Economics

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Double Taxation Avoidance Agreement (DTAA): Mauritius

In 1983, the Government of India negotiated a Double Taxation Avoidance Agreement (DTAA) with Mauritius under which tax payers who reside in one country and earn their income in another would not be taxed twice for the same. This had however led to an anomalous situation where entities ended up not paying taxes in both the countries since Mauritius does not levy a tax on its citizens and these companies set up subsidiaries or operated through Mauritian companies. Thus, the transaction resulted in a nil tax liability and double non-taxation from both sides. By virtue of this agreement, the same held in Singapore too.

The DTAA was one of the main reasons why a large quantum of foreign portfolio investors (FPI) and FDI entered though the Mauritius route. Between April 2000 and March'16, Mauritius accounted for $ 95.9billion which is almost a third of the total FDI of $ 289 billion. In terms of FPI, the share of Mauritius was 19% till April 2016. In case of Singapore, it was 16% and 11% respectively. Hence, almost half of the FDI and a little of a quarter of FPI was linked to such tax agreements with Mauritius and Singapore.

New dispensation

The recent renegotiation of this agreement has led to an amendment where the capital gains exemption will be withdrawn, in a phased manner. The scheme would now run in the following manner.

- All investments up to March 31, 2017 will remain under the old regime i.e. 'double non-taxation'. They will neither be taxed in India nor in Mauritius.
- Between 2017 and 2019 capital gains would be taxed at 50% of the domestic tax rate which will be 7.5% for listed equities and 20% for unlisted ones. The benefit of the two-year transition period will be limited to companies that are not regarded as a shell company with their total expenditure on operations in Mauritius being at least Rs 27 lakh in the preceding 12 months.
- The full rate would apply after 2019 which will be the full domestic rates of 15% and 40% respectively.
- The interest arising in India to Mauritian resident banks will be subject to withholding tax in India at 7.5% after March 31, 2017.

What does this mean?

The government has levelled the playing field for domestic and foreign investors and the incentive for an Indian investor to channel investments via Mauritius has been diluted.

- Funds and investors from Mauritius which are investing in India will have to factor in paying capital gains taxes against their own other expenses.
- Since investments until March 31, 2017 have been exempted from capital gains tax, there is no risk of an immediate outflow of funds.
- This new dispensation will affect all prospective investments with effect from April 1, 2017 and the imposition of capital gains tax on the acquisition of shares of Indian companies after this date could, however result in a slowing of the flow of investments.

- The Singapore Treaty which the government has signed will also be automatically be renegotiated along identical lines as the two agreements are linked. The India-Singapore tax treaty provides that the capital gains exemption in India will be available only till such time the India-Mauritius treaty provides for the benefit. Therefore, the benefits accorded under the Singapore Tax Treaty would also be under scrutiny.
- Some experts have opined that Netherlands may emerge as an attractive destination as the India-Netherlands treaty provides that if a company based in Netherlands holds less than 10% equity in an Indian entity, it would not attract capital gains on the sale of those shares to residents or non-residents.

What does it not mean?

- It has been clarified that there will be no impact of this amendment on ***P-Notes*** and refers to transfer of shares only. P-Notes (Participatory Notes) are essentially derivative instruments deriving value from listed securities where the names of the holders are kept anonymous and are issued by registered foreign institutional investors to overseas investors. While the FPIs are registered with SEBI, overseas investors investing in P-Notes are not.
- ***Derivatives*** continue to be exempt from capital gains tax under the revised India-Mauritius tax treaty. This is significant because derivatives account for 90% of all equity trading in India and are equally important for the FPIs.
- Income from transfer of ***debt securities*** would also continue to be exempt under the provisions of the amended India-Mauritius tax treaty as the amendment is only with respect to the transfer of shares. This will hence not affect the debt market which is positive as there have been moves made to increase FPI presence in the debt market, where the limits under corporate debt have not yet been used up. However, by opening the window to FPIs to invest in SDLs and reckon their limit based on outstanding securities for also GSecs, this component does become even more important.

Why has this been done?

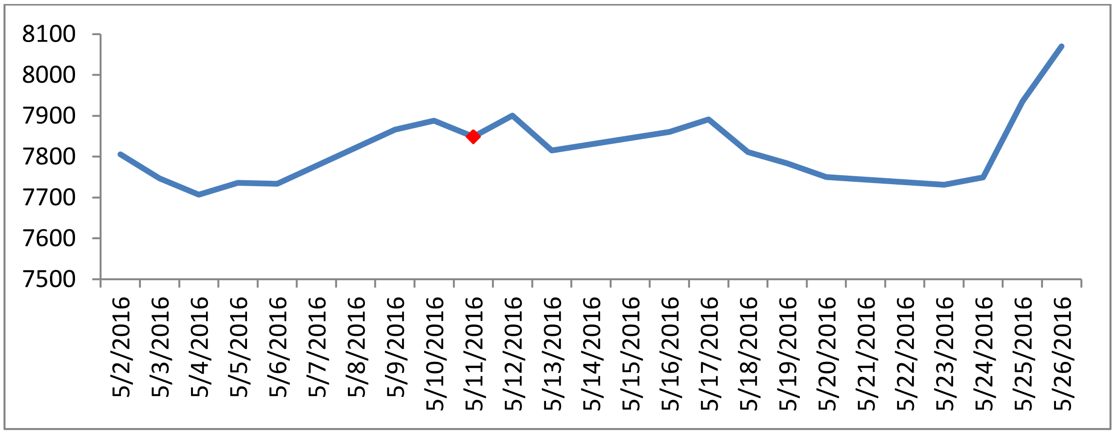
The main objective of this treaty is to bring transparency into the tax system and also bring tax evasion and round tripping under check.

- While the agreement was supposed to encourage Indian investors in Mauritius, it ended up with money round tripping from India to Mauritius to return to India in order to avoid tax.
- This may also be interpreted against the background of the government's effort to curb black money in the system as well as money laundering.
- This protocol according to the government will tackle issues of treaty abuse and round-tripping of funds attributed to the India-Mauritius treaty, curb revenue loss, prevent double non-taxation, streamline the flow of investment, and stimulate the flow of exchange of information between India and Mauritius.
- This will lower the role of speculators and non-serious investors which will stabilize the stock market in terms of volatility as there will be a medium term commitment.

Immediate impact on stock markets

It may be recollected that India had an agreement with Cyprus too which provided for capital gains tax exemption similar to Mauritius. However, as there was no clarity after the turbulence of 2013 the imposition of withholding tax on all payments to Cyprus entities have reduced investments from Cyprus to a trickle. Hence, there is always the fear that a similar reaction may be witnessed when this law comes into force. The chart below looks at the movements in Nifty just before and after this announcement was made.

Exhibit 1: Nifty movements May 2nd to May 26



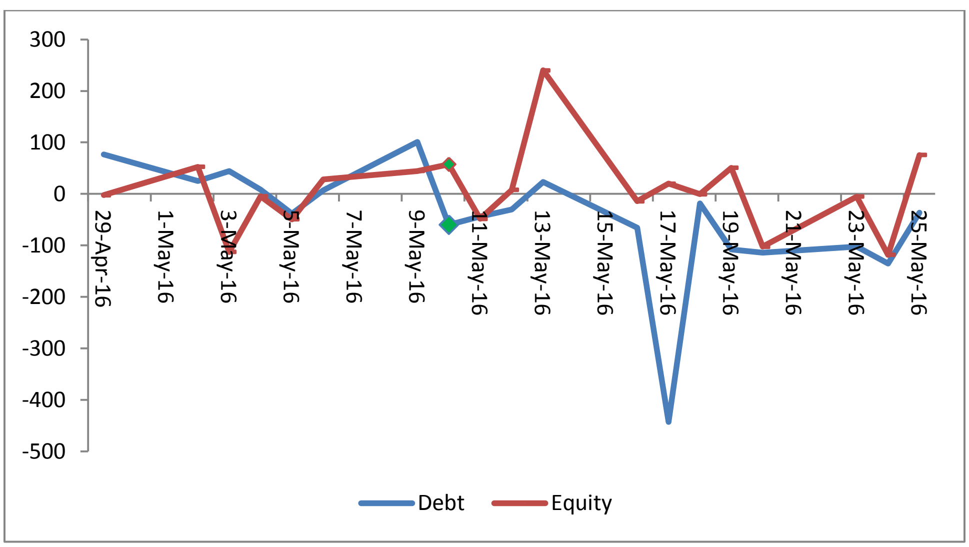
Source: NSE

The Nifty witnessed a decline on the 11th – one day after the release was made public by the government and came down by 40 points. However subsequently, it went up the next day and followed the normal path. Therefore, the immediate impact does appear to be quite mild.

How have FPI funds behaved?

FPI investments in both the equity and debt segments have been plotted in the graph below for the month to a certain any trends in change in movements.

Exhibit 2: FII flows in May



Source: NSDL

The Chart above shows that there was no clear pattern in the movement of FPI investments post 10th May. But given that equity has done better than debt, it may be concluded that this new agreement has not quite affected decisions of FPIs significantly in this month.

Concluding remarks

1. The revision in the agreement with Mauritius was expected at some stage given the government's goal of curbing improper flow of funds solely from the point of view of dodging taxes.
2. To the extent that such money was increasing volatility in the stock market, the same would be curbed.
3. The phasing of these taxes is pragmatic as it allows investors to review their options.
4. The immediate impact on the stock market as well as FII flows does not appear to be volatile this month.
5. It may be expected that once the tax comes into force, there will be a slowdown in flows of investments in equities. However, funds may substitute the same with debt, provided it remains attractive relative to other countries. It must be pointed out that while India is on the downward path of the interest rate ladder, the western countries will only increase interest rates, albeit over a period of time. In this situation, it could lead to some element of volatility in the stock market.
6. On the positive side, there is clarity brought on this issue which has otherwise been at the back of the government's mind for quite some time now.

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