UNDERSTANDING THE FUNCTIONING OF DOUBLE TAXATION AVOIDANCE AGREEMENTS WITH REFERENCE TO THE INDO - MAURITIUS DTAA

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ABSTRACT

With the growth of liberalization, one of the major focus of most countries has been to increase foreign investment in their economies. However, taking into consideration that the problem of double taxation could hinder such foreign investments, many countries have entered into taxation treaties, which addresses the issue of double taxation. The current article focuses on this issue of double taxation with special regards to the Indo – Mauritius Double Taxation Avoidance Agreement. The article identifies certain issues that have cropped up in relation of this agreement such as *treaty shopping* and *round tripping*. The article further explains the Indian jurisprudence that has evolved in the past with respect to these issues and the efforts taken by the policy makers to solve these issues by bringing about an amendment in the article. Finally, the article goes on the justify these amendments by attempting to explain the possible intention of the government to proceed in that manner.

INTRODUCTION

The economic system of the world has changed immensely over the period of time. Earlier, self-sufficiency was considered to be the key factor in deciding whether or not a country is powerful. This factor for deciding the superiority of a nation has not changed much in the recent times. However, unlike earlier times when self-sufficiency depended on the quality and quantity of resources available within the territorial boundaries of a nation, in the recent times, it depends upon which country is able to attract the maximum investments. As a result of this, every country is engaged a battle where they are racing each other to make their economic environment more investment friends.

In order to ensure that the economy of the country is investment friendly, various factors must be achieved, such as: laws related to incorporation of a business and the compliances involved in carrying out business must be simple and uncomplicated, the laws regarding enforcement of contracts must be strong and effective, non-prohibitive tax regime, etc. One of the impediments in securing non-prohibitive taxation regime is the issue of double taxation. Although this issue persists to be one of the major reasons for low investments in most developing countries, including India, many efforts have been undertaken to overcome this hurdle.

One of the ways to curb the problem of double taxation is by entering into agreements with various countries for the purpose of avoidance of double taxation. Such agreements are called as Double Tax Avoidance Agreements (Hereinafter referred to as **'DTAA'**) and it is being used as a tool to encourage investments in India by the central government. The current paper intends to address the issues regarding such DTAAs with specific reference to the Indo – Mauritius DTAA entered into in 1982.

THE PROBLEM OF DOUBLE TAXATION

The fiscal committee of OECD in Model Double Taxation Convention on Income and Capital, 1977, has defined double taxation as,

> *"the imposition of comparable taxes in two or more states on the same tax payer in respect of the same subject matter and for identical periods."*

In most countries, tax is majorly imposed for two reasons; firstly for securing proper regulatory environment in the country regarding various economic activities and secondly, to earn revenue which shall be used for developing infrastructure for the betterment of the nation. In order to achieve the second objective of earning more and more revenue, every country aims to bring maximum units under the purview of taxation and impose high taxes. This becomes very problematic in case of those situations where the units are exposed to the taxation laws of more than one country for the same economic activity as it leads to additional burden. This phenomenon of a single unit being exposed to the tax liability in more than one jurisdiction for the same economic activity is called as double taxation and this problem is more susceptible to happening in case of income tax imposed on an individual or an organization.

The imposition of income tax usually takes place on the basis of dual criteria. It can either be imposed on the income of a unit, based on his residential status or on the basis of the source of income itself.[i] In India, the residential status test takes place in the first instance wherein, if the person is a resident of India, then his entire income shall be exposed to the income tax liability.[ii] On the contrary, if the person is not a resident of India, he shall be exposed to the tax liability only on that income which is generated in India.[iii] Assuming for the purpose of exemplification that the same criteria exists in the jurisdiction of some other country as well, if we consider a person who is a resident of that country and investing in shares of an Indian company, he shall be liable to pay tax on the income derived from alienation of those shares in India as it is the source of that income and also in the jurisdiction of the other country as he is a resident there. In severe cases, there might be a situation where if the tax rate in both these countries is very high, for example more than 30%, it might lead to a total tax liability of more than 60%, which will reduce the actual income earned by the assessee to a very meager sum.[iv] This is said to be the phenomenon of double taxation and the existence of this, will discourage the resident of the other country from investing in shares of Indian company thereby leading to reduction in foreign investment in India.[v]

In order to keep such double taxation in check and to ensure that the residents of India and the investors in India are not unnecessarily burdened, the Income Tax Act, 1961 (Hereinafter referred to as the **'ITA'**) provides for reliefs in case of double taxation of individuals and organizations. Such a relief is available in the form of tax credit to those individuals and organizations that are residents of India if they prove that the income that is taxed in India is actually accruing from some other country that has already taxed it in their jurisdiction.[vi] However, in case of those individuals and organizations who are not residents of India, the relief that might exist is only if the government of India enters into an agreement with foreign countries i.e. the DTAAs.[vii]

MEANING AND SIGNIFICANCE OF DTAA

As discussed above, the Central Government derives its power to enter into DTAAs with other countries as a result of the provisions of the Income Tax itself. Such DTAAs become necessary, as they are the only means of providing relief to those individuals and organizations that are not residents of India but are receiving income by investing in shares of Indian Companies. These agreements are in the nature of the treaties that are entered into at the international level and are therefore made under the purview of Public International Law and are governed by the rules of the Vienna Convention on Law of Treaties.[viii]

The main reason that the DTAAs have gained momentum in the modern times is due to the fact that the countries have realized the fact that in the absence of the DTAAs it is not possible to effectively curb the problem of double taxation as it is not necessary that all the countries have such relief clauses as are existing in the ITA. The object, purpose and need of DTAA is provided for by the OECD in the 'Model Tax Convention on Income and on Capital' in the following words:

> *"It is desirable to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation"*

The existence of proper double tax avoidance provisions in the DTAA is very effective in increasing and encouraging foreign investment as the investors are not under the additional burden of paying taxes in the country of their residence as well as in the country of investment.[ix] The taxing liability is also clearly defined in the DTAA for individuals and organizations in case of various incomes, which further enables the investor in taking informed decisions regarding foreign investments.[x] This encouragement of foreign investments is specifically advantageous to the developing countries as it ensures free and constant flow of foreign investment. It also reduces the attempts of tax evasion on the part of the individuals and organizations as the burden reduces and the element of injustice by the reason of double taxation is also eliminated.[xi] It also helps in clearly defining the taxing rights of the countries who are a party to the DTAA and helps in free flow of information thereby increasing international cooperation.[xii]

In order to ensure that the above positive effects of DTAA are effectively derived, the negotiations involved before entering into a DTAA between two countries becomes of major significance. The negotiations usually take place in the form of reciprocal promises between the countries such that if a country is getting benefit from the right to tax a particular income, it will have to forgo its right to tax with respect to some other category.[xiii] The negotiations between the countries may lead to either of the two possible frameworks depending on whichever is more beneficial:

a) Double Tax Avoidance by way of Tax Exemptions:

This framework exists when a particular category of income is exempted from being exposed to the taxing liability in one of the countries that are parties to the DTAA in spite of the fact that such country might have the taxing right with respect to that category of income according to its domestic legislation.[xiv] This framework is adopted in the DTAA that is entered into between India and Libya, Greece and UAE for deciding the taxation of dividend, interest, royalty and fees. Under this agreement, the income that is accrued to the residents of Libya, Greece and UAE from India shall be exempt from being taxed in India although technically according to the ITA India has a right to tax such an income. Similarly, the income accruing to a resident of India from the above stated countries shall be liable to be taxed only in India and the above countries are exempt from taxing such income.

b) Double Tax Avoidance by way of Tax Credit:

Under this framework, there is no ab-initio exemption available to the assessee as is available in the above stated framework. However, the assessee shall be given an option to declare any income that is already taxed in some other country and receive the tax paid for the second time as credit, which can be set off against his future tax liabilities.[xv] This framework provides for a relief, which is very similar to the relief available to the Indian residents under section 91 of the ITA.

Considering the above stated frameworks available with the countries which can be incorporated into the DTAA, a question arises as to how exactly the provisions of the DTAA apply in so far as it clashes with the provisions of the domestic tax legislations of the countries that are a party to it. In most of the circumstances, the assessee is given the opportunity to choose between the provisions of the domestic legislation or that of the DTAA depending upon whichever is more beneficial to him.[xvi]

In addition to these frameworks that are mentioned in the DTAA for the purpose of double tax avoidance, the subject matter of the DTAA, it may be comprehensive or limited in nature. Limited DTAA refers to that agreement, that provides for the avoidance of double taxation with respect to income from particular industries or assets, for example, taxes related to the air and shipping industries, estate tax, gift tax, inheritance tax, etc.[xvii] Comprehensive DTAA on the other hand contains provisions to avoid double taxation of headings of income such as provisions related to salary earned by an Indian Resident in a foreign country, capital gains earned by an assessee, profits and losses earned by a corporation have a global existence, etc.[xviii] One such comprehensive DTAA is the one entered into between India and Mauritius in the year 1982.

HISTORY OF INDO – MAURITIUS DTAA

After independence, India had been a closed economy for the longest time. However, in 1980s, there was an acute need for globalization as India's foreign exchange had reduced to a great extent and the country was facing a Balance of Payment crisis. Thus, in order to improve India's economy and to allow the Indian investors to invest in the global markets, India started entering into certain agreements with foreign countries in order to discuss and negotiate certain favorable terms for global trade and investment. One such agreement was the DTAA with Mauritius. After this agreement, the investments from Mauritius to India increased drastically and accounted for almost 44% of the total foreign investment in India.[xix] However, certain provisions such as Article 13 of the Indo – Mauritius DTAA (Hereinafter referred to as the **'Agreement'**) have been convoluted and misused to advance the personal gains of corporations over the world.

Article 13 (4) of the Agreement provides as follows,

> *"Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs 1, 2 and 3 of this Article shall be taxable only in that State."*

Paragraphs 1, 2 and 3 of the Article 13 provide for the gains derived from sale of immovable property, movable property and ships and aircrafts. Therefore, paragraph 4 shall bring under its ambit alienations of shares of companies. As a result of this, if shares are considered to be the property referred to in Article 13 (4) of the Agreement, it is interpreted as follows,

> *Whenever capital gain is derived by a Mauritian resident from alienation of shares of an Indian company shall be taxable only in Mauritius.*

By the operation of this provision, India is exempt from imposing capital gains tax when it is obtained as a result of selling of shares of an Indian company. On the face of it, this seems to be a balanced provision, however, the misuse aspect comes into picture when we realize that capital gains as a head of income is not taxed in Mauritius. In addition to this, the Agreement does not contain anything, which provides for any limitations on its applications in the form of General Anti – Avoidance Rules (GAAR) provisions. As a result of this, any assessee resident in Mauritius and investing in Indian shares shall not be liable to pay any tax with respect to the capital gains received from the alienation of those shares. This leads to two major illegal usage by corporations and individuals i.e. treaty shopping and round tripping.

i. Treaty Shopping:

Treaty Shopping is a phenomenon, which came into light as a result of Article 13 (4) of the Agreement, wherein, the individuals and corporation all over the world realized that a Mauritian resident is exempt from paying any tax on capital gains from alienation of shares in India. Such individuals and organizations from third countries either plotted together to use a Mauritian investor as a vehicle to invest their own funds in India or they themselves floated shell companies in Mauritius through which they invested in India to get benefit of the tax exemption.[xx] These adjustments are referred to as "treaty shopping". When such instances started growing in number, the Indian authorities started resisting the application of the Agreement to such investments, which were done through Mauritian residents with the sole purpose of avoiding the payment of taxes. However, the Central Board of Direct Taxes (CBDT) issued Circular No. 682 dated March 30, 1994 to clarify this situation, which stated that capital gains derived, by a resident of Mauritius by alienating shares of an Indian Company shall be taxable only in Mauritius according to Mauritius tax laws. Even after this, the Indian Revenue authorities resisted the application of the Agreement to those companies that did not have any commercial activities in Mauritius and that seemed to be shell companies.[xxi] This was done by the authorities by citing the GAAR provisions in the ITA specifically Section 96 which did not allow for any tax concessions in the absence of commercial substance of a corporation. This was again clarified by the CBDT by its Circular No. 789 dated April 13, 2000 wherein it was stated that the Mauritius Tax Residency Certificate was adequate evidence to determine the residence of a corporation under the Agreement and a corporation or an individual holding such a certificate shall be entitled to the treaty benefits. When this circular was issued, both the Circular No. 682 and

Circular No. 789 were challenged before the Delhi High Court, which successfully quashed it. However, when this decision was appealed against before the Supreme Court of India, the court overruled the judgment of the Delhi High Court and upheld the validity of the Circulars issued by the CBDT.[xxii] The Supreme Court stated the following reasons for this decision:

a) It is the state's sovereign right to enter into treaties with other countries and if the state decides to allow the applicability of the treaty to such cases that fall under the ambit of treaty shopping, the judiciary does not have a right to judge its legality.[xxiii]

b) If at all the legality of the Circulars is to be judged it can be done only on the basis of the provisions of the treaty that has been signed between the states who are party to it. Since the current Agreement does not include any limitation of application clause or any other provision to indicate that such instances of treaty shopping are not to be given benefit of the treaty, the Circulars issued by the CBDT are perfectly valid.[xxiv]

c) The main purpose of the Agreement was not just avoidance of double taxation and tax evasion but also promotion and encouragement of foreign investments in India. Thus even if at the first glance such a provision which allows for treaty shopping may seem to be an evil, it might be tolerated by developing democratic countries to improve the investment and lead to economic growth.[xxv]

Thus, after this judgment, the resistance by the revenue authorities reduced as the situation had become very clear regarding the applicability of the Agreement in cases of treaty shopping.

ii. Round Tripping:

This provision of Article 13 (4) of the Agreement also led to one more illegal activity of round tripping. In this, the residents of India itself found it a lucrative method of investing in India through Mauritian entities to get exempted from paying tax on the capital gains under the ITA. Thus, the Indian investors started colluding with Mauritian investors and floating shell companies through which they invested their funds generated in India back in the shares of the Indian companies so that when the shares are alienated, the capital gains would not be taxable.[xxvi] This activity was called as "round tripping". Due to this, there were lot of instances where even black money generated in India was routed to Mauritius and from there invested back in India thereby getting dual benefit of conversion of black money into clean money and tax exemption. This made the Central Government realize that, in an attempt to increasing the foreign investments in India, the practices of round tripping undertaken by the Indian companies has led to drainage of the Indian funds into foreign economies. As a result of this, both India and Mauritius entered into an agreement to introduce an amendment to the provisions of the Indo – Mauritius DTAA in the year 2016.

RECENT AMENDMENTS IN THE INDO – MAURITIUS DTAA

As mentioned earlier, due to the resulting misuse of the complete exemption of taxation on capital gains as a result of the Agreement, negotiations were once more initiated between India and Mauritius to amend the provisions of the Agreement. The amendment that was proposed was that the capital gains arising out of the alienation of shares of the Indian company acquired by the Mauritian resident should be taxable according to the Indian tax laws. In the negotiations it was decided that to avoid a sudden impact on the Mauritian investments in India, the amendment shall materialize in a phased manner whereby firstly, all the investments made by the Mauritian residents before April 2017 shall be continued to be governed by the earlier regime of complete exemption on capital gains.[xxvii] In addition to this, 2017 and 2019, the capital gains shall be taxed at 50% of the tax rate applicable in India. In India, for capital gains arising out of selling of shares, the rates are 15 % for listed equities and 40% for unlisted equities.[xxviii] Therefore, during the phasing period, the capital gains received by Mauritian residents shall be 7.5% for listed companies and 20% for unlisted companies. However, this benefit of phasing out under the amendment is available only to those companies who have a total expenditure of 27 lakhs during the immediately preceding 12 months.[xxix] As a result of this limitation of benefit clause introduced in the amendment, both the countries have made an active effort to curb the problem of floating of shell companies for the purpose of receiving tax exemptions.

This amendment is expected to have a resultant effect on the Indian economy as well as on the foreign investors. The impact of this amendment on the Indian economy will majorly be evidenced in the reduced in-flow of foreign investment in India especially with respect to those investors who utilized the Mauritian entrance into the Indian capital market to obtain the benefits of tax exemption. Currently, the result of this amendment has not led to any drastic change in circumstances related to foreign investments in India. However, it is expected that the foreign investment specifically through Mauritius will reduce over a period of time, as the extra encouragement received by them in the form of complete exemption on taxation is not available to them anymore. One of the questions that arises in this scenario is with respect to the phasing out benefit that is applicable to the Mauritian investors for the period between 2017 and 2019. If such an adjustment was possible, both the governments could have easily just included a limitation of applicability clause in the erstwhile Agreement prohibiting shell companies with no commercial existence in Mauritius from obtaining benefit of exemption under the Agreement. Alternatively, the amendment could have included the GAAR provisions to the Agreement, which would have ensured that the benefits under the agreement are not misused. The current blanket applicability of the capital gains tax according to Indian tax laws seems to be drastic especially because of the favorable in-flow into India of investments and benefits from Mauritius.

An explanation to the above question could be the fact that both India and Mauritius were attempting to fulfill obligations undertaken by them under the OECD Base Erosion and Profit Shifting (BEPS) package to avoid double non-taxation. BEPS refers to the tax evasion strategies that are employed by corporations wherein they divert their profits and income to companies floated in such jurisdictions that have complete tax evasions or more favorable tax treatment.[xxx] Such practices are not necessarily illegal always however; they tend to render the various tax strategies used by countries to further their developmental goals completely useless. It leads to a situation wherein the corporation uses the resources and infrastructure of the countries without giving anything back in the form of tax, which ultimately leads to huge exploitation and revenue loss in the countries. This becomes especially problematic in developing countries as they largely depend on the taxes from such corporations for their revenue needs. In order to overcome such practices, the OECD countries came out with the BEPS package along with the G20 countries wherein an action plan consisting of monitoring, reviewing and setting of standards was agreed upon.[xxxi] The recent efforts of India and Mauritius seem to have undertaken this action plan as its basis and made the changes accordingly to ensure that a developing country like India does not lose its revenue due to a glitch in the Double Taxation Agreement.

In addition to the above stated avoidance of revenue loss achieved as a result of this amendment, it is also expected that the American investors might also face a problem as for them the capital gains will be taxed in their home country as well as in the source country i.e.

India. As a result of this, there may be a need now to renegotiate and amend the terms of the Indo – American DTAA as well. It must also be noted that the DTAA signed between India and Singapore had a clause which stated that the exemptions with respect to capital gains shall extend till the time the exemption under the Indo – Mauritian DTAA exist.[xxxii] Thus, now that the exemption under the Indo – Mauritian DTAA has been discontinued, the same will be applicable in case of the DTAA signed between India and Singapore as well.

CONCLUSION

The higher extent of globalization that has been achieved by certain developing countries has always been a cause of concern for those countries that are still at the developing stage. Entering into a DTAA with another country is a tiny but important step towards achieving the goal of globalization. India being a developing country is not very behind in its endeavor to maximize its foreign investment and emerge as an investment hub. As has been noticed in the aforementioned discussion, India has achieved the maximum success in its endeavor as a result of the Indo – Mauritius DTAA. However, a few faults in the manner in which the Agreement was negotiated and drafted had caused a situation where various corporations and investors misused the benefits under the Agreement. The amendment introduced to remedy this situation is also susceptible to causing collateral damage in the form of deferred and non-continuous investments from Mauritius. As a result of this, India is under a burden of experimenting with other strategies to increase the in-flow of foreign investment at the same pace as before since such investments will help in speeding up the process of economic growth just as evidenced in the past.

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