty benefits. However, two writ petitions were filed with the Delhi High Court as public interest litigations, challenging the constitutional validity of the abovementioned circulars. These circulars were sought to be struck down as unconstitutional so as to render the Treaty virtually inoperable.

We give below a summary of a few important cases which chart out the controversies surrounding the Treaty.

- In Re: Advance Ruling No. P-9 of 1995:

In this case, the applicant companies were two limited liability companies incorporated in Mauritius. Their 100% ownership was with an English bank. The Mauritius companies invested in an Indian company and sought the ruling on their taxation in

India. The AAR observed by way of obiter that all the shares of the applicant companies were held by the English bank. It held that the English bank and not the applicants were the real and beneficial owner of the assets of the applicant companies including the shares in the Indian company. It was held that the Mauritius companies were only conduits and the entire transaction was undertaken to take the benefit of the Treaty more particularly for the purpose of avoidance of Indian income tax. In this case, the AAR denied the ruling on the grounds that the transaction was designed prima facie for the avoidance of tax. Under the provisions of Income Tax Act, 1961 ("ITA"), the AAR is not empowered to issue rulings on tax planning techniques. The AAR, however, confirmed that the benefits of the capital gains tax article should nevertheless be available to the Mauritius companies as the Article on capital gains in the Treaty, unlike the Article dealing with Dividends, does not use the phrase 'beneficial owner'.

- In Re: Advance Ruling No. P-10 of 1996:

In this case, the applicant together with certain group affiliates set up a fund to pool funds from international investors for investment in Indian infrastructure projects. In view of the commercial, cost and tax advantages the applicant decided to set up the fund in Mauritius. The fund sought the ruling on the tax implications in India.

The AAR gave weight to the commercial considerations for locating the company in Mauritius, in particular, low cost of professional services and regulatory constraints under Indian law which made it more expedient to channel all foreign investments into India through one entity rather than attempting to persuade investors to come into India individually. The AAR allowed the application and stated that the benefits of the Treaty were available to the applicant as it had commercial justification in investing in India via Mauritius.

- In Re: XYZ/ABC, Equity Fund:

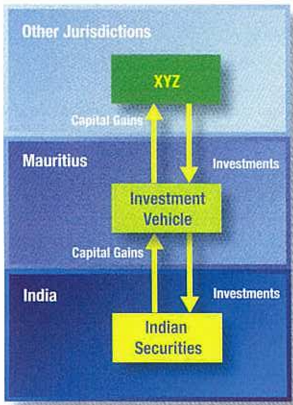
In this ruling, the AAR held that the gains realized on the divestment of shares in India by a Mauritius-based private equity fund would be regarded as business profits. According to the AAR, private equity funds are carrying on a systematic business of buying and selling shares and hence gains arising on sale of shares should be taxed as business profits and not as capital gains. The AAR considered all the aspects of a private equity fund structure and ruled that neither the investment adviser in India, nor its custodian could be said to constitute a Permanent Establishment (PE) of the Mauritius based fund in India. Hence, in the absence of a PE, the entire business profits will be taxable only in Mauritius and will not be taxable in India. The AAR upheld the Circular and stated that a 'Tax Residency Certificate' granted by the relevant Mauritius tax authorities was adequate proof of the "resident" status of the fund, pursuant to which the fund was eligible for the tax benefits under the Treaty.

- The Azadi Bachao Andolan Controversy:

This controversy deals with the abovementioned writ petitions filed with the Delhi High Court as public interest litigations. The petitions challenged the constitutional validity of the abovementioned circulars of the CBDT, which were sought to be struck down as unconstitutional so as to render the Treaty virtually inoperable. In this case, the applicability of benefits of the Treaty to residents of a third country by means of

"treaty shopping" through 'shell companies' was under consideration.

Subject to specified exceptions, Article 13 of the Treaty provides that income in the nature of capital gains derived by a resident in the Contracting State from the alienation of movable property is taxable only in the State in which such a person is a 'resident'. Therefore, should a resident of Mauritius receive capital gains income from the sale of shares of an Indian company, the same are liable to tax in Mauritius. However, Mauritius does not levy any tax on capital gains tax. Therefore, this resulted in what is alleged to be "double non-taxation" of capital gains earned by a resident of Mauritius.



Arrangement in Azadi Bachao Andolan

As discussed above, this was confirmed by CBDT Circular No. 682 dated 30.3.1994. Through this circular, it was clarified that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius taxation laws and will not be liable to tax in India. It was further clarified by CBDT Circular No. 789 dated April 13, 2000, which stated that wherever a Certificate of Residence is issued by the Mauritian Authorities, such Certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the Treaty. These circulars were challenged in the Delhi High Court, which struck it down as bad and illegal.

On appeal, however, the Supreme Court of India overruled the judgment of the Delhi High Court. It held that it is the sovereign power of the State to enter into treaties with other States under the Constitution of India. It was held that the Judiciary has no power to judge the legality of treaty shopping merely because one section of thought considers it improper. In other words, the Supreme Court held that the State was free to negotiate the terms of a treaty and that the judiciary would have no power to decide on the legality of such terms. The Supreme Court further noted that if it was intended that a national of a third State should be precluded from the benefits of the Treaty, then a suitable term of limitation of benefits to that effect would have been incorporated therein. It was further pointed that the Treaty was entered into, not only for the purpose of avoidance of double taxation and prevention of fiscal evasion, but also to encourage mutual trade and investment between the two countries. Quoting the Supreme Court: "There are many principles in fiscal economy which, though at first blush might appear to be evil, are tolerated in a developing economy, in the interest of long term development. Deficit financing, for example, is one; treaty shopping, in our view, is another". The Court held that since there was nothing in the Treaty against the

so-called treaty shopping, the circular was neither bad nor illegal.

• The Controversy, Post-Azadi Bachao Andolan:

The above ruling of the Supreme Court of India has now laid to rest the controversies surrounding the use of Mauritius as a tax-efficient offshore investment jurisdiction. However the controversies surrounding the Treaty were not completely subsided with the above judgment of the Supreme Court. India was concerned about the abuse of the Treaty by Indian nationals and issues of "round-tripping". In September, 2006, an Indian government official had said: "We are proposing to bring the DTAA with Mauritius on a par with the DTAA with Singapore. The DTAA with Singapore had included additional clauses to check round-tripping of investments." The new proposals were said to include a rule that only companies listed on a recognized stock exchange be eligible for capital gains tax exemption under the Treaty, and that a company should have a total expenditure of $200,000 or more on operations in Mauritius for at least two years prior to the date on which a capital gain arises.

In response, in October, 2006 the Mauritian government announced that it would tighten up rules on the issuance of Tax Residence Certificates, and in future would issue them for only one year at a time. Mauritius Minister of Finance, Rama Sithanen stated that that he was willing to co-operate with India to prevent misuse of the Treaty.

"Let me state very clearly that we will collaborate to prevent any alleged misuse of the Treaty," said Mr. Sithanen, at a news conference on a trip to New Delhi. "But keeping in view historical, cultural, political and diplomatic ties between the two countries we need a global solution that will not penalize Mauritius." He Asserted that "the problem of round tripping has been eliminated completely."

Mauritius and India have also signed a Memorandum of Understanding ("MoU") laying down rules for information exchange between the two countries. The MOU provides for the two signatory Authorities to assist each other in the detection of fraudulent market practices, including insider dealing and market manipulation in the areas of securities transactions and derivative dealings. Its principal objective is to support the sound development of the securities markets in both countries by encouraging legitimate best practices. Structures have been established for effective implementation of exchange of information, both on request and on a voluntary basis, about suspicious securities dealings between the two countries. The intention behind the MOU is to track down transactions tainted by fraud and financial crime, not to target bona fide legitimate transactions. Further, Mauritius has also enacted stringent 'Know your Clients' ("KYC") regulations and anti money laundering laws, which seek to avoid abusive use of the Treaty.

Another often debated controversy surrounding the Treaty is whether the gap left by the non inclusion of a limitation of benefits provision can be bridged by unilaterally amending provisions of the ITA. At a casual glance at the issue, it may seem that this difficulty may be easily overcome by amending the domestic income tax law. Generally, the executive is, qua the State, competent to represent the State in all international matters and may by agreement, convention or treaty incur obligations, which are binding upon the State. However these

obligations are not per se binding upon Indian nationals, unless they are domesticated by the Parliament by appropriate legislation. While it is true that the power to legislate lies with the Parliament, a closer examination of the provisions makes it clear that the Constitution does not provide for a watertight separation of powers between the executive and the legislature. The power of the executive extends to matters with respect to which the Parliament can make laws. Therefore, no legislative measure is needed to give effect to the agreement or treaty insofar as the justiciable rights, as guaranteed by the Constitution, are not affected by the treaty. Therefore, it may be said that the applicability of a treaty is independent of the provisions of the ITA and the same cannot be altered by a mere amendment thereof. Further, any attempt to alter the applicability of the Treaty could amount to a breach of the rule of "pacta sunt servanda" as contained in Article 26 of the Vienna Convention on the Law of Treaties, 1969, which is part of customary international law and has been adopted by the Constitution of India. It appears that such an amendment could lead to various litigious issues against the backdrop of the Constitution of India.

IV. Conclusion – A Long Way Ahead for Economic Co-operation

The expression 'globalization' refers to the optimal integration of national economies into the international economy through trade, foreign direct investment, capital flows, migration, and the spread of technology. Simply, the expression can be used to mean sourcing from where a product or service is cheapest and selling where it is dearest. However, taxation can distort this equation of optimal integration. International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Thus, double taxation involves the taxation of the same entity in its domestic jurisdiction and at least one foreign jurisdiction. While domestic taxes can be considered obligatory, taxation in foreign jurisdictions are generally perceived as extraneous costs. In the global village that the world has become, these additional costs may prove to be fatal to business and, consequently, the global economy itself. Various arrangements, within the framework of law, are adopted by businesses to avoid or plan the phenomenon of international double taxation. The use of the Treaty is an example of such an arrangement.

While many resent the loss of tax on capital gains in India on account of the Treaty, often times, one fails to recognize the benefits India derives through the very same Treaty. Mauritius has indeed facilitated investments from third countries, which may not have been otherwise feasible, due to difficulties in claiming tax credits in certain jurisdictions for taxes paid in India coupled with either unfavorable provisions of a corresponding DTAA, or the absence of a DTAA. These investments received by India have further generated enormous corporate and indirect tax collections. As the following chart depicts, Mauritius accounts for approximately 44% of the Foreign Direct Investment received by India since April, 2000. Further the Treaty does not restrict India's right to levy corporate income tax, dividend distribution taxes, and other indirect taxes under the Treaty.

Further, it must be noted that India is no longer only a capital importing country.

Rank	Country	2005-06 (April – March)	2006-07 (April – March)	2007-08 (April – March)	2008-09 (April – May 08)	Cumulative Inflows (from April.	%age with total Inflows (in terms of rupees)
1.	Mauritius	11,441 (2,570)	28,759 (6,363)	44,483 (11,096)	11,768 (2,858)	122,141 (28,493)	43.99
2.	U.S.A.	2,210 (502)	3,861 (856)	4,377 (1,089)	3,303 (794)	23,260 (5,327)	8.38
3.	Singapore	1,218 (275)	2,662 (578)	12,319 (3,073)	2,508 (616)	20,633 (4,973)	7.43
4.	U.K.	1,164 (266)	8,389 (1,878)	4,690 (1,176)	901 (216)	19,965 (4,579)	7.19
5.	Netherlands	340 (76)	2,905 (644)	2,780 (695)	362 (86)	12,284 (2,791)	4.42
6.	Japan	925 (208)	382 (85)	3,336 (815)	104 (25)	9,440 (2,151)	3.40
7.	Germany	1,345 (303)	540 (120)	2,075 (514)	381 (93)	7,120 (1,637)	2.56
8.	Cyprus	310 (70)	266 (58)	3,385 (834)	720 (177)	4,787 (1,162)	1.72
9.	France	82 (18)	528 (117)	583 (145)	989 (236)	4,373 (997)	1.58
10.	U.A.E.	219 (49)	1,174 (260)	1,039 (258)	574 (139)	3,447 (802)	1.24
Total FDI Inflows *		24,613 (5,546)	70,630' (15,726)	98,664 (24,579)	31,568 (7,681)	301,668 (70,191)	-

**Source: Fact Sheet on Foreign Direct Investment, Department of Industrial Policy & Promotion*

Capital outflows have risen sharply in the recent past. While overseas direct investments from India for the year 2006-07 stood at US$ 13.512 billion, the figure stood at US$ 16.782 billion for the year 2007-08. These figures account for more that 50% of the FDI received by India for the respective years. Mauritius, which is a member of the South African Development Community, provides a very lucrative platform for investment in Africa and exploration of its vast virgin natural reserves. Given its wide treaty network, Mauritius could prove to be an outstanding base for Indian overseas investment into the African continent. Further, under the Treaty, India reserves the right to tax capital gains generated by Indian residents in Mauritius.

Quite evidently, the Treaty is not only an efficient channel into India, as an investment destination, but also provides tremendous opportunities for India, as a capital exporting nation. Along with the Treaty and other cordial economic and cultural relations, Mauritius and India have a long way to go as mutually beneficial allies.