Debt Investment in India: Is Mauritius now the Preferred Route?

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Introduction

On May 10, 2016, after years of protracted negotiations, India and Mauritius signed a protocol ("Protocol") amending the agreement for avoidance of double taxation between India and Mauritius ("Indo-Mauritius DTAA"). This Protocol has been hailed by the Indian government as a key measure to tackle the long pending issues of tax evasion and tax avoidance attributed to the Indo-Mauritius DTAA, thereby proposing to curb revenue loss and encourage the exchange of information between India and Mauritius. Under the Protocol and once it comes into effect, India will get the right to tax capital gains arising on alienation of shares (of companies' resident in India) acquired on or after April 1, 2017. For shares acquired and transferred between April 1, 2017 and March 31, 2019, the tax rate will be limited to 50% of the Indian tax rate subject to fulfilment of conditions specified under the limitation of benefits ("LoB") article. The Protocol has also made changes to the taxation of interest income, widened the definition of 'Permanent Establishment' ("PE") to include 'service PE', included articles on taxation of 'fees for technical services' and 'other income' not specifically covered under the Indo-Mauritius DTAA. The Protocol also included articles on facilitation of exchange of information and lending assistance with collection of revenue claims.

While most of the changes introduced by the Protocol now make the Indo-Mauritius DTAA more restrictive (with the big game changer being India's ability to tax capital gains), the significant introduction is the concessional tax treatment in respect of interest income accruing to Mauritius tax residents (7.5%) provided they are beneficial owners of such income. The erstwhile Indo-Mauritius DTAA imposed rates that could have been as high as 40% (plus other applicable taxes) in respect of certain instruments, including convertible debentures.

Given that the Indian corporate debt market is heating up, with approximately INR 253 billion worth of non-convertible debenture issuance planned in the coming months, the question on the mind of foreign investors is: should Mauritius be used to route investments into Indian debt?

Investing in Indian debt instruments: entry routes for foreign investors

Foreign investors can invest in debt instruments under three routes: the Foreign Portfolio Investor ("FPI") route, the foreign venture capital investor ("FVCI") route, and the external commercial borrowing ("ECB") route. Offshore investors desirous of investing in the listed market (both primary and secondary), invest under the FPI route. FVCI route is opted for by offshore investors when making primarily unlisted equity investments in the limited ten permitted sectors (including infrastructure, biotechnology and IT related to hardware and software) and start-ups. FVCIs are permitted (subject to limits) to invest in the debt securities of companies in which they have equity participation. The ECB framework is available only for eligible borrowers in India (such as certain non-banking financial companies, companies in manufacturing and software development sectors, shipping and airlines companies, companies in infrastructure sector, etc.) to borrow from eligible lenders located offshore (such as international banks, multilateral financial institutions, financial institutions, export credit agencies etc) in the form of loans including bank loans, securitized instruments (such as floating rate notes, fixed rate bonds, non-convertible, optionally convertible or partially convertible preference share / debentures), and foreign currency convertible bonds. This is a restricted and heavily regulated route for exposure to the Indian borrower market.

The decision of which of the above routes should be taken to access the debt markets in India is intertwined with how best to structure the investment in the most tax efficient manner. To make that decision, foreign investors look to jurisdictions with whom India has favourable tax treaties (if their own treaty is not favourable or if they are a fund house looking to set up a pooling vehicle for investing in India) and where business operations can be undertaken smoothly.

India has entered into several double taxation avoidance arrangements with other countries. The treaties that India has with Mauritius and Singapore have been used the most for making foreign investments in India. This has been primarily due to the ease of doing business in both the jurisdictions, their geographic proximity to India and to avail of capital gains tax benefits under the respective treaties. For structuring debt investments in particular, the jurisdictions which have typically been used by foreign investors to invest in India include Singapore (10-15% withholding on interest income), Cyprus (10% withholding on interest income, but not a viable route post its notification as a 'notified jurisdictional area'), Luxembourg (10% withholding on interest income) and the Netherlands (10% withholding on interest income). With

the Protocol in place, it is widely believed that Mauritius will now be the 'go-to' jurisdiction for foreign investors making debt investments in India. To understand if that really is the case, it is important to understand the nature of income that can arise from debt investments and how it will be taxed under the Indo-Mauritius DTAA.

Taxation of debt instruments under the Indo-Mauritius DTAA after the Protocol

A foreign investor investing in debt instruments could earn the following incomes from investments in India: (a) gains arising from sale / transfer of securities held in Indian companies; and (b) interest income.

Taxation of gains: Gains arising from alienation of securities (whether debt or equity) depends upon its characterization as 'capital gains' or 'business income'. While for foreign investors using the FPI route, it has been clarified that any gains arising to a FPI from sale of securities held in Indian companies will be characterized as 'capital gains', this clarity has not been extended to other routes.

The Central Board of Direct Taxes ("**CBDT**") has recently clarified that sale of listed securities held for more than 12 months would be treated as capital gains unless the tax payer himself treats the same as stock in trade and in other cases involving sale of listed securities held for a period of 12 months or less or sale of certain unlisted securities, the characterisation of income would be decided on the basis of previous circulars and instructions issued by the CBDT on this subject; the thumb rule being that in determining the nature of the gain, one has to see the manner in which they are held i.e. whether as a capital asset (in which case its sale will be a capital gain) or stock-in-trade (in which case its sale is a business income).

Under the Indo-Mauritius DTAA, if the gain from alienation of debt instruments (compulsorily, optionally and non-convertible debentures), other than redemption premium, is treated as 'capital gains', such instruments shall only be taxable in the contracting state where the alienator is resident i.e. Mauritius (even after the Protocol has been introduced), which is beneficial as Mauritius does not levy tax on capital gains. If however, the gains are characterized as 'business income' and the foreign investor has a business connection/PE in India, then the gains attributable to such PE would be liable to be taxed in India on a net income basis broadly at the rates varying between 41.2% to 43.26% (subject to minimum alternate tax).

Taxation of interest income: Prior to the execution of the Protocol, with respect to interest income, Mauritius banks were exempt from tax in India and other entities in Mauritius were taxable as per the domestic tax laws in India. Under the domestic tax laws of India, interest arising to a non-resident may be taxable at rates ranging from 5% to 40%, as increased by other applicable taxes, depending on the nature of debt instrument and status of the investor. Accordingly, in cases where the domestic tax rate of 5% (as increased by other applicable taxes) is applicable, since the domestic tax rate would be more beneficial than the treaty, there may not be any need to rely on the treaty for tax on interest.

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The Protocol provides that all Mauritius entities including banks earning interest income from Indian sources will now be required to pay tax at a rate of not more than 7.5% of the gross amount of interest provided that the Mauritius entities are the beneficial owners of such interest income. Mauritius banks carrying on bonafide banking business would continue to be exempt from tax on interest earned from debt claims existing as on March 31, 2017. It is pertinent to note that 'interest income' under the Indo-Mauritius DTAA includes income from debt claims of every kind, whether or not secured by mortgage, whether or not carrying a right to participate in the debtor's profits, income from government securities, bonds, debentures, including premiums. If however, the recipient of the interest has a business connection/PE in India, then the interest income which is attributable to the business connection/PE will be taxed in India at the rates varying between 41.2% to 43.26% (subject to minimum alternate tax) on a net income basis.

Based on the above analysis, it can be said that for now, Mauritius is certainly the preferred route for investing in the debt market in India. But the euphoria around this may be short lived and the implications of the Protocol are not free from doubt. Here is why.

Challenges that the Indo-Mauritius DTAA faces

General Anti-Avoidance Rules ("GAAR"): India is set to bring GAAR into effect from April 1, 2017. The extant GAAR provisions have the impact of regarding an arrangement as an impermissible avoidance arrangement, when its main purpose

is to obtain a tax benefit and it contains any of the following tainted elements – is not at arm's length, results in misuse or abuse of provisions of tax laws, lacks commercial substance and is carried out in a manner not ordinarily employed for bona fide purposes. The domestic tax law expressly provides that GAAR provisions would override all tax treaties. The GAAR provisions vest tax authorities with wide powers to disregard, look through or re-characterise arrangements, ignore arrangements, amongst other things. The open-ended residual power granted to the authorities, allowing them to determine tax consequences as they deem appropriate, is a cause for some concern. Therefore, with Mauritius historically being under the tax scanner and capital gains from transfer of debt instruments being taxable in Mauritius under the Indo-Mauritius DTAA (with no need to comply with recently introduced limitations of benefit clause under the Protocol), Mauritius as a route for making foreign investment can be brought to question by Indian tax authorities invoking GAAR.

Treatment on conversion of quasi-debt instruments: The Indian Government has set up a working group to analizee the implications of the Protocol and the concerns raised by market participants. In particular, there is ambiguity on the tax treatment which will be accorded to quasi-debt instruments such as compulsorily convertible debentures, if they are converted after April 1, 2017, and if such instruments will be taxed as shares acquired after April 1, 2017 and accordingly taxed in India. The CBDT generally has clarified that the period for which a debenture as held prior to conversion would be taken into account to determine the date of acquisition of shares. However, here is ambiguity regarding the applicability of this clarification to the Indo-Mauritius DTAA.

Place of Effective Management ("POEM"): Under Indian tax laws, a company will be considered a resident of India, if its POEM, at any time in that year, is in India. POEM has been defined to mean a place where the key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance made. The Indian government is in the process of formulating rules to effectively determine POEM. As per the extant Indian tax laws, if a POEM is said to be constituted in India, the worldwide income of the investor would be subject to tax in India at the rates varying between 41.2% to 43.26% (subject to minimum alternate tax) on net income basis. However, if the POEM is not in India, the foreign investor should not be taxable in India in respect of its worldwide income, but only in respect of income which is received in India or accrues or arises in India or is deemed to be received in India or is deemed to accrue or arise in India. The investor should then be entitled to claim benefits under the Indo-Mauritius DTAA in respect of such income, subject to satisfaction of eligibility conditions for availing benefits under the Indo-Mauritius DTAA and the Protocol, including meeting with the requirements as prescribed under the Indian tax laws.

Other treaty negotiations: News reports suggest that India is already in dialogue with Singapore and has officially started discussions with Cyprus to introduce source based taxation of capital gains on transfer of shares, similar to what has been proposed under the Protocol. India is also considering de-notifying Cyprus as a 'notified jurisdictional area', thereby rescinding the greater disclosure norms, more stringent transfer pricing provisions, and levy of 30% withholding tax that was imposed by India. It is pertinent to note that before notification of Cyprus as a 'notified jurisdictional area', Cyprus was a preferred route for making debt investments with withholding tax being as low as 10%. How the treaty re-negotiations will take place and whether the interest income related clauses will also be negotiated to bring these jurisdictions at par with the Protocol, remains to be seen.

Conclusion

The Protocol puts to rest the uncertainty that surrounded the Indo-Mauritius DTAA during the prolonged negotiation period. One hopes that the working group will iron out the challenges that are being seen in the implementation of the Protocol. As can be seen, with Singapore and Cyprus treaties with India also heading towards India negotiating for source based taxation of capital gains on sale of shares, the key differentiator will be the manner in which these treaties are negotiated with respect to taxation of debt instruments. Post the Protocol, Mauritius, as it now emerges is the preferred jurisdiction for debt considering the lower withholding tax rates for interest income as well as the capital gains tax exemption. However, with the impending implementation of GAAR, there is no longer a standard formula for investors to use Mauritius as an entry point to India to minimize tax costs. A careful analysis of the investment strategy, nature of investment and commercial reason to use a treaty jurisdiction will need to be undertaken before deciding which route to take to India.

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