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Mauritius Global Business Update 15

India Budget 2012

The Indian Finance Minister, Pranab Mukherjee, presented the Indian Union Budget 2012-13 (the "Budget") on Friday 16 March 2012. This Update focuses solely on a few salient proposals with reference to the international aspects of the Budget.

The Budget seeks to introduce a number of drastic direct tax reforms aimed at:

1. Making the Tax Residence Certificate ("TRC") mandatory for an entity to seek benefits from double tax avoidance treaties but not sufficient to obtain such benefits in all cases;
2. Curbing tax evasion and avoidance through the General Anti Avoidance Rules ("GAAR");
3. Negating the Indian Supreme Court ruling in Vodafone which went against the Indian Government by ushering in legislation with retrospective effect to 1962;
4. Making India's Transfer Pricing Provisions applicable to India outbound international transactions;
5. Amending Section 195 of the Indian Income Tax Act to provide that withholding tax will apply to both residents & non-resident irrespective of presence in India with respect to payments made to non-residents

While India, being a sovereign nation, has a legitimate right to introduce or amend its legislation, it is a fact the proposed budgetary have been framed with such confusing provisions and language without much guidance on their operation that it is definitely not a surprise that the Indian markets are reacting so negatively to them.

It is important to note that the Budget proposals apply unilaterally to ALL foreign jurisdictions and we urge our clients, proposed clients and colleagues to refrain from reacting to the Budget based solely on highly speculative media reports and experts of all kind which suddenly seem to have sprung from nowhere.

Please consider our views on the measures stated above which we present to you after reviewing and clarifying these with reputed experts from India and locally and after considering information which we obtained from local sources.

TRC

The Central Board of Direct Taxes of India (“CBDT”) issued the famous Circular No.789 dated 13.04.2000 which in effect makes the TRC issued by Mauritius solely sufficient to enable its holder to benefit under the India Mauritius DTAA.

The Budget proposal which states that the TRC is mandatory but may not be sufficient for its holder to benefit under the DTAA has indeed caused unnecessary confusion.

We draw your attention to media reports (an example is the Economics Times of India of 19 March 2012) which says that:

1. “The [Indian] Finance Ministry has said that the Budget change in the residency law will not affect investments from Mauritius, source of maximum foreign direct investment into India, but investments inflows through other countries could face heat.”
2. "The circular remains valid even now in the case of investors coming from Mauritius... There is no change in the situation," as per an official of the Finance Ministry.

The unbiased opinion of senior Indian Counsels and CAs is that the Circular 789 remains valid until formally revoked. So holders of the Mauritius TRC should continue to benefit from the DTAA.

GAAR

The Indian Government’s own appointed Finance Standing Committee to consider the proposed Direct Tax Code (“DTC”) had issued its report shortly before the Budget. The Finance Minister explained in his Budget speech that the DTC is being postponed pending the review of the recommendations. He however nevertheless ushered in the GAAR provisions which become effective from 1st April 2012.

GAAR contains several insufficiently defined or undefined terms and broad impact provisions with the more critical ones being “Impermissible Avoidance Arrangement” and “Commercial Substance”.

Media reports are harping on the fact that entities are considering relocating from Mauritius to other jurisdictions like Singapore because the India Singapore DTA provides more certainty than the India Mauritius DTA. It is important to note that GAAR may be invoked in respect of transactions originating from any jurisdictions and not just Mauritius.

While the Limitation of Benefits (“LOB”) of the Singapore India DTA prescribes certain conditions for a Singapore tax resident entity to achieve substance as required under the DTA, GAAR is much wider and may nevertheless still apply to the Singapore entity as the DTA also contains the following provision: "A resident of a Contracting State shall not be entitled to the benefits of Article 1 of this Protocol if its affairs were arranged with the primary purpose to take advantage of the benefits in Article 1 of this Protocol." The benefits referred to here are treaty benefits.

Please also note Article 6 of the India Singapore Protocol or DTA which gives Singapore the taxing right for Singapore resident entities:

"Articles 1, 2, 3 and 5 of this Protocol shall remain in force so long as any Convention or Agreement for the Avoidance of Double Taxation between the Government of the Republic of India and the Government of Mauritius provides that any gains from the alienation of shares in any company which is a resident of a Contracting State shall be taxable only in the Contracting State in which the alienator is a resident."

This means that should there be an amendment in the India Mauritius treaty then this may have direct consequence on the Singapore India treaty. Any aggressive shift to Singapore may very much have the same impact.

We now draw your attention to the fact that the rules under which GAAR will operate have not been issued yet. The Indian Government has on several occasions explained that GAAR will contain safeguards so as not to burden genuine investors into India.

It is also a fact that GAAR may only be invoked in cases where broadly speaking, an Impermissible Avoidance Arrangement ("IA") may exist and there is no Commercial Substance ("CS").

At GWMS, we have always ensured that minimum substance requirements are always maintained by client entities under our administration and have always recommended and advised the extra substance measures that could be introduced, in agreement with our clients.

For example, we ensure and monitor all our clients activities to ensure that the TRC substance requirements like Mauritius board meetings, Mauritius audited accounts, Mauritius resident directors, Mauritius principal bank accounts, Mauritius board minutes preparation, etc.. are always met. In addition, we have always drawn attention of our clients towards implementing additional measures like review of documents in Mauritius by Mauritius lawyers, implementing Mauritius jurisdiction as the law of agreements and for arbitration, doing as much work as possible here including the putting in place of PII and Directors & Officers insurance covers, opening of accounts and all such work which may be done in Mauritius to enhance substance in Mauritius. Furthermore, some of our clients have set up their own office in Mauritius.

In addition, all our fund clients have their NAV computed in Mauritius by us and we strongly recommend that their investor relation communications, reports, transactions & queries channeled through us in Mauritius. Our fund clients also mostly pool their investors' investments through the Mauritius fund vehicle.

For the above reasons, our fund clients cannot be said to be shell entities and are most unlikely to fall foul of GAAR. Even the more passive investment holding vehicles under our administration meet the minimum substance requirements and as stated above and most accept the extra substance recommendations that we propose to them. **We reiterate that GAAR will most likely be successful with respect to shell companies with no substance in their operations in Mauritius.**

The proposed Direct Tax Code introduces the concept of Place of Effective Management ("POEM") to determine the residence of an entity. This is closely related to substance requirements and hence to the applicability of GAAR.

The DTC defines POEM as:

(i) the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; OR
(ii) in a case where the board of directors routinely approve the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions:

The above criteria to meet POEM are already being satisfied by our clients which comply with the Mauritius TRC requirements and the extra substance measures that we have recommended.

GAAR is loosely defined and this is likely to lead to a mountain of litigation in India but this is the reality faced by domestic Indian entities as well as entities from ALL foreign jurisdictions.

The important thing to do is to build as much substance as possible in Mauritius and to have a trail of evidence to prove same. We request you to seriously consider GWMS's recommendations and implement same and PLEASE do not adopt a "penny wise pound foolish" approach.

Vodafone

The matter of retrospective legislation will most probably be examined for its constitutionality under Indian laws by Indian Courts. Meanwhile transfer of shares outside India between companies where the underlying assets are situated mostly in India will be scrutinized closely by Indian tax authorities.

It is therefore important that Mauritius entities build as much substance in their local operations to avoid being classified as shell companies.

Withholding tax

This measure will only apply where the Indian Income Tax assessors deem that certain gains or income made by foreign entities are taxable in India.

Conclusion

We bring to your attention the Office Memorandum dated 22.03.2012 whereby the CBDT has set up an ‘Advisory Group for International Taxation and Transfer Pricing’ comprising of 12 high-ranking persons to advise the [Indian] Government on legislative amendments & administrative measures with a view to reducing litigation and bring in more tax certainty.

We believe that this panel should have been set up before introducing the loose budgetary measures. However, the mere fact that this is being announced points to the fact that CBDT has taken stock of the potential litigation mountain and uncertainty havoc that lie ahead. For this reason also we take the view that there will be changes brought to the measures proposed.

Furthermore, as was widely expected, the Indian Government has issued some reassuring comments. The latest media report dated today, 28 March 2012, of the Economic Times of India says that:

“Finance Minister Pranab Mukherjee on Tuesday evening, said he may modify some provisions of the General Anti-Avoidance Rules (GAAR) prescribed in this year's budget, holding out hope that the government could adopt a lenient position on the issue of taxing short-term capital gains of Mauritius-based foreign institutional investors (FIIs).”

We again draw your attention that the phrase “adopt a lenient position on the issue of taxing short-term capital gains of Mauritius-based foreign institutional investors” as used by Economic Times of India is implicitly pre-supposing that all such Mauritius FIIs lack substance in Mauritius and as such are vulnerable. This is of course totally untrue at least in so far as GWMS fund clients are concerned.

We are not saying that Indian Income Tax Authorities will definitely not invoke GAAR and the rest against our client entities. You need to know that assessments are raised by junior level revenue assessors and then escalated to Commissioner of Income Tax level. Arranging your affairs in such a manner which makes it that more easier to prove commercial substance in Mauritius is the way to go to protect your interests. Please remember that the onus to disprove the applicability of GAAR lie on the taxpayer.

Please therefore exercise caution before concluding on any matters related to the Budget.

PLEASE CONSULT US.

International network

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