

India and Mauritius treaty protocol introduces source-based taxation of shares

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In brief

The governments of India and Mauritius signed a protocol amending the countries' tax treaty on May 10, 2016.

Key features of the protocol include the introduction of source-based taxation of capital gains on the transfer of Indian companies' shares acquired on or after April 1, 2017, and source-based taxation of interest income of Mauritian banks and fees for technical services.

In detail

The India-Mauritius tax treaty was signed in 1982 and entered into force April 1, 1983.

Under the treaty, India does not have the right to tax capital gains of Mauritius tax residents on the sale of shares of Indian companies. This provision, coupled with the fact that Mauritius does not levy a capital gains tax, has made Mauritius a favorable jurisdiction for investing into India.

Tax disputes have arisen regarding the availability of treaty benefits relating to capital gains; the Indian tax authorities have sought to deny the benefits on the grounds of 'treaty shopping.' Indian courts generally have ruled against the tax authorities in these cases.

The Indian government has been negotiating a revision of the treaty with the Mauritius government for a long time. The protocol is a result of the negotiations.

The protocol addresses the following issues, in terms of Indian taxability of Mauritius residents' income.

Taxation of capital gains

Gains of Mauritius residents on the transfer of shares in Indian companies acquired before April 1, 2017, will continue to be exempt from tax in India, regardless of when the shares are transferred. In other words, gains from the transfer of shares acquired before April 1, 2017, will not be taxable in India even if the shares are transferred on or after March 31, 2017.

India will have the right to tax capital gains arising from the sale of shares in an Indian company acquired on or after April 1, 2017.

There is no change to the current provisions of the treaty under which gains of a Mauritius resident on the alienation of immovable property, movable property associated with a permanent establishment (PE), or ships and aircraft operated in international traffic and associated movable property can be taxed in India in certain cases.

Gains arising to a resident of Mauritius from the alienation of any other property can be taxed only in Mauritius.

Lower capital gains tax rate

A lower tax rate will apply to shares acquired on or after April 1, 2017, and sold before April 1, 2019. In such cases, the gains from such sales will be taxable in India, but at a rate equal to 50% of the applicable tax rate for such capital gains.

The lower rate will be available to a Mauritius tax resident (the alienator) only if the affairs of the alienator are not arranged with the primary purpose of taking advantage of the lower rate; the alienator passes a 'main purpose' test and a 'bona fide business' test; and the alienator is not a shell/conduit company.

Companies not having a bona fide business activity will be treated as if their affairs were arranged with the primary purpose of taking advantage of the benefit of the lower rate.

A shell/ conduit company means any entity with negligible or no business operations, or with no real and continuous business activities carried on in Mauritius.

A Mauritius-resident company with expenditure on operations of less than 1.5 million Mauritian Rupees (approx. USD 40,000) during the 12 months preceding the date on which the gains arise will be deemed to be a shell/ conduit company.

However, a Mauritius resident company shall be deemed not to be a shell/ conduit company, if it is listed on a recognized stock exchange in Mauritius; or its expenditure on operations in Mauritius is at least 1.5 million Mauritius Rupees during the 12 months preceding the date on which the gains arise.

Gains arising from the transfer of shares in an Indian company acquired on or after April 1, 2017, and transferred on or after April 1, 2019,

will be subject to full taxation under Indian tax laws.

Interest income

Under the prior rules, there was no limit in most cases on the Indian tax that could be levied on interest arising in India and paid to a resident of Mauritius other than a bank. Further, the interest income of a bank resident in Mauritius carrying on bona fide banking business was not subject to tax in India.

The protocol provides for interest arising in India and paid to a resident of Mauritius to be taxed in India, but the tax cannot exceed 7.5% of the gross amount of interest if the beneficial owner of the interest is a resident of Mauritius.

The previous exemption for interest income of a bank resident in Mauritius carrying on bona fide banking business will continue for interest arising from debt claims existing on March 31, 2017.

Other changes

The protocol introduces a provision relating to taxation of fees for technical services that is similar to provisions in other Indian tax treaties.

Fees for technical services arising in India and paid to a resident of Mauritius may be taxed in India, but the tax cannot exceed 10% of the gross amount of fees for technical services if the beneficial owner of the fees is a resident of Mauritius.

The treaty provides that income not expressly dealt with by any other provision of the treaty is taxable in the country of residence of the income recipient. The protocol amends the treaty to provide that such income also may be taxed in the country in which the income arises. In other words, any income of a Mauritius resident arising in India will be

subject to tax in India unless it is expressly dealt with by a specific treaty provision.

The protocol widens the scope of the term PE to include the activity of furnishing services, including consultancy services. Such activities will constitute a PE if the activities continue for a project (or two or more related projects) for a period aggregating more than 90 days within any 12-month period.

The protocol modifies the existing provisions in the treaty relating to exchange of information and assistance in tax collection.

Effective date

The Protocol will come into force once both governments have notified each other that they have completed the procedures required by their respective laws for the bringing the protocol into force.

Once the protocol is so notified, it will apply beginning in tax year 2017-18 for all purposes except for the provisions relating to exchange of information and tax collection, which will come into effect immediately.

Observation - impact on India-Singapore tax treaty

Based on the protocol, the India-Singapore treaty would be affected to the extent that it provides that capital gains may be taxed only in the country of residence, since the relevant provisions have been linked to the continuation of the corresponding provisions of the India-Mauritius treaty. In this respect, a senior official of the Indian government has stated that the Indian government intends to renegotiate the treaty with Singapore to bring it into line with the India-Mauritius treaty.

The takeaway

Going forward, India will have the right to tax capital gains arising to a Mauritius resident company on the transfer of shares of companies resident in India acquired after April 1, 2017.

Note that gains on the transfer of shares of companies that are not resident in India or on the alienation

of debt instruments should continue to be not taxable in India.

This protocol's impact on the taxation of capital gains under the India-Singapore tax treaty should also be assessed.

When compared to other countries, Mauritius generally has not been a preferred jurisdiction for making loans or debt investments, except for

loans from Mauritius-resident banks. The change in the tax rate to 7.5% on interest income should provide Mauritius with a competitive edge over other countries.

Going forward, fees for technical services arising in India earned by a Mauritius resident generally will be taxable in India, but at a rate not to exceed 10% if certain conditions are satisfied.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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