Is the Mauritius-India Route Well and Truly Kaput?

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Following the issue of the Indian budget proposals for the financial year 2003-2004 innumerable budget highlights, briefs and summaries have circulated in India and abroad to explain Minister Jaswant Singh's recipe for improvement of India Inc. Most, if not all of these budget related documents have at least one thing in common: either a separate or highlighted paragraph explaining why offshore structuring of investments into India might no longer be required in the wake of the proposed removal of long term capital gains tax on the transfer or disposal of listed investments, subject to certain conditions, and the proposed removal of shareholders' tax on dividends and its replacement by the familiar dividend distribution tax. With regards to investments, doubts are being expressed as to whether Mauritius is still the preferred route to India.

Could it be true then that the Mauritius route to India is kaput? Let's have a closer look at a few of the proposals contained in the budget.

I. Capital Gains Taxation

The Finance Minister has proposed to exempt the transfer or disposal of listed securities purchased between March 1, 2003 and March 1, 2004 from long term (more than a year) capital gains tax. This follows a recommendation by the Kelkar's task force and is an attempt to bolster the depressed capital markets in India.

The effect of this proposal on the Indian capital markets remains to be seen. However, it appears that planning opportunities are already being devised to take advantage of this budgetary measure. Hence it is proposed that redeemable preference shares be issued against bought back equity shares, purchased in previous years, to exempt the resultant long term capital gains from taxation when redeemed in the following year(s) and also to escape the dividend distribution tax of 12.5 percent otherwise payable on any dividend paid to the holders of the equity shares if status quo is maintained.

Moving on, one would no doubt find noteworthy the fact that the gains arising on sale or transfer of unlisted securities and short term capital gains would continue to be taxed at the applicable rates.

In terms of the Mauritius-India Double Tax Avoidance Treaty (the "Treaty") capital gains on movable property, whether long term or short term, is not taxed in Mauritius at present. Investment managers are often required to react promptly to market fluctuations. The structuring of investments into India using the Treaty adds flexibility to investment decision-making and obviates the need to have recourse to complex corporate actions!

It is believed that the long-term capital gains tax exemption provision is likely to be reviewed during 2004, hence the restriction of this measure to listed securities purchased in the running budget year. In the event that this exemption is reversed next year, direct investments into India may be penalised. The Treaty adds an element of comfort and certainty to an ingredient much sought after by investors worldwide – that of certainty of taxation.

Furthermore, a large percentage of the India bound investments of Foreign Institutional Investors is short term in nature so the Treaty still holds great attraction to them.

The ICT industry in India has been buoyed to a large extent to funding provided by VCs. Several prominent VCs have used Mauritius for their entry into India and this is likely to continue as capital gains on investments in unlisted securities are excluded from the Minister's budget proposals.

II. Taxation of Dividends

In a departure from last year's budget, Finance Minister Jaswant Singh, has re-introduced the Dividend Distribution Tax ("DDT") at the expense of the shareholders' tax, itself introduced during 2002 at the expense of the DDT introduced in the 2001-2002 budget.

It is now proposed to exempt dividends in the hands of individual shareholders to the detriment of companies which will now have an added tax liability represented by the DDT at the rate of 12.8 percent (12.5 percent tax plus 2.5 percent surcharge). The distributions made by open-ended equity oriented funds are not subject to DDT.

A recurrent feature of budgets worldwide is for certain measures to be introduced, chasing out previous fiscal measures, which are in turn often re-introduced in future periods. This has been the case with the DDT. In view of this, an important merit of tax treaties is consistency. Hence, if India taxes shareholders on receipt of dividends, the Treaty, subject to proper structuring, allows a reduction of the withholding tax,

where applicable, plus foreign tax credits and the added bonus of underlying tax credits (see below). If India eliminates shareholder's tax on dividends, treaty benefits still include foreign tax credits and the added bonus of underlying tax credits. On the other hand, if direct investments are made into India, a foreign entity will often only benefit from the absence of withholding tax.

The Treaty has been often used as a planning tool to reduce the shareholders withholding tax which was re-introduced during 2002 and replaced by the DDT during 2003. There is no doubt that foreign companies acquiring shares in Indian companies will no longer be required to use offshore structures to mitigate Indian withholding tax on their dividend income.

However, another planning point, from the point of view of foreign companies investing in India, has emerged from the reintroduction of DDT, *i.e.,* the availability of foreign tax credit on DDT (paid in India) in the country of tax residence of the foreign entity. Tax experts in India say that very few tax treaty countries have clarified the availability of such foreign tax credit on DDT.

Mauritius has made it amply clear in "The Income Tax (Foreign tax Credit) Regulations 1996" introduced in that year, that foreign tax credit is available in respect of foreign taxes paid on dividend income received by Mauritius tax resident entities or individuals. Section 7 of the regulations further clarifies that, in addition to the DDT tax credit, an underlying foreign tax credit will also be given for the underlying tax charged in the foreign country on the profits out of which the dividend is paid. The underlying tax credit is available to all residents of Mauritius, whether companies, individuals, trusts and by implication partnerships.

Furthermore, only a holding of 5 percent of share capital is required, as opposed to 10 percent or more in many other countries, to qualify for the underlying foreign tax credit and very interestingly, there is no limit to the number of tiers through which one can claim the credit, provided that there is a shareholding of at least 5 percent at each level of the structure.

III. Business Connection

The Budget proposes to amend the definition of "business connection", as used in Section 9 of the Indian Income-tax Act, 1961, along the lines of the concept of permanent establishment as used in tax treaties. The proposals seek to clarify, amongst others, the circumstances under which an Indian agent would constitute a business connection of a non-resident entity in India.

Therefore, foreign companies appointing agents or distributors in India will now have to reckon with the said Section 9, along with the Double Taxation Avoidance Agreements ("DTAA") entered into by India with the country of residence of such foreign company. Otherwise, they risk being taxed on profits arising in India at the effective rate of 41 percent.

The Treaty provides that only certain defined activities, exceeding a generous nine months, as opposed to six months in most other tax treaties, will constitute a permanent establishment. This may prove to be a useful planning tool.

IV. Threats to the Treaty

The Minister has announced that in cases where any term has not been defined in the Indian Income-tax Act, 1961 or in any DTAA, the Central Government of India may, by way of a notification in the Official Gazette, define such term in a manner not inconsistent with the provisions of the Income Tax Act, 1961.

Such provisions appear to have been included to deal positively with the adverse ruling (in appeal) issued by the Delhi High Court challenging the Tax Residence Certificate issued by the Government of Mauritius in respect of a company claiming benefits under the Treaty.

So is the Mauritius India Treaty well and truly kaput? I'm not so sure!

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