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Updates on India's Tax Treaties With Mauritius and Its Impact on the India-Singapore Tax Treaty

The Government of India notified a protocol on 10 August 2016 (the "**India-Mauritius Protocol**") amending a 33-year-old tax treaty with Mauritius (the "**India-Mauritius treaty**") that had exempted the island's investors from capital gains tax on investments in India. The exemption encouraged foreign funds and companies to route investments into India through Mauritius, impeding India's efforts to increase tax revenues.

Pursuant to the India-Mauritius Protocol, India now has the right to tax capital gains on transfer of Indian shares acquired on or after 1 April 2017. The India-Mauritius Protocol will mainly impact hedge funds and other short-term portfolio investors, which have been using the "Mauritius route" to invest in India.

The Indian government has said the India-Mauritius Protocol would prevent "round-tripping", a phenomenon by which Indian individuals and companies avoid tax by sending funds abroad and then bringing them back to India via Mauritius-based companies. Additionally, the India-Mauritius Protocol would "help curb tax evasion and tax avoidance" and "double non-taxation". However, unlike other recent attempts to tighten its tax rules, the Government of India appears to have taken care to ensure that the changes do not have a retrospective impact on existing investments. The tax will be phased in gradually, while existing investments will not be affected and will remain tax-free.

The key amendments highlighted in the India-Mauritius Protocol are as follows:

- **Shares in Indian companies acquired on or after 1 April 1, 2017** – Disposal of such shares will now be subject to tax in India. This change shifts the residence based test for capital gains under the India-Mauritius treaty to a source-based test.
- **Shares in Indian companies acquired before April 1, 2017** – Such shares will continue to benefit from the current capital gains exemption in Article 13(4) of the India-Mauritius treaty.
- **Shares acquired on or after April 1, 2017 but disposed of before March 31, 2019** – Limited transitional provisions will be applicable. Disposal of such shares will be subject to a reduced tax rate of 50% of the domestic rate in India. The application of the reduced rate is however subject to a Limitation of Benefits (LOB) clause.

Under the LOB clause, the reduced tax rate during the transitory period will be available if a Mauritius resident company passes the main purpose and bona fide business test and has total expenditure on operations in Mauritius of at least Rs1.5 million (approximately US$40,000) in the 12 months preceding the disposal. The LOB conditions that need to be satisfied are:

  - The Mauritius resident should not be a shell/conduit company with insignificant or no real and continuous business operations in Mauritius.
  - The Mauritius entity should not be such that its primary purpose is to take advantage of the concessional tax rates.

While certain quantitative criteria have been set out to determine if such an entity is a shell or conduit, no such objective test has been laid down to assess the primary purpose condition.

- **Interest arising in India on loans made after March 31, 2017 –** Such interest derived by Mauritian residents will be subject to withholding tax at the rate of 7.5%. Under the pre-amended India-Mauritius treaty, withholding tax at the prevailing domestic (Indian) rates was applied, which would go as high as 40%. The capped rate of 7.5% is significantly lower than 15% and 10%, the withholding tax rates under the Singapore-India treaty and Netherlands-India treaty, respectively. Importantly, the tax considerations highlighted above with respect to capital gains, are relevant only for share transfers, and do not apply to sale/purchase of debentures, call and put options, and other structured products.
- **Permanent establishment for service providers –** With effect from 1 April 2017, any Mauritius entity providing services in India will qualify as being a permanent establishment if it meets the following two criteria:
  - It provides such services through its employees or other personnel
  - Such services are provided for an aggregate of 90 days within any 12 month period
- **Source based taxation of "other income" –** Previously, "other income" derived by a resident of a contracting state was subject to tax only in the country of residence of such entity. By way of the India-Mauritius Protocol, the right to tax has been flipped over to the country from which such "other income" is derived. Accordingly, a Mauritian resident deriving "other income" from India, will now be subject to taxes levied by the Indian authorities on such income.

Impact on the "Mauritius Route"

Mauritius has for a long time been the main vehicle for Foreign Direct Investment (FDI) into India. Mauritius accounted for 34% of foreign direct investments in the country between 2000 and 2015 (source: Department of Industrial Policy and Promotion – India). With the capital gains exemption no longer being available for shares acquired after 1 April 2017, questions will be raised on whether Mauritius will continue to be used as a vehicle for investments in India. Investments into India can possibly be structured around other tax efficient routes such as Netherlands. For alienation of shares in an Indian company by a resident of Netherlands, the tax liability is determined in accordance with Dutch laws, if the shares are not sold to an Indian buyer and are not the shares of a real estate company. Accordingly, routing investments through Netherlands could be expected to gain popularity, but investors need be careful of possible amendments to the Netherlands-India treaty.

Impact on the "Singapore Route"

While the India-Mauritius Protocol was finalized after extensive negotiations between the Indian and Mauritius governments, it does have a significant impact on the double taxation avoidance agreement that governs investments between India and Singapore (the "**Singapore DTAA"**).

Article 6 of the Singapore DTAA provides that the residency based taxation right on capital gains is co-terminus with the similar rights available under the India-Mauritius treaty. Therefore, the amendment to the India-Mauritius treaty could also impact the capital gains tax treatment of Singapore residents.

Conclusion

The announcement of the protocol entering into force comes along with various other developments happening on cross-border taxation in India. With the India-Mauritius Protocol coming into force, the impact on the Singapore DTAA needs to be evaluated. The matter has gained the attention of the tax authorities of both jurisdictions and there have been media reports about possible renegotiation between the governments of India and Singapore. Recently, the Central Board of Direct Taxes issued a press release announcing that India and Cyprus have finalized the renegotiation of the DTAA between the two countries. Furthermore, there have also been news reports of revision of the DTAA between India and the Netherlands

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