Pre-2017 investments of Mauritius-based funds may face enhanced tax scrutiny

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Investments from Mauritius-based funds to India before March 31, 2017 may face additional tax scrutiny because of the Mauritius government's recent decision to alter the India-Mauritius tax treaty, experts said.

Last week, the Mauritius cabinet agreed to amend the Double Taxation Avoidance Agreement (DTAA) with India to comply with standards prescribed by the Economic Co-operation and Development (OECD), an intergovernmental organization.

New regulations

Experts said with the regulatory changes now in force, Mauritius-based funds which made investments in India before the cut-off date and are yet to exit those, will be asked to furnish proof of 'substantiation', that is they will be asked to explain why Mauritius was chosen as the jurisdiction, and whether these funds had genuine business operations in the island nation. If these funds fail to provide the adequate proof of 'substantiation', capital gains tax in India will apply, said a senior tax expert.

The India-Mauritius DTAA was amended with effect from April 1, 2017. Prior to April 1, there was no capital gains tax for Mauritius entities in India. However, the amended post 2017 DTAA did not provide any such exemption.

In a parallel development during this period, the Indian government also introduced General Anti Avoidance Rules(GAAR) from April 1,2017. These rules made it mandatory for any foreign funds to meet certain requirements to be eligible to claim tax treaty benefits. Prior to GAAR, there were no strict substance requirements for foreign entities wanting to avail treaty benefits.

The development assumes significance as Mauritius was the second largest source of FPI flows into India in 2017. According to depository data, Mauritius-based FPIs owned shares worth Rs 5.2 lakh crore in April 2017, contributing to 20 percent of the total FPI assets in India. According to the Reserve Bank of India, Mauritius was also the top source of FDI inflows into India between FY14 and FY18. In those five years, Mauritius accounted for $43 billion worth of FDI inflows, contributing about 30 percent to overall FDI investment into India during the period.

Mauritius is currently the fourth largest source of FPI flows with funds from the island nation owning shares worth Rs 4 lakh crore, or 6 percent of total FPI assets in India. In FY23, Mauritius was the second largest source of FDI with inflows to a tune of $6.1 billion, data showed.

Passing the purpose test

“Based on similar Protocols entered by India with other countries it seems that the grandfathering benefit might not be automatic and taxpayers with Mauritius structures will have to pass the principal purpose test in order to avail treaty benefits even for pre 2017 investments,” said Rajesh Gandhi, partner, Deloitte India. “Therefore going forward, heightened questioning by tax authorities on investments made from Mauritius before 2017 is likely.”

DTAAs are bilateral agreements that allow foreign investors investing in India to choose where they want to be taxed. A Mauritius investor can choose to be taxed in India or Mauritius depending on where tax rates are lower.

Since the investments made by Mauritius-based investors are in Indian shares, there is a capital gains tax incidence in India. Hence if a foreign fund wants to be taxed in Mauritius, instead of India, for these transactions, the Indian tax department has to allow the Mauritius fund to claim treaty benefit. Indian tax department has powers to decline such benefits if they feel the fund has chosen Mauritius just to avail lower tax rates.

“Mauritius taxpayers may have to demonstrate adequate commercial rationale to show that the principal purpose of undertaking the transaction was not to take benefit of the tax treaty,” said Ipsita Agarwalla, leader, international tax practice at Nishith Desai Associates.

“Having said this, considering that the Mauritius treaty was specifically amended to provide grandfathering for investments made prior to April 1, 2017, one may argue that the ‘object and purpose’ of the Mauritius treaty was to grant tax treaty benefits”.

Until April 2017, the India-Mauritius tax treaty provided for zero capital gains tax for Mauritius-based funds. However, both the countries amended the treaty, and hence investments made post 2017 are not capital gains exempt anymore. Mauritius-based funds are subject to 10 percent tax rate plus surcharge for investments held more than a year. While investments held for less than a year are taxed at a rate of 20 percent plus surcharge.

However, both the nations agreed to exempt investments already made by foreign funds from the ambit of this law even if they sell those shares post 2017. This exemption is called ‘grandfathering’ in tax parlance.

The OECD framework

The OECD framework is an international framework aiming to establish common minimum standards for all the member countries. Once member countries of OECD agree to adopt these standards, any previous bilateral DTAAs will have to be read along with the OECD standards.

One of the conditions of the OECD standards is what is called a principal purpose test (PPT). Under this standard, a foreign investor has to show tax departments that they did not choose a particular jurisdiction to avail beneficial tax rates. It is a common practice amongst global funds, including the US and European-based ones, to route their India investment through Mauritius, Singapore, Netherlands, or Luxembourg since these countries had favorable tax agreements with India.

“It is expected that proposed changes will be focusing on incorporating provisions of the principle purpose test. Such changes are likely to also cover those investments that had been otherwise covered through grandfathering benefits. Thus, past investments (prior to 2017) will also have to satisfy the principal purpose test to avail tax benefit vis capital gains tax,” said Saurrav Sood, leader - international tax and transfer Pricing ,SW India.

Foreign funds can pass the PPT by showing substantial presence, which usually involves a permanent office, a work force and revenue generation. The fund should be compliant of PPT conditions at the time when the fund was started.

Even investments made post 2017 will have to meet PPT conditions if they want to claim treaty benefits. However, now there is no capital gains exemption for Mauritius investors, so even if Indian tax department denies treaty benefits, it won’t lead to any extra tax burden for post 2017 investments.

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