# India-Cyprus tax treaty renegotiated: key provisions

*Posted on December 12, 2016 in Asia-Pacific, Cyprus, Europe, Featured News, India, Multinational*



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India and Cyprus on November 18 signed a a revised double taxation avoidance agreement, providing for source-based taxation of capital gains arising from alienation of shares. The agreement sets the stage for Cyprus to be used again as a jurisdiction for tax planning and should result in more foreign direct investment into India from Cyprus.

The agreement may also have important implications for investors that have already made investments through Cyprus, as it is expected to pave the way for India to reassess its treatment of Cyprus as a notified jurisdiction.

**Background**

Prior to 2013, the India-Cyprus tax treaty was very beneficial for investing into India. Similar to the popular India-Mauritius tax treaty, capital gains upon exit from Indian companies was not taxable in India; rather, the right to tax such capital gains remained with Cyprus, which does not tax capital gains. Add to that the reduced rate of interest withholding rate under the treaty and, understandably, Cyprus was favored by many foreign investors looking to invest in India.

However, on November 1, 2013, The CBDT, in Notification No. 86/2013, deemed Cyprus a non-cooperative jurisdiction for failure to provide information requested for under the exchange of information provisions under the India-Cyprus tax treaty.

The impact of the notification has been significant. Under section 94A of the Income Tax Act, 1961 (ITA), the transfer pricing provisions became applicable to all transactions entered into with a person located in Cyprus; a withholding tax rate of 30% applied to potentially all payments to a person in Cyprus; no deduction was allowed for any payment made to any financial institution located in Cyprus unless the taxpayer furnished an authorization in Form 10FC in the manner as laid down in the Income Tax Rules; and no deductions were allowed for or other expenditure or allowance, including depreciation, arising from the transaction with a person located in Cyprus.

Further in a situation where the taxpayer received or credited any amount of money from any person located in Cyprus but failed to provide any explanation about the source of the money, or the assessing officer is not satisfied with the explanation of the taxpayer, then such amount was deemed to be the income of the taxpayer for that year.

When the notification was issued, Cyprus was the 7th largest FDI investor into India, with total inflows amounting to around 4% of total FDI flows. Following the notification, there was naturally a significant drop in the number of investments from Cyprus into India, so much so that eventually almost no new investments were made from Cyprus.

While new investments could be structured differently, for investments existing at the time of the notification, there has since been a period of uncertainty. The Finance Ministry of Cyprus, in an effort to comfort investors, had announced that they were in direct contact with the Indian Government to clarify and resolve the situation that had been created and had directly affected the business communities in both countries. However, no amicable resolution was reached from those discussions at that point of time.

Interestingly, the press release by the Indian Government which followed the notification of Cyprus as a non-cooperative jurisdiction stated that any payment made to Cyprus shall be liable for a withholding tax at 30%.

The language in the ITA in this regard states that withholding is required to be done on any sum or income or amount on which tax is deductible. Consequently, the question that arose was whether in a situation where there was no Indian tax payable (which should be in the case of capital gains), would withholding still be required just because a payment was being paid to Cyprus.

There has been a Supreme Court decision holding that chargeability is necessary for withholding obligation. This resulted in the press release being challenged before the High Court. However, to the disappointment of the investors, the High Court upheld the press release. A special leave petition before the Supreme Court was filed challenging the decision of the High Court (although now, as discussed below, the issue may be moot).

## Latest Developments

Following the renegotiation of the India-Mauritius Double Taxation Avoidance Agreement, which took place a few months ago, a notification was issued by the Cyprus and Indian revenue authorities stating that the Cyprus and the Indian revenue authorities had also successfully completed negotiations to amend the India-Cyprus DTAA.

The CBDT issued a press release on July 1, 2016, stating that an official level meeting took place between India and Cyprus to finalize the new India-Cyprus tax treaty. All pending issues, including taxation of capital gains, were discussed and an in-principle agreement was reached on all pending issues.

The CBDT then confirmed on November 18 that the treaty was signed. While the new DTAA has not been made public by the Indian Revenue Department, it has been since been published in the Cyprus Gazette.

## New India-Cyprus tax treaty

The text of the new DTAA provides for source based taxation of capital gains arising from alienation of shares.

Further, a grandfathering clause has been provided for investments made prior to April 1, 2017, in respect of which capital gains will be taxed in the country of which the taxpayer is a resident.

These changes are consistent with those brought about by the renegotiated India-Mauritius tax treaty, i.e., source based taxation of capital gains and a grandfathering clause.

The protocol to the India-Mauritius tax treaty also provides for a two year transition period and a limitation of benefits clause which are a prerequisite to a reduced rate of tax of 50% of the domestic tax rate on capital gains arising during such transition period. The new DTAA, however, does not provide for such a provision.

Therefore, sale of shares of an Indian company purchased on or after April 1, 2017, should be subject to tax in India at the local domestic tax rate.

## Permanent establishments

Interestingly, the new India-Cyprus tax treaty provides for an expanded scope of permanent establishment (PE). The definition of PE now includes a sales outlet, a warehouse in relation to a person providing storage facilities for others and a farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on.

In the context of warehouse forming a PE it is pertinent to note that Article 5(4) of the India-Cyprus tax treaty specifically provides that a PE shall be deemed not to include "*maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display*." Therefore, it would interesting how one would differentiate a warehouse with maintenance of stock of goods.

Thus, from an Indian perspective, a Cyprus entity having any of the above in India would result in the Cyprus entity having a PE in India. Further, the current DTAA provides for the formation of a construction PE if activities in relation to the construction are carried on for more than 12 months. The new DTAA reduces this time period to 6 months.

Further, a new service PE clause has been added which provides that a service PE may be formed in a country if services, including consultancy services, are provided within the country for a period or periods aggregating more than 90 days within any 12-month period.

The new treaty also provides for a more expansive definition of dependent agent PE to include maintenance of stock of goods from which regular delivery takes place and providing for habitual securing of orders to the definition.

The India-Cyprus tax treaty also provides that an insurance business will be construed to have a PE in the other country if it collects premiums in the other country or insures risks through a person other than an independent agent. Re-insurance is an exception to this rule, however.

## Withholding tax rates

As far as debt investments are concerned, which, as mentioned above, Cyprus was popular for, Mauritius negotiated a better rate at 7.5% than that in the current India-Cyprus tax treaty. There is no change in this rate and the rate under the new India-Cyprus tax treaty, which continues to be 10%.

The new India-Cyprus tax treaty reduces the tax rate on royalties and fees for technical services in the country from which payments are made to 10% from the existing rate of 15%, in line with the tax rate under Indian tax laws.

It should be noted that the current DTAA includes an article on Royalties and Fees for Included Services which has been amended in the new DTAA. An article on Technical Fees, which is a separate article under the current DTAA, has been subsumed within the Royalty and Fees for Technical Services Article in the renegotiated treaty.

Provisions in relation to exchange of information have been updated in the new treaty and are now in in accordance with international standards and Indian tax treaty policy. The provisions related to exchange of information will enable exchange of banking information and allow the use of such information for purposes other than taxation with the prior approval of the competent authorities of the country providing the information.

Provisions of the new tax treaty will enter into force after the completion of necessary internal procedures in both countries and are expected to come into effect in India in respect of income derived in fiscal years beginning on or after April 1, 2017.

## Cyprus notification

Importantly, India tax officials confirmed that, during the discussions for a new tax treaty, they decided to consider rescinding India's notification of Cyprus as a non-cooperative jurisdiction under the ITA, with retrospective effect from 1 November, 2013.

Although this was not explicitly mentioned after the signing of the treaty, Cypriot Minister Georgiades said that the completion of the negotiation and the successful agreement on all pending issues paves the way for the retrospective removal of Cyprus from the list of Notified Jurisdictional Areas.

For those who have invested through Cyprus in the past, certainty on this development would bring respite. Once the notification is rescinded, particularly with the grandfathering of investments, it should be possible for investors to rely on the India-Cyprus tax treaty and obtain a clean exit without being subject to capital gains tax in India.

As such, quick resolution of this issue is expected; in fact, if the notifications are done quickly, this may even encourage new investments through Cyprus prior to April 1, 2017.

As a closing note, it is remarkable how the Indian Government has been able to negotiate its tax treaties to provide for source-based taxation of capital gains. In an interview after the India-Mauritius re-negotiation, the India's Revenue Secretary said that this move would bring certainty and predictability, prevent double nontaxation by companies and also to stop round-tripping of funds, a source of big worry for the government.

In the times to come, it will be exciting to see the interplay between India's General Anti-Avoidance Rules (GAAR), slated to come into effect April 1, 2017, and the renegotiated tax treaties, as well as the impact these tax provisions have on structures and investments.

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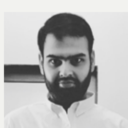

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Ashish holds a Bachelors degree in law from Government Law College, Mumbai. He focuses on cross border tax and corporate structuring transactions and has has been involved in the recent issues relating to applicability of Minimum Alternate Tax on foreign investors before the High Court.

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