Analysis of the amendment in the India Mauritius Treaty

I. INTRODUCTION

India and Mauritius have entered into a limited revision in the tax treaty ("DTAA") vide entering a protocol dated May 10, 2016. As a result India shall now be eligible to tax interest payable to banks residents in Mauritius and capital gains arising out of sale of shares held in Indian Companies by person resident in Mauritius, acquired on or after April 1, 2017.

The protocol has ended a one and half year of negotiation process between the two countries.

The above amendment is in line with the General Anti Avoidance Rule ("GAAR") which denies treaty benefit to any entity lacking substance.

II. THE CURRENT SITUATION

- The Article 11 of the DTAA provides for a Residence rule of taxation, wherein the state of which the recipient is the resident, shall only be allowed to tax the receipts. Further Para (3)(c) of the article states that income accruing to a bank carrying out *bona fide* banking business shall be exempt from tax in the Source state.
- The current Article 13(4) of the DTAA provides resident state taxation rule for gains resulting from the alienation of shares. Though, India taxes its investors (resident or non-resident) on Capital Gains at a rate varying from 10 per cent to 40 per cent, Mauritius does not impose any Capital Gain tax. This benefit allowed people to route their investments in India through Mauritius and escape Capital Gains tax in India.

III. TRANSITION PERIOD

To avoid instant offloading of shares by the Foreign Institutional Investors, Private Equity and Venture Capital Investors, the Government of India has introduced a three phase transition system for an effective introduction of the new taxation regime.

Under the first phase no tax shall be levied on the investments made before 31-03-2017, id est, no tax shall be imposed on shares purchased before 31-03-2017 but subsequently sold after the said date;

Under the second phase, shares bought on or after 01-04-2017 but up to 31-03-2019 shall be taxed at a concessional rate of 50 per cent i.e. in case of listed shares on which STT is paid the short term capital gains ("STCG") shall be taxable at the rate of 7.5 per cent, whereas long term capital gains ("LTCG") shall remain exempt. However, in case of unlisted shares the STCG shall be taxed at 15 per cent and LTCG at 10 per cent;

Under the third phase, any shares acquired on or after 01-04-2019 shall be taxed at the rate applicable under the Income Tax Act 1961.

IV. THE LIMITATION OF BENEFIT CLAUSE ("LoB")

As per the new protocol, the benefit of 50 per cent reduction in tax rate during the transition period from 01-04-2017 to 31-03-2019 shall be subject to the newly introduced LoB Article, whereby a resident of Mauritius (including a shell / conduit company) will not be entitled to benefits of 50 per cent reduction in tax rate, if it fails the main purpose test and *bona fide* business test. As such, the concessional rate shall only be applicable if the company's total expenditure from operations is not less than INR 2.7m (MUR 1.5m).

V. INTEREST TREATMENT

With effect from 01-04-2017, any income accruing or arising in India due to a Mauritius resident bank shall be taxed in India at the rate of 7.5 per cent for debt claims or loans made after 31-03-2017.

As a result the projects on which direct participation is restricted by the government, investments made by way of loan or other debt instruments issued by a Mauritian bank, shall now be taxable in India. Thus, eliminating any investments made by a conduit bank in India from the point of view of avoiding tax payments in India.

VI. IMPACT ON SALE 0F QUASI-EQUITY

The new protocol provides India the taxing rights in case of capital gains arising from alienation of shares of Indian Companies by residents of Mauritius. However, the impact of such amendment on quasi-equity or hybrid instruments such as Compulsorily Convertible Debentures ("CCDs") and Compulsorily Convertible Bonds ("CCBs") has not been provided in the press note released by the Government of India.

However, the Ministry of Finance, has clarified that there will be no benefit available to the investors seeking benefits by taking the Mauritius route. However, if the investor holding such instruments gets it converted into equity on or before the cutoff date, i.e. 31-03-2017, then no capital gains tax shall be imposed on their subsequent sale.

It is further clarified that, the date of acquisition, in case of quasi-equity instrument, will be the date on which an entity or individual comes to own shares and not the date on which investment in the instrument was carried out.

VII. EXCHANGE OF INFORMATION

As an attempt to increase transparency in trade, the governments of both the countries have resolved to update the existing Article 26 of the DTAA to incorporate international standards on exchange of information, collection of taxes, source-based taxation of incomes, etc.

Though the existing Article 26 did contain provisions for sharing of information between the two countries, however, the Para (3) provided an overridden condition by stating that the contracting states shall not be under any obligation to provide such information.

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