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Investing in India? Take a Look at the Amended India-Mauritius Tax Treaty Before You Do

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On May 10, 2016, India and Mauritius signed a protocol amending the India-Mauritius double income tax treaty that would, among other things, permit India to tax a Mauritian resident on capital gains arising from the sale of shares of Indian companies acquired on or after April 1, 2017. Although equity investments made prior to April 1, 2017 will not be subject to the protocol, the protocol will have a profound impact on foreign investors' use of Mauritian entities to structure inbound equity investment into India. Foreign equity investors will likely turn away from Mauritius and toward jurisdictions that have more favorable tax treaties with India such as the Netherlands, Cyprus (although it is currently blacklisted in India) and UAE. Although Singapore historically has been among the more favored countries for inbound India investment, the protocol will also apply to Singapore investors because the India-Singapore double income tax treaty links its capital gains tax regime to the capital gains tax regime in the India-Mauritius double income tax treaty.

Background:

In 1983, the treaty between India and Mauritius for the avoidance of double taxation (the "India-Mauritius double income tax treaty") entered into force.[1] Under Article 13, capital gains derived by a resident of one contracting state from the "alienation" of certain property—meaning the sale, exchange, transfer or relinquishment of property—are only taxable in such contracting state. In general, this applies to any property except for immovable property, movable property forming part of the business property of a permanent establishment or fixed base, and ships and aircraft. As a result, Mauritian companies owning shares of Indian companies can sell or transfer such shares without the capital gains being subject to taxation in India. Mauritius, thus, has been an attractive jurisdiction from which equity investment in India is originated.

The Protocol:

Although the protocol addresses a handful of topics, the key takeaway is that the protocol amending the India-Mauritius double income tax treaty (the "protocol") changes the tax treatment of capital gains. It specifically provides that gains from the sale or transfer of shares acquired on or after April 1, 2017 in a company which is resident of a contracting state may be taxed in that state.[2] India thus will have the right to tax Mauritian residents on the sale of shares in Indian companies. This right, though, is limited to gain on shares

[1] A copy of the India-Mauritius double income tax treaty is available at http://www.mra.mu/index.php/taxes-duties/double-taxation-agreements (last visited May 17, 2016).

[2] The text of the protocol is available at http://mof.govmu.org/English/Pages/default.aspx (last visited May 17, 2016). See the press release from the government of India dated May 10, 2016 available at http://www.incometaxindia.gov.in/Pages/press-releases.aspx (last visited May 17, 2016).

acquired on or after April 1, 2017. Gain from the sale or transfer of shares acquired before April 1, 2017, regardless of when sold or transferred, is "grandfathered" under the old rules described above. Also, the protocol provides a phase-in for the capital gain tax rates if certain requirements are met: gain with respect to shares acquired on or after April 1, 2017 but transferred during the period of April 1, 2017 through March 31, 2019 shall be taxed at a rate not to exceed 50% of the applicable tax rate applied to such gain in the state of the company whose shares are being sold or transferred. However, under new limitation on benefits provisions, this phase-in of a lower tax rate only applies if (i) the selling company has not arranged its affairs with the primary purpose of taking advantage of the lower tax rate, (ii) the selling company must satisfy a main purpose test and a bona fide business test, and (iii) the selling company is not a shell or conduit company.[3]

In addition to the capital gains rules, the protocol contains several other amendments including:

- Interest - In general, tax withholding in India imposed on interest arising in India and paid to Mauritian resident banks will be limited to a withholding rate of 7.5% with respect to debt-claims or loans made after March 31, 2017. For debt-claims existing on or before March 31, 2017, interest income arising to a Mauritian resident bank will be exempt from tax withholding in India.[4] As a result of this reduction in the withholding tax applicable to interest, Mauritius may become a more favorable location for companies that hold debt issued by Indian entities.
- Permanent establishment - The definition has been broadened to encompass the furnishing of services (including consultancy services) if such services and activities continue for a period aggregating more than 90 days within any 12-month period.[5]
- Fees for technical services - In general, fees for technical services arising in India and paid to a Mauritian resident may be taxed in India so long as the tax does not exceed 10% of the gross amount of fees if the beneficial owner of the fees is a Mauritian resident.[6]
- Other income - Income that is not addressed in any other provision may be taxed in the state in which the income arises. This adds to the existing provision in the treaty that only allows such other income to be taxed in the state of residence of the recipient.[7]

The protocol is not yet in force but will be once the governments of India and Mauritius notify one another that the procedures required by their laws for bringing the protocol into force are completed.

Effects of the Protocol:

The change in the treaty will have significant effects on how third party investors place capital in India. Hundreds of private equity, venture capital and real estate funds are organized under Mauritius law due to the favorable provisions of the treaty. It seems likely

[3] See Article 8 of the protocol.
[4] See Article 2 of the protocol.
[5] See Article 1 of the protocol.
[6] See Article 3 of the protocol.
[7] See Article 5 of the protocol and Article 22 of the India-Mauritius double income tax treaty.

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that, as noted above, other jurisdictions will emerge as the primary focus of new investments into India. At a minimum, more complex, tiered Mauritian structures may be required to minimize the effects of the protocol.

Importantly, the scope of the implications of the change with respect to future investments by Mauritian companies holding "grandfathered" stock is not certain. Consider a Mauritian company that, prior to April 1, 2017, owns 100% of an Indian company and subsequently makes an additional capital investment. It is unclear under the protocol whether the additional capital investment into the 100% owned Indian company would affect the "grandfathered" status of the existing shares in the Indian company and whether any new shares actually issued as a result of such an additional capital investment would be similarly "grandfathered" or would be treated as newly acquired shares. Unless clarity emerges regarding the treatment of situations like this under the protocol, care will need to be taken with respect to subsequent capital investments in existing Indian entities. Likewise, any proposed restructuring or reorganization transactions (including purely internal reorganizations) that involve Mauritian entities holding "grandfathered" Indian equity investments should be closely scrutinized to ensure that "grandfathered" status is preserved.

Conclusion:

The protocol may cause foreign investors to rethink using Mauritian entities for equity investment in India, resulting in investors looking to other jurisdictions such as the Netherlands or UAE. Mauritian entities holding "grandfathered" stock should be mindful of the effects that the new rules potentially could have on additional capital investments.

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