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INDIA AMENDS ITS TAX TREATY WITH MAURITIUS, ADDS ANTI-ABUSE CONDITIONS

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The Indian and Mauritian Governments have recently signed a protocol dated 7 March 2024 (Protocol) to amend the India-Mauritius tax treaty (Tax Treaty). The text of the Protocol was not available in public domain until 11 April 2024. The amendments appear to address the concerns surrounding 'treaty shopping' by incorporating a 'Principal Purpose Test' (PPT) under the Tax Treaty. The Protocol will enter into force when both Mauritius and India notify the Protocol in accordance with their domestic laws. However, whether the proposed amendments could apply retrospectively is not clear at this stage.

Brief History

The Mauritius route for making investments in India was popular given the beneficial Tax Treaty and no local taxes in Mauritius on capital gains. As per the Tax Treaty, capital gains earned by a tax resident of Mauritius on sale of shares of an Indian company were not taxable in India. The Tax Treaty was amended in 2016 and the said exemption was withdrawn for gains on sale of shares of an Indian company acquired by a Mauritian resident after 31 March 2017. Therefore, investments made prior to 1 April 2017 were grandfathered and sale of such grandfathered shares continued to benefit from the capital gains tax exemption under the Tax Treaty regardless of when such shares would be sold. Notably, no anti abuse conditions were introduced in the Tax Treaty in 2016.

Introduction of anti-abuse tests under domestic law and tax treaties: Legislative developments

The Indian Government introduced 'General Anti-Avoidance Rules' (GAAR) in the Indian domestic tax law with effect from 1 April 2017 codifying the 'substance over form' approach. GAAR empowers the tax authorities to deny tax benefits, including, tax treaty benefits, where the 'main purpose' of an arrangement (or any step thereof) is to obtain a tax benefit and the arrangement lacks commercial substance or meets certain other specified tests. Gains from transfer of investments acquired prior to 1 April 2017 were specifically excluded from the scope of GAAR.

In 2019, the Indian Government ratified the 'Multilateral Instrument' (MLI) – an OECD initiative to address concerns of base erosion and profit shifting. The provisions of MLI adopted by India also include application of PPT, which aims at tackling instances of 'treaty shopping'. As per the PPT, tax benefits under a tax treaty may be denied if one of the 'principal purposes' of such arrangement is to obtain a tax benefit, and that providing such benefit is not in line with the objects and purposes of such tax treaty.

Notably, the Tax Treaty was not included as a 'covered tax agreement' under the MLI and therefore, the provisions of MLI do not apply to the Tax Treaty.

Introduction of principal purpose test in Tax Treaty

The Protocol expands the 'objects and purposes' of the Tax Treaty to include a commitment to ensure that no opportunities for non-taxation or reduced taxation arise through tax evasion or avoidance. This specifically includes treaty shopping arrangements aimed at obtaining benefits under the Tax Treaty for indirect benefit of residents of other jurisdictions.

Furthermore, the Protocol incorporates PPT in the Tax Treaty. The language of PPT in the Protocol is similar to the PPT language contained in the MLI as discussed above.

Accordingly, once the Protocol is effective, any benefit under the Tax Treaty such as concessional withholding tax rate on dividends, capital gains tax exemption (on sale of instruments other than shares of an Indian company acquired after 31 March 2017), etc. will have to pass the muster of 'principal purpose test'.

The Protocol will enter into force and become effective from the date when the Indian Government as well as the Mauritian Government notifies the Protocol as per their domestic legal procedures, whichever is later.

Comments

The PPT under the MLI (which is applicable to tax treaties covered by the MLI) does not exclude investments made prior to 1 April 2017. Similarly, the PPT under the Tax Treaty could apply despite the domestic GAAR not applying to investments made prior to 1 April 2017 on account of statutory safeguards.

While the Protocol is consistent with the MLI, it deviates from the approach the Government of India adopted when it amended the Tax Treaty in 2016 and introduced GAAR. Additionally, it may be interpreted to the effect that the PPT is applicable to transactions concluded or income earned in the past years. Whether this is indeed the intent or just imperfect drafting should hopefully be clarified soon. The present government has generally refrained from making retrospective amendments which are substantive in nature and not merely clarificatory.

In terms of impact, the capital gains tax exemption benefit on (a) a direct sale of shares of an Indian company acquired prior to 1 April 2017; (b) sale of capital assets, other than shares and immovable property; and (c) indirect transfer (i.e., transfer of foreign assets deriving substantial value from Indian assets), sold before or after the effective date of the Protocol could be hit by the PPT test.

It remains to be seen if the government will clarify this anomaly in its formal notification which is awaited. Lack of clarity in this regard could have a far-reaching impact and may adversely impact investor sentiment. There are several court rulings including from the Supreme Court of India upholding treaty entitlement of Mauritius resident investors basis a valid tax residency certificate confirming their tax residency. Retrospective application of such substantive anti-abuse conditions could unsettle the settled position on treaty eligibility in the context of Mauritian structures. One hopes that the position will be clarified sooner rather than later and that the investors will be given a reasonable opportunity to review their structures and assess their positions going forward.

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