THE ECONOMIC TIMES

Tax treaty: Realigning Mauritius

May 12, 2016, 5:48 AM IST

By Nishith Desai

The Mauritius Treaty has been in existence since 1983 and, over a period of time, played a critical role in attracting investments into India. Right from the inception, the focus of the Mauritian government has been to develop a robust offshore financial centre regime that attracted reputed financial investors to use Mauritius as a platform for investment into India.

In fact, most of the initial companies that were set up in Mauritius were funds looking at investing into India. The Indian government was also instrumental in promoting the Mauritius route and vehemently defended the Mauritius route before the Supreme Court in the Azadi Bachao Andolan case, besides issuing circulars to ensure that treaty benefits on capital gains were provided to Mauritian companies.

It must be recalled that during the 1990s, when the treaty first began to be extensively used, the capital gains tax rates in India were significantly higher than they are today. Investors, especially those from the US, were concerned about direct investment into India due to a credit mismatch issue that arose due to differences in the source rules in India and US. The concern for US investors was that the taxes paid in India on capital gains were not available as a credit in the US. With time and the lowering of the Indian tax rates, this has become less of an issue for investors.

Over the last decade, the stance of the government in respect of the Mauritius treaty has undergone a change and everyone has expected amendment to the treaty for the last 10 years. So, it is not coming as an absolute bolt out of the blue for anyone to see the modification to the treaty benefits.

We must compliment both the governments for ensuring that there is an orderly phasing out of the capital gains tax exemption over a period of three years without unduly burdening the investors who invested in India relying on the treaty. This has ensured that there is no knee-jerk reaction, unlike in the past, due to the revisions in the treaty.

More importantly, apart from the changes to the capital gains tax benefit, renegotiating a reduced rate of tax of 7.5% on interest will also usher the India-Mauritius tax relationship into a new era. While the press release only talks about increase in rate of tax for banks, my understanding is that the 7.5% rate of tax on interest will be extended to all investors who are investing from Mauritius.

India has a shallow debt market and it is likely that the country’s debt markets will get a boost providing for a reduced tax rate on interest. Already, we are seeing India relaxing its exchange controls to facilitate debt from overseas and has, in some circumstances, reduced tax rates to even 5% (but not across the board). The protocol will make Mauritius even more attractive than Singapore, Cyprus, Netherlands, etc, at least for debt investments.

We must celebrate the implementation of the treaty by both the countries in good faith for all these years. Time and time again, despite all the news reports on treaty benefit being denied, at the highest levels in the government, the view has been that any change has to be made through an amendment to the treaty.

In fact, we must acknowledge that when the Indian capital gains taxes were high (ranging between 25-50% until recently), the India-Mauritius treaty along with the offshore financial centre regime in Mauritius reduced the rigours of Indian taxes and facilitated large amounts of foreign investments into India, transforming India into the growth driver for the world economy that we see today.

The changes to the treaty will, of course, lead to some short-term impact on investments in India. There are unresolved tax issues that especially arise in the context of P-Notes issued by FPIs/FIIs. Further, today, unfortunately, there is an artificial characterisation of business income of the FPI/FIIs being treated as capital gains.

This leads to a situation where even portfolio trading investors who would have otherwise not been taxable in India are being subject to tax here.

Hopefully, the government will revisit this issue and align the position with other countries so that mere trading in Indian securities should not give rise to tax implications in the country, absent a permanent establishment in India. This artificiality is unfair and also gives rise to possible non-availability of tax credits in the home country.

While the government has renegotiated the treaty with Mauritius, it is also hoped that they continue on the path of tax reforms to ensure that investors are not put off by constant adverse changes to tax policy.

The writer, considered in tax circles as the man who discovered Mauritius, had advised the first FII investing into India