IMPACT OF DRAINAGE OF INDIAN CURRENCY ON HOME ECONOMY DUE TO DTAA WITH REGARDS TO MAURITIUS

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ABSTRACT

Foreign investors have been using the Mauritius holding company structure to make investments in India right from the early 1990s. Following the liberalisation of the Indian economy, the Indo-Mauritius Double Tax Avoidance Agreement, or DTAA, was "discovered" as an effective mechanism to avoid capital gains tax on sale of shares in Indian companies. The first "attack" on the (misuse) use of the Mauritius DTAA was instigated by Indian revenue officials in 2003 against some foreign institutional investors, or FIIs.

A large number of Foreign Institutional Investors who trade on the Indian stock markets operate from Mauritius. According to the tax treaty between India and Mauritius, Capital Gains arising from the sale of shares is taxable in the country of residence of the shareholder and not in the country of residence of the Company whose shares have been sold. Therefore, a company resident in Mauritius selling shares of an Indian company will not pay tax in India. Since there is no Capital gains tax in Mauritius, the gain will escape tax altogether.

India and Mauritius are likely to begin renegotiating the current India-Mauritius Double Taxation Avoidance Agreement (the “DTAA”) in the near future. Million of untaxed money flows out of India to foreign investors annually as a consequence of the DTAA, and the ability to increase tax collections without directly burdening domestic taxpayers appears to be too tantalizing for the Indian government. The revision of the DTAA could have a significant impact on foreign investors’ returns on their Indian investments, which may in turn necessitate a re-evaluation of foreign investors’ strategies for structuring investments in Indian businesses.

KEYWORDS: Tax haven; DDTA; FIIs; PE.

INTRODUCTION

It is not bizarre for a business or individual who is resident in one country to make a taxable gain (earnings, profits) in another. This person may find that he is obliged by domestic laws to pay tax on that gain locally and pay again in the country in which the gain was made. Since this is inequitable, many nations make bilateral Double taxation agreements with each other. In some cases, this requires that tax be paid in the country of
residence and be exempt in the country in which it arises. In the remaining cases, the
country where the gain arises deducts taxation at source ("withholding tax") and the
taxpayer receives a compensating foreign tax credit in the country of residence to reflect
the fact that tax has already been paid. To do this, the taxpayer must declare himself (in
the foreign country) to be non-resident there. So the second aspect of the agreement is that
the two taxation authorities exchange information about such declarations, and so may
investigate any anomalies that might be a sign of tax evasion.

Over the past several years, Mauritius has been used as a platform by investors to invest
into India. Over 40 per cent of total foreign direct investment in India comes from
Mauritius, a low tax jurisdiction. The Mauritius structure has also been very common with
private equity funds investing in India.

Under the India-Mauritius tax treaty (tax treaty), India does not have a right to tax gains
derived by a resident of Mauritius from the sale or disposal of shares of an Indian
company. In other words, a Mauritian resident selling shares of an Indian company can
take the benefit of the India-Mauritius tax treaty and not be liable to Indian capital gains
tax. To add more flesh to this, the Supreme Court of India has held that tax residency
certificate issued by Mauritius tax authorities is sufficient evidence to prove tax residency
in Mauritius for availing tax treaty benefits. This has lent a lot of credibility to the
Mauritius route.

India is estimated to lose over $600 million a year in revenue on account of this benefit
under the tax treaty. Further, concerns have also been raised that Mauritius may have
been used for illegitimate purposes by Indian tax residents for 'round-tripping
transactions.'

In August 1982, the governments of India and Mauritius signed a double-taxation
avoidance treaty (DTAT) ostensibly aimed at boosting the economies of both nations. India
has signed more than 79 such treaties with different countries, including at least 16 which
are virtually identical to the one signed with Mauritius.

Yet, the Mauritius treaty has been -- and continues to be -- misused as a channel to launder
illegal money. Because of its reputation as a tax haven, a claim that is officially denied,
Mauritius has been a favourite destination for much of the black money generated in India,
including a large proportion of the slush funds stashed away by some of the country's most
powerful politicians and industrialists.

A set of glaring loopholes have been deliberately left wide open in this country's laws to
enable racketeers of various hues to use the Mauritius route for a range of nefarious
activities. These include the manipulation of India's notoriously corrupt stock exchanges.

TAX HAVEN

Before continuing, it would be useful to explain what a tax haven is. Perhaps the oldest tax
haven in the world is Jersey, which is part of the Channel Islands off the coast of
Normandy in France. Geoffrey Colin Powell, former economic adviser to Jersey, candidly
defined a tax haven: “What... identifies an area as a tax haven is the existence of a composite tax structure established deliberately to take advantage of, and exploit, a worldwide demand for opportunities to engage in tax avoidance.”

A December 2008 report of the U.S. government Accountability Office was unable to define categorically a tax haven but considered the following characteristics as indicative of a tax haven:

(a) nil or nominal taxes;

(b) lack of effective exchange of tax information with foreign tax authorities;

(c) lack of transparency in the operation of legislative, legal or administrative provisions;

(d) no requirement for a substantive local presence; and

(e) self-promotion as an offshore financial centre.

THE DOUBLE TAX AVOIDANCE AGREEMENTS (DTAA)

The Double Tax Avoidance Agreements (DTAA) is essentially bilateral agreements entered into between two countries, in our case, between India and another foreign state. The basic objective is to avoid, taxation of income in both the countries (i.e. Double taxation of same income) and to promote and foster economic trade and investment between the two countries. The advantages of DTAA are as under:

- Lower Withholding Taxes (Tax Deduction at Source)
- Complete Exemption of Income from Taxes
- Underlying Tax Credits
- Tax Sparing Credits

The Provisions of DTAA override the general provisions of taxing statute of a particular country. It is now well settled that in India the provisions of the DTAA override the provisions of the domestic statute. Moreover, with the insertion of Sec.90 (2) in the Indian Income Tax Act, it is clear that assessee has an option of choosing to be governed either by the provisions of particular DTAA or the provisions of the Income Tax Act, whichever are more beneficial.

The Non Resident can certainly take the benefit of the provisions of DTAA entered into between India and the country, in which he resides, more particularly in respect of Interest Income from NRO account, Government securities, Loans, Fixed Deposits with Companies and dividends etc.
CURRENT BENEFITS AT ISSUE

The DTAA became effective on April 1, 1983 for the purpose of (1) avoiding the imposition of double taxation, (2) preventing fiscal evasion, and (3) encouraging mutual trade and investment. Article 7 of the DTAA stipulates that the profits of a company formed in India or Mauritius (each is a “Contracting State” or “State”) are to be taxed in such company’s State of formation unless that company (an “Enterprise”) conducts business in the other Contracting State through a permanent establishment situated in such other Contracting State.

Article 13 of the DTAA limits the taxation of capital gains by the Contracting States. Article 13 provides that gains from the sale of:

- immovable property may be taxed in the Contracting State in which such immovable property is situated;

- movable property forming part of the business property of a permanent establishment that an Enterprise has in a Contracting State may be taxed by such Contracting State; and

- ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft may be taxed by such Contracting State in which the place of effective management of the Enterprise is situated.

All other gains derived by an Enterprise from the sale of property other than those specifically mentioned above are taxable by the Contracting State in which such Enterprise was formed and may not be taxed by the other Contracting State.

Capital assets can be short-term or long-term capital assets under India’s Income Tax Act (the “ITA”). Shares held as capital assets held for a period of less than 12 months are short-term capital assets, and shares held for longer than 12 months as capital assets are regarded as long-term. The tax rate on the gain from the sale of short-term capital assets recognized by foreign investors can be between 15% and 40%, while the tax rate for gains on long-term capital assets can be between zero and 20% for these investors. These rates may be reduced to zero when earned by an Enterprise holding a Category 1 Global Business License (a “GBL1”). Under Mauritius law, a GBL1 is able to benefit under the DTAA because Mauritius does not impose a tax on capital gains or levy any withholding tax on any gains, dividends, or interest derived by a GBL1. Accordingly, a GBL1 can claim benefits under the DTAA and pay no capital gains tax in either India or in Mauritius.

THE INDIAN ARGUMENT

Indian companies have benefited, and continue to benefit, from the DTAA with respect to their investments in certain African countries by investing through Mauritius, because Mauritius has negotiated preferential trade agreements with many of these African countries. However, during the period in which the DTAA has been in force, Mauritius has
transitioned from an offshore banking jurisdiction to an offshore holding-company jurisdiction often utilized by foreign investors making investments into India.

This change in purpose has generated some concern that the DTAA is now being used for unacceptable tax avoidance by foreign and, perhaps more importantly, Indian investors. Currently, an estimated US$600 million of profits flows out of India to foreign investors without taxation in India or Mauritius as a consequence of the DTAA each year. Some Indians argue that these foreign businesses are utilizing the DTAA in a manner that should be considered impermissible tax avoidance. Additionally, some Indians argue that some Indian residents may be abusing the DTAA by channelling their investments in Indian businesses through Mauritius. These types of investments have been dubbed “round-tripping transactions” because the money begins and ends in India.

INDIA-MAURITIUS TAX TREATY BEING RE-NEGOTIATED

In the backdrop of these concerns, India and Mauritius had set up a Joint Working Group (JWG) way back in August, 2006, comprising of senior officials to work on important issues in the existing tax treaty. Press reports indicate that JWG had met on several occasions in the past to discuss issues relating to adequate safeguards to be put in place to prevent misuse of the tax treaty and strengthening of the mechanism for exchange of information. However, it is understood that there was no consensus reached.

It is learnt that both the countries have recently agreed in principal to recommence discussions in this regard. It is indicated that the tax treaty may be revised to introduce:

1. Exchange of information on banking transactions (in addition to the existing information exchange article).

2. Limitation on benefits (LOB) clause to restrict the benefits of the treaty – this should provide guidance on meeting the substance test to qualify for treaty benefits.

Thus, under the revised treaty, a mechanism can be put in place to prevent its abuse. It remains to be seen the conditions which will be prescribed under the LOB clause.

The re-negotiations on the Double Taxation Avoidance Agreement (DTAA) with Mauritius will not have a major impact on India's equity capital markets. Company analysts and tax experts say neither the foreign direct investment (FDI) nor the portfolio investment by large institutions will be affected.

The experts are not worried for two reasons. All the past investments through Mauritius are safe as India cannot impose any tax on foreign investment with retrospective effect. Also, India has a comprehensive DTAA with 79 countries, which effectively means that foreign flow of money from tax havens will continue from other locations, if not Mauritius. Till now, over 40 per cent of FDI in India has come from Mauritius.
Mauritius has given no commitment to India; instead, it put forth its demand of giving more concessions to investors. Mauritius wants India to apply provisions of the DTAA to Permanent Establishments tool.

As per the current provisions of the DTAA, the Mauritian entity should not have a PE (Permanent Establishments) in India if it wants exemption from capital gains tax. The treaty defines a PE as a fixed place of business such as a place of management, a branch, office or factory through which the business of the enterprise concerned is wholly or partly carried on.

Thus any income attributable to the PE is subject to taxation at present. Bringing PEs under the DTAA would exempt them from capital gains tax in India. Though India may not heed to this demand by Mauritius, it would find it even more difficult to renegotiate the treaty in the light of these fresh demands. India has started raising tax demands against many companies re-routing their investments, and some of these cases are being disputed in various courts.

Mauritian Prime Minister Navinchandra Ramgoolam had, during his visit to New Delhi last month, said the country was prepared to address the issues, “whilst remaining guided by the assurance given to us by India that nothing will be done to hurt the economic interest of Mauritius”.

THE IMPACT

The DTAA may be revised to introduce provisions mandating the exchange of certain information on banking transactions and a limitation-on-benefits (“LOB”) clause to restrict the benefits of the treaty. The scope of a LOB clause will likely be one of the key elements of the negotiations. The LOB may be revised to require a foreign company to be listed on a recognized stock exchange in its state of residence (i.e., Mauritius) or that a foreign company must have total expenditures of at least US$200,000 in its state of residence (i.e., Mauritius) for at least two years before the date on which a capital gain arises in order to claim treaty benefits. Such residency requirements would mirror those set forth in the Double Taxation Avoidance Agreement between India and Singapore (the “India-Singapore Tax Treaty”). It is important to note, however, that the capital-gains tax benefits set forth in the India-Singapore Tax Treaty as amended in 2005 will remain in force only as long as the DTAA between India and Mauritius provides that any gains from the transfer of shares in a company that is a resident of either India or Mauritius shall be taxable only in the country in which the transferor is a resident.

Even if the elements of the DTAA that make Mauritius a preferred investment channel into India for foreign business remain untouched, certain provisions of the new Direct Tax Code (the “DTC”), which is slated for implementation from April 1, 2012 and will replace the ITA, are designed to addressed perceived abuses of the DTAA. General AntiAvoidance Rules (“GAAR”) are included in the proposed DTC, which will subject investors claiming treaty benefits under the DTAA to a commercial substance and bona fide business purpose test. Under GAAR, Indian tax authorities will be empowered to declare any
“arrangement” as an “impermissible avoidance arrangement” if a ownership or investment structure has been implemented that, in whole or in part, has the main purpose of obtaining a “tax benefit.” The burden of proof will be on the investor whenever an investment structure is challenged under GAAR, as an “arrangement” will be presumed to be for obtaining tax benefits unless the investor demonstrates that obtaining a “tax benefit” was not the main objective. Whether the DTC, a domestic Indian law, would override the DTAA, a treaty, is an issue that may not be settled until the middle of 2012. However, the resolution of any conflict may be that the DTC’s GAAR and the DTAA will be interpreted as complementary, and not conflicting, laws.

INTRODUCTION OF GENERAL ANTI-AVOIDANCE RULES (GAAR) IN THE INDIAN TAX LEGISLATION

Some believe that a revision of the Mauritius treaty to prevent abuse may not be necessary now, given that anti-avoidance provisions are already proposed under the new Direct tax Code (DTC), to be effective from April 1, 2012.

GAAR is proposed as an anti-avoidance measure under the DTC. Under GAAR, the Indian tax authorities will be empowered to declare any ‘arrangement’ as ‘impermissible avoidance arrangement’, if part or a whole of a structure has been set up with the main purpose of obtaining ‘tax benefit’. An ‘arrangement’ will be presumed to be for obtaining tax benefit, unless the taxpayer demonstrates that obtaining tax benefit was not the main objective of the arrangement.

Under the DTC, GAAR is a tool available with the tax authorities to question any such structure, including the Mauritius structure.

In summary, under the DTC regime, commercial substance and bona fide business purpose test will be among the key requirements for availing treaty benefits.

IS SHIFTING TO ANY OTHER FAVOURABLE JURISDICTION A SOLUTION?

Countries like Singapore and Cyprus also provide similar tax benefits as Mauritius. The India-Singapore tax treaty already has an LOB clause to prevent abuse. In any case, once GAAR is enacted under the DTC, substance requirements and bona fide business purpose test will have to be satisfied to claim treaty benefits, irrespective of whether the investor comes from Mauritius or any other jurisdiction. Once enacted, GAAR will not only impact the new structures but may also impact the existing structures, if there is a claim for capital gains exemption under the DTC regime.

THE WAY FORWARD

PE funds coming into India from Mauritius should take note of these developments, review its existing structure and perform an impact assessment. PE funds, which are likely to be
impacted due to these proposals, should see if any corrective step can be taken, if necessary. Alteration of existing structure may, therefore, be on the cards for some of the PE funds. Based on the outcome of the impact assessment, some PE funds may also have to reconcile to the fact that tax cost may have to be factored in while making investment decisions going forward.

The government, of course, looks confident than ever and assumes that India’s strong economic fundamentals will continue to attract investments, notwithstanding the additional tax cost on investors.

CONCLUSION

Now we will have a clearer picture of India’s revamped taxation system and related tax planning opportunities for foreign investors. In order to satisfy both substantive-activity and investment-threshold requirements, pooling investments in a Mauritius fund might ultimately prove to be a successful strategy for foreign investors seeking the benefits of the DTAA. To do so, foreign investors seeking treaty benefits may wish to increase their substantive presence in Mauritius and grant more independence and control to their Mauritius operations. Additionally, in order to minimize the risk posed by India’s frequent regulatory changes, foreign investors might consider purchasing tax-insurance policies to safeguard the tax benefits of their Indian investment structures. A tax-friendly regime in Mauritius has always been a key factor in entities wishing to invest in India to set up shop in Mauritius. However, this tax benefit has also come in handy for those wishing to indulge in round-tripping activities or routing of illicit funds back into India through Mauritius. While there are agreements in place for exchange of information on entities indulging in tax evasion and tax frauds, it is suspected that the response has not been so encouraging from the authorities in Mauritius. This has led to Indian government seeking revision of its tax treaty with Mauritius to make it easier for it to keep a tab on illicit wealth flow to and from the island nation.

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