IMPACT OF THE INDIA – MAURITIUS PROTOCOL

Introduction

Under the bilateral double taxation avoidance agreement between India and Mauritius (the "**Mauritius DTAA**"), any capital gain arising from the sale of shares can be taxed only in Mauritius and not in India. India has been attempting to renegotiate the Mauritius DTAA over the past decade to check round-tripping of funds and treaty abuse.

On May 10, 2016, India's Central Board of Direct Taxes issued a press release announcing the signing of the protocol amending the Mauritius DTAA. Although the text of the protocol is awaited, the key changes to the Mauritius DTAA and their impact are listed below.

Capital gains taxation

India will have the right to tax capital gains arising from the alienation of shares of an Indian resident company that are acquired on or after April 1, 2017. Shares acquired before April 1, 2017 will be exempt, and will not be subject to capital gains tax even if transferred after April 1, 2017. For transactions taking place between April 1, 2017 and March 31, 2019, the capital gains tax rate will be limited to 50% of the domestic tax rate in India, but subject to the fulfillment of the limitation of benefits article specified in the protocol. However, with effect from April 1, 2019, the capital gains tax rate will be 100% of the domestic tax rate prevailing in India.

Limitation of benefits

A Mauritius resident (including a shell company) will not be eligible for the benefit of the 50% reduction in tax rate during the period April 1, 2017 to March 31, 2019, if it fails to fulfill the main purpose test and the *bona fide* business test. Moreover, a Mauritius resident will be deemed to be a shell company, if its total expenditure on operations in Mauritius is less than INR2,700,000 (approx.US$40,500) in the immediately preceding twelve (12) month period. Therefore, it is imperative that appropriate substance is created in Mauritius holding companies.

Interest taxation

Mauritian resident banks earning interest income from India will be subject to a withholding tax at the rate of 7.5% in respect of debt claims or loans made after March 31, 2017. Interest income earned prior to March 31, 2017 will be exempt from tax in India.

Our comments

This is a colossal tax development and will have a significant impact for numerous venture capital funds, foreign portfolio investors and foreign companies who have invested in India through the Mauritius route. In our view, the investment flow from Mauritius will definitely be impacted, and investors who have structured through Mauritius will have to re-examine their structures as also their permanent establishment status in India.

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From the standpoint of the Indian government, the protocol will tackle the long pending complaint that India has had over suspected treaty abuse, round-tripping of funds, curbing revenue loss, preventing double non-taxation, and improving transparency in tax matters, as promulgated under the OECD BEPS initiative for stopping double non-taxation.

However, the good thing about the protocol is that the capital gains tax implications are prospective, and investments up to April 1, 2017 have been grandfathered.

More importantly, the protocol may also impact investors who have structured through Singapore. This is because Article 6 of the protocol dated July 18, 2005 between India and Singapore under the India Singapore double taxation avoidance agreement (the "**Singapore DTAA**") states that the benefits in respect of capital gains arising to Singapore residents from the sale of shares of an Indian company will only remain in force so long as the comparable provisions under the Mauritius DTAA continue to provide the benefit. With the amendments to the Mauritius DTAA, a concern is that while the protocol in the Mauritius DTAA contains a provision protecting investments made before April 1, 2017, it may not be possible to extend such protection to investments made under the Singapore DTAA, notwithstanding the limitation of benefits clause. Consequently, this will mean that the alienation of shares of an Indian company (acquired before April 1, 2017) by a Singapore resident after April 1, 2017, may not necessarily be able to avail of the benefits of the existing provision on capital gains because the beneficial provisions under the Mauritius DTAA would have terminated on that date. Any clarity on this issue will be available only after the text of the protocol is released. It remains to be seen if India and Singapore will enter into fresh discussions to renegotiate the Singapore DTAA pursuant to the Mauritius DTAA amendment.

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