Tax Flash News

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India and Mauritius sign a protocol to amend their tax treaty, introduce principal purpose test provisions

Executive summary

A protocol has been signed to amend the India-Mauritius tax treaty (the treaty). The Protocol proposes to replace the existing treaty preamble and introduce the principal purpose test (PPT) in the treaty.

The new preamble, *inter alia*, provides that India and Mauritius intend to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance including through treaty shopping arrangements.

The PPT clause is an anti-abuse provision which provides that the treaty benefit will not be available in respect of income if it is reasonable to conclude that obtaining the treaty benefit was one of the principal purposes of the arrangement or transaction.

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Background

India-Mauritius tax treaty was signed in 1982. The preamble specified the purpose of the treaty as 'the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment'.

The treaty, *inter alia*, granted the capital gains tax exemption in India in the hands of the Mauritian tax resident i.e., capital gains arising to a Mauritian resident on the sale of shares of an Indian company was not taxable in India. The treaty also provided a lower tax rate for dividend income earned by Mauritian tax residents from companies resident in India. The Indian tax authorities have been denying these benefits on the grounds of treaty shopping[1] by foreign multinational groups by establishing a shareholding company in Mauritius for the purpose of making investment in India i.e., intermediary holding structure.

The Central Board of Direct Taxes (CBDT) issued Circular No. 789[2] which provided that a tax residency certificate issued by the Mauritian Authorities would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the treaty. The validity of the circular was challenged and the Supreme Court in the case of *Azadi Bachao Andolan*[3] upheld the validity of the circular and observed that the developing countries allow treaty shopping for the encouragement of mutual trade and investment.

The treaty was amended through a protocol in 2016 to give India the capital gains taxation rights for the new investments made (i.e., shares acquired by a Mauritian tax resident on or after 1 April 2017 in a company resident of India) and the erstwhile investments (i.e., share acquired before 1 April 2017) continued to be exempt from capital gains taxation in India.

On 7 March 2024, India and Mauritius signed another protocol to amend their treaty by replacing the existing treaty preamble and introducing the PPT in the treaty.

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[1] 'Treaty shopping' is an expression used to describe the act of a resident of a third country taking advantage of a treaty between two countries. [UOI v. Azadi Bachao Andolan [2003] 263 ITR 706 (SC)]

[2] Dated 13 April 2000

[3] *UOI* v. *Azadi Bachao Andolan* [2003] 263 ITR 706 (SC)

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The 2024 Protocol

Preamble

The new preamble provides that India and Mauritius, though intend to eliminate double taxation, but do not intend to create opportunities for non-taxation or reduced taxation through tax evasion or avoidance or treaty-shopping arrangements aimed at obtaining reliefs provided in the treaty for the indirect benefit of residents of third jurisdictions.

Principal purpose test

The PPT clause provides that the treaty benefit shall not be granted in respect of an item of income if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of the arrangement or transaction.

The clause has a carve-out which provides that the above provision will not apply if it is established that granting the benefit would be in accordance with the object and purpose of the relevant provisions of the treaty.

The PPT clause overrides other provisions of the treaty.

Entry into force

India and Mauritius shall notify to each other the completion of the procedures required by its law for the bringing into force of this Protocol.

The Protocol shall enter into force on the date of the later of these notifications.

The provisions of the Protocol shall have effect from the date of entry into force, without regard to the date on which the taxes are levied or the taxable years to which the taxes relate.

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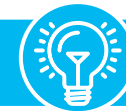
Our comments



The amendment of the preamble and the introduction of the PPT in the treaty could create additional challenge for intermediary holding structures to claim treaty benefit, especially for capital gains on pre-April 2017 investments and dividend income.

In the context of capital gains, the domestic anti-abuse provision i.e., General Anti-Avoidance Rules (GAAR) has a grandfathering provision i.e., it does not apply to capital gains arising from transfer of investments made before 1 April 2017. A similar provision has not been introduced in the PPT in the treaty.

Further, the language of the PPT clause is wider than the domestic GAAR provisions. The GAAR treats the transaction as an 'impermissible avoidance arrangement' when the 'main purpose' of the transaction is to obtain a tax benefit. However, the PPT clause denies tax treaty benefit to the transaction if taking such benefit is 'one of the principal purposes' of the transaction.

It may be noted that in the context of the date of effect of the protocol, it has been stated that it would be "without regard to the date on which the taxes are levied or the taxable years to which the taxes relate". Use of this expression is raising concerns as to whether this proposed protocol can be made applicable to any tax proceedings pertaining to the past years. A clarification from the CBDT on this aspect should allay these concerns.

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