

# Tax Hotline

December 14, 2016

## INDIA AND CYPRUS SIGN REVISED TAX TREATY

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- India and Cyprus sign revised agreement for avoidance of double taxation with Cyprus.
- As per the revised agreement, India shall have the right to tax capital gains arising from the transfer of investments made on or after April 01, 2017.
- Investments made before April 01, 2017 have been grandfathered and will continue to enjoy the benefits of the erstwhile provisions of the existing agreement for avoidance of double taxation with Cyprus. Gains arising from the transfer of such investments will not be subject to capital gains tax in India on the basis of the revised agreement.
- No clarity, yet, on whether Cyprus has been de-notified as a Notified Jurisdictional Area.

### OVERVIEW OF THE REVISED TAX TREATY

Recently, India and Cyprus have signed a revised agreement for the avoidance of double taxation and fiscal evasion ("**Revised Treaty**"). The Revised Treaty is the outcome of prolonged and extensive negotiations. While the text of the Revised Treaty has recently been published in the Cyprus Gazette,<sup>1</sup> the Indian Government is yet to make the text of the Revised Treaty public. However, the Indian government has recently announced the signing of the Revised Treaty by way of a press note dated November 18, 2016, highlighting the major amendments ("**Press Note 1**"). Press Note 1 follows on the heels of a press release dated July 1, 2016 ("**Press Note 2**") in which the Indian Government stated that the text of the Revised Treaty was being placed before the Cabinet for approval and a press release dated August 24, 2016 ("**Press Note 3**") in which the Indian Government stated Cabinet approval had been accorded to the Revised Treaty.

#### (a) Source Based Taxation of Capital Gains

The Revised Treaty provides for source based taxation of capital gains arising from the alienation of shares, instead of residence based taxation as provided under the existing tax treaty ("**Existing Treaty**").

However, the Revised Treaty provides for the grandfathering of investments made prior to April 1, 2017. Therefore, the source based taxation under the Revised Treaty shall only be applicable to capital gains arising from the transfer of investments made on or after April 1, 2017, and capital gains arising from the transfer of investments made prior to April 1, 2017 should continue to be taxed only in the jurisdiction in which the taxpayer is a resident.

#### (b) Expansion of the 'permanent establishment' concept

The Revised Treaty expands the scope of 'permanent establishment', introducing the concept of a 'service' permanent establishment, created where employees of an enterprise furnish services, including consultancy services in a country and such activities continue within the country for a period or periods aggregating more than 90 days within any 12- month period. The Revised Treaty has also specifically includes (i) sales outlets, (ii) warehouses (in relation to a person providing storage facilities for others) and (iii) farms, plantations or other places where agricultural, forestry, plantation or related activities are carried on, within the inclusive definition of 'permanent establishment'. Further, the Revised Treaty provides for the creation of a construction permanent establishment if activities carry on for more than 6 months, instead of the earlier requirement that the activities be carried on for more than 12 months.

Further, the Revised Treaty amended the following explicit deemed permanent establishment exclusions:

1. *the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information or for scientific research, being activities solely of a preparatory or auxiliary character in the trade or business of an enterprise;*

The amended provision now simply reads: *the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*

2. the use of facilities solely for the purpose of *storage, display and delivery* of goods or merchandise belonging to the enterprise, or the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of deliver.

The amended provision excludes the word "delivery".

#### (c) Exchange of information, mutual assistance and other changes

The Revised Treaty has also reduced the permissible withholding tax rate on royalty payments to 10% from the

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existing rate of 15%, thus bringing the rate under the Revised Treaty in line with the tax rate under Indian tax laws. The permissible withholding tax rate on interest remains at the earlier 10%.

The Revised Treaty has also updated the provisions dealing with the exchange of information between India and Cyprus to match prevailing international standards and to enable the exchange of banking information and allow the use of such information for purposes other than taxation with the prior approval of the competent authorities of the country providing the information. The Revised Treaty also provides for assistance between India and Cyprus in relation to the collection of taxes.

## DE-NOTIFICATION OF CYPRUS AS A NOTIFIED JURISDICTIONAL AREA WITH RETROSPECTIVE EFFECT

In November, 2013, following a determination that Cyprus was not providing the information requested by Indian tax authorities under the exchange of information provisions of the Existing Treaty, the Indian Government notified Cyprus as a Notified Jurisdictional Area ("NJA") under Section 94A of the Income Tax Act, 1961 ("ITA"),<sup>2</sup> resulting in:

- the application of transfer-pricing regulations to transactions between taxpayers and persons located in Cyprus.
- the denial of deductions in respect of any payment made to any financial institution in Cyprus unless the taxpayer authorized the Indian tax authorities to seek relevant information from the said financial institution, on its behalf.
- the denial of deductions in respect of any expenditure or allowance arising from transactions involving a person located in Cyprus unless the taxpayer maintained and furnished certain specified information.
- requiring the taxpayer to satisfactorily explain the source of any sum received from a person located in Cyprus, in the hands of such person or in the hands of the beneficial owner, with failure to do so resulting in such sum being treated as income of the taxpayer.
- subjecting payments made to a person located in Cyprus to a withholding tax at the higher of a rate of 30% or a rate prescribed under the ITA.

Following the notification of Cyprus as a NJA, a press release dated November 7, 2013 ("**Cyprus Press Release**") was released by the Cypriot Ministry of Finance stating that the Cypriot Government was in direct contact with the Indian Government and was exerting every effort to clarify and resolve the situation. Despite this, Cyprus has remained a NJA, which has directly affected the business communities in both countries, creating uncertainty for existing investments from Cyprus and resulting in a drop in foreign investment in India from Cyprus.

Press Note 2 had stated that India and Cyprus had discussed the issue of notification of Cyprus under section 94A of ITA, and that both sides had agreed that India will consider rescinding the said notification with effect from 1st November, 2013, and would initiate the process for the same. However, Press Note 3 made no mention of whether Cyprus will cease to be a NJA.

However, on November 18, 2016, following the signing of the Revised Treaty, the Cypriot Minister of Finance stated that *"the completion of the negotiation and the successful agreement on all pending issues pave the way for the removal of Cyprus from the list of Notified Jurisdictional Areas retrospectively as of 1st November 2013"*.

As on the date of this publication, there is still no clarity on whether Cyprus will remain a NJA.

## IMPACT AND ANALYSIS

### (i) A shift towards source based taxation.

By and large, India's network of over 100 tax treaties provide for source and residence based taxation of capital gains arising from the transfer of shares of a company. However some exceptions exist, for example, India's tax treaties with Singapore, Jordan (provided the transferor is subject to tax in the state of residence), Philippines, Portugal, and Zambia provide for taxation of gains arising from the transfer of shares of a company only in the state of residence of the transferor.<sup>3</sup>

Over the last few years, India has undertaken a concerted effort to revise its tax treaties and has successfully revised its treaties with Indonesia, Thailand, Mauritius, and most recently Korea, to provide for source based taxation of capital gains arising from the transfer of shares of a company. The revision of the treaty with Mauritius (one of India's largest sources of foreign investment) showed the determination of the Indian government to move towards a source based taxation of capital gains regime (please refer to our earlier hotlines [\[here\]](#) and [\[here\]](#)). The Indian Government is reportedly also in the process of amending its treaty with Singapore along similar lines. The Revised Treaty with Cyprus marks yet another milestone in this process.

For the time being, residence based taxation of gains arising from the transfer of investments in instruments other than shares e.g., debentures continues.<sup>4</sup> Further, in the absence of an enabling treaty provision along the lines of that in the tax treaty with South Africa<sup>5</sup> gains arising from the indirect transfer of Indian shares should continue to be taxable only in the state of residence of the transferor.<sup>6</sup>

### (ii) De-notification of Cyprus as a Notified Jurisdictional Area

While Press Note 1 is silent on whether Cyprus has been removed from the list of notified jurisdictional areas, it is likely, based on the Cyprus Press Release, Press Note 1 and the comments of the Cypriot Minister that it is only a matter of time before Cyprus is removed from the list of notified jurisdictional areas, with retrospective effect. Once the Cyprus is de-notified as an NJA, particularly with the grandfathering of investments, it should be possible for investors to rely on the Revised Treaty to obtain a clean exit without being subject to capital gains tax in India.

### (iii) Cyprus as a tax efficient jurisdiction for investing into India?

While Mauritius negotiated a better interest withholding rate (7.5%) than the Revised Treaty currently contains (10%), and, unlike the India-Mauritius tax treaty, the Revised Treaty does not provide for a transition period<sup>7</sup> of taxation at reduced rates, the continuation of residence based taxation for gains arising on transfer of instruments other than shares, and Cyprus' membership of the European Union should serve to return some of some of the country's lustre as an efficient jurisdiction for investment into India. A quick de-notification of Cyprus as an NJA may even encourage fresh investments through Cyprus prior to April 1, 2017.

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## SIAC 2025 Rules: Key changes & Implications

February 18, 2025

Interestingly, the Revised DTAA does not contain a Limitation of Benefits clause (“**LOB**”). This is contrary to the trend that arisen in recent years, with India amending / revising many of its tax treaties to include an LOB clause.<sup>8</sup> In the times to come, it will be exciting to see the interplay between the General Anti-Avoidance Rules (“**GAAR**”) which are slated to come into effect from April 1, 2017 and the re-negotiated tax treaties (especially the LOB clauses) and the impact on structures and investments. Notably, the Shome Committee report had recommended that where anti-avoidance rules are provided for in a treaty, the GAAR provisions should not apply to override the provisions of the treaty. Interestingly, the LOB clause in the amended Mauritius tax treaty requires a company desirous of claiming benefits to either (i) be listed on a stock exchange in Mauritius or (ii) incur expenditure on operations in its state of residence to a tune of INR 2.7 million in the 12 months immediately preceding the date on which the gains arise. This is similar to the language of the LOB clause in the Singapore tax treaty. However, the Singapore LOB clause will cease to be in effect on April 1, 2017, unless the Singapore treaty is amended prior to that date.

– Joachim Saldanha & Ashish Sodhani

You can direct your queries or comments to the authors

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<sup>1</sup> <http://www.cygazette.com/Gazette.dtl/%7B45FB63C7-A07D-429B-809A-B2D8D57A6ECE%7D/AppPgView?IssueNo=4216&PageNo=386&AppNo=7&PartNo=1&IssueDate=11/25/2016>

<sup>2</sup> Section 94A of the ITA was introduced by the Finance Act, 2011 as an anti-avoidance measure. Under Section 94A, the Indian Government may, having regard to the lack of effective exchange of information with any country or territory outside India, notify such country or territory as a notified jurisdictional area.

<sup>3</sup> Some treaties, like those with Belgium, Denmark, France, Sweden, Spain & the Netherlands provide for taxation of gains only in the state of residence subject to fulfillment of certain criteria (e.g., shareholding thresholds, subject to tax test etc.)

<sup>4</sup> Under India's tax treaties, with the exception of gains arising from the transfer of (i) immovable property, (ii) movable property forming part of a permanent establishment and, (iii) ships and aircraft, gains arising from the transfer of any other property are usually taxable only in the state of residence of the transferor. India's tax treaties with China, the USA, UK and Canada and Australia are some notable exceptions, with gains from any the transfer other property being taxable in both the state of source and the state of residence. Conversely, India's tax treaties with Fiji, Greece and Egypt, provide for taxation of gains from the transfer any other property only in the country of source. The recently amended tax treaties with Mauritius, Korea and Thailand continue to provide for residence based taxation of gains arising from the transfer of "other property".

<sup>5</sup> Article 13(5) of the India-Africa tax treaty provides that “*Gains derived by a resident of a Contracting State from the sale, exchange or other disposition, directly or indirectly, of shares or similar rights in a company, other than those mentioned in paragraph 4, which is a resident of the other Contracting State, may be taxed in that other State.*”

<sup>6</sup> Article 13(6) of the Revised Treaty provides that “Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5, shall be taxable only in the Contracting State of which the alienator is a resident.” Based on the ruling of the Andhra Pradesh HC in *Sanofi Pasteur Holding SA v. Dept. of Revenue* [W.P.Nos. 14212 of 2010, 3339 and 3358 of 2012] gains arising from the transfer of shares of a Cypriot company whose value is derived substantially from shares of an Indian company should fall within the scope of Article 13(6) and therefore be taxable only in Cyprus.

<sup>7</sup> Under the recently notified Protocol amending the India-Mauritius Tax Treaty (set to come into effect from April 1, 2017), gains from the sale investments made after April 1, 2017 but before March 31, 2019 are subject to taxation in the source country at only 50% of the applicable domestic tax rate. Gains from the sale of investments made prior to March 31, 2017 remain taxable only in Mauritius, but gains from investments made after March 31, 2019 will be taxable in Mauritius and India.

<sup>8</sup> India's has incorporated variations of an LOB clause in its tax treaties with the USA, (1990), Singapore (1994 / 2005), Namibia (1999), Armenia (2004), UAE (2007), Iceland (2008), Kuwait (2008), Syria (2009), Luxembourg (2010), Myanmar (2010), Tajikistan (2010), Finland (2011), Mexico (2011), Mozambique (2011), Georgia (2012), Lithuania (2012), Norway (2012), Tanzania (2012), Taiwan (2012), Uzbekistan (2012), Ethiopia (2013), Jordan (2013), Malaysia (2013), Nepal (2013), Romania (2013), UK (2013), Albania (2014), Bhutan (2014), Columbia (2014), Fiji (2014), Latvia (2014), Sri Lanka (2014), Uruguay (2014), Macedonia (2015), Malta (2015), Thailand (2015), Poland (2015), Indonesia (2016), Korea (2016), Mauritius (2016).

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