The Offshore Tax Planning Review

MAURITIUS AND OTHER ROUTES FOR DIRECT INVESTMENT INTO INDIA[1]

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Introduction

There are a number of people who claim the credit for having "discovered" the Indo-Mauritian Double Taxation Agreement. It is understood that the name of the Bombay branch of a "big six" accountancy firm and that of a major City of London firm of solicitors are vying for the crown. Whoever it was who noticed Mauritius's treaty with India, which had been lying gathering dust in the statute books since 1981, there can be no doubt that it was a happy time to do so.

The Indian economy had launched in 1991 the liberalisation reforms of Prime Minister Rao and was opening its arms to foreign investment.

At around the same time, in August 1992, Mauritius instituted its panoply of offshore legislation, creating a variant of the domestic company which was eligible to access the Double Taxation treaty network, but which paid Mauritian corporate income tax at the favourable rate of zero per cent.

Accurate statistics are difficult to obtain; however, over the last two and a half years since the offshore centre was launched, massive volumes of capital have flowed through Mauritian holding companies and into India. Thirty offshore funds with an asset base of US$1.9 billion have been registered in Mauritius. Major multi-nationals with household names have routed or re-routed their Indian investment through Mauritius. High net worth non-resident Indians, traditionally cautious about entrusting their funds to anything other than the sound coffers of the Swiss Banks, are coming to Mauritius to inspect the local service providers, and are entrusting their money to Mauritian banks and Mauritian companies with

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Mauritian directors. Mauritius is undoubtedly the most attractive tax-efficient route into India today.

The principal attractions of the Indo-Mauritian Double Taxation Agreement are now well-known:

Firstly, a reduction of Indian dividend withholding tax from the current rate of 20% to 5% where the Mauritian company owns more than 10% of the equity of the Indian Company:

- This is of interest to the joint venture investments in India, for example.

Secondly, a corporate exemption from Indian tax on capital gains arising from the sale of moveable property, including shares, in an Indian company:

- This is of interest to portfolio investors and to investors in companies owning immoveable property

These attractions are combined with a zero rate of corporate income tax and the absence of Mauritian withholding tax or capital gains tax.

India has signed over fifty Double Taxation Agreements and it would be beyond the scope of this article to refer to them all. There are other routes into India, but none of them has the all round appeal of the Mauritian route.

It is therefore proposed to use the Mauritian route as the basis of this article and to refer to the other "routes" by reference to the aspect of the Mauritian route to which they offer an alternative.

India

To understand why Mauritius is the compelling route into India, it is necessary to look briefly at the tax regime in India and tax problems which the non-resident faces when making an investment into India.

Despite the tax incentives and reliefs which have formed part of the post-July 1991 liberalisation measures, India remains a high tax-planning jurisdiction.

While it shares a common heritage with the UK tax code, the Indian tax system contains some significant differences.

Most notable of these is that unlike in the UK, non-residents remain subject to Indian capital gains tax on transfer of Indian assets. It is not necessary for there to be some further connection with India, for example, through a branch or agency. This feature has considerable significance for portfolio investors.

Indian income tax applies to both income and capital gains, and to individuals and companies. The current corporate tax rate for domestic companies is 40% with an additional income tax surcharge of 15% of the tax resulting in an effective rate of 46%. The rate for foreign companies is 55 per cent. There is no additional surcharge payable by foreign companies.

Residence is the principal connecting factor: all residents are subject to tax on their worldwide income. Non-residents are subject to tax on actual or deemed Indian income. Indian income is taxable either because it accrues or arises in India, or because it is received in India. A company is resident in India if it is incorporated there or if the control and management of its affairs is situated in India - the same text as in the UK.

Deemed Indian income is categorised in section 9 of the Income Tax Act and includes:

(i) income arising through an Indian business connection, or through the transfer of capital assets situated in India;

(ii) dividends paid by Indian companies outside India;

(iii) interest, royalties and fees for technical services payable by the government or a resident except where they relate to non-Indian activities.

"Business connection" is not defined by statute but has been interpreted as real and intimate relationship between any business activity carried on outside India and a business activity carried on inside India, where the two together contribute to the earning of income by the non-resident. The establishment of a branch office or even the appointment of a local sales agent could give rise to a business connection. Liaison or representative offices are specifically excluded.

Business connections not only give rise to substantive tax charges, but also enable the Indian tax authorities to collect the tax due.

(1) All Indian taxpayers are required to withhold tax from payments to non-residents. The taxpayer may or may not be a business connection.

(2) There is a category of taxpayer called the representative assessee, who could be any person in India employed by a non-resident or a person who has acquired on a transfer a capital asset from a non-resident.

Foreign investors register with the Reserve Bank of India to obtain Foreign Institutional Investor status or Non-Resident Indian Investor status before investing in Indian stock. Registration is the means for the Indian tax authorities to keep control of foreign ownership of shares.

Where a non-resident transfers shares in an Indian company to a resident, the transferee constitutes a representative assessee for the purposes of tax collection. Where the transfer occurs between non-residents the stockbroker and the banks fulfil this role.

Dividends payable on shares of Indian companies sold to international investors and traded overseas in depository receipt form are caught by the deeming provision. The dividends are paid outside India in US dollars and are subject to an Indian withholding tax of 10%.

Short-term capital gains arise on short-term assets, that is, assets held for not more than 3 years, or, in the case of shares, 12 months. They are generally subject to the same rates of tax as other items of income. Long-term capital gains are taxable at a lower rate.

The Mauritius Treaty

Against this background, the significance of the Mauritian Double Taxation Agreement's exemption for non-residents from Indian capital gains tax on the sale of shares in Indian companies and of the sizeable dividend withholding tax reduction is evident.

It would be advantageous now to examine in a little more detail the Mauritian treaty. The qualifying test for accessing the treaty is laid down in Article 4, the usual Residence article.

Two types of Mauritian companies so qualify.

The first is the domestic company, which is governed by the Mauritian Companies Act, in which majority foreign ownership is not permitted and which pays corporate income tax at a rate of 35%. (The Mauritian Companies Act of 1984 is modelled on the English Companies Act of 1948.)

The second is the Mauritian Offshore Company. This Company is also governed by the Companies Act, but as modified by the Mauritius Offshore Business Activities Act of 1992 which exempts the Offshore Company from certain provisions of the Companies Act, including those which prohibit majority foreign ownership and which require full filing with the Companies Registry.

By an amendment to the Income Tax Act, section 59D the Offshore Company is liable to Mauritian corporate income tax not at 35% but at the rate of zero per cent. Section 59F provides an interesting option to an Offshore Operator (which includes an Offshore Company) to opt to pay tax at any rate up to a maximum of 35%.

The offshore authority has laid down a series of criteria which must be satisfied for the Offshore Company to show that it is liable to taxation in Mauritius by reason of its place of management being there. It is the "place of management" element of the Residence test in Article 4 which the offshore authority has identified as being critical.

An Offshore Company thus has to undertake to the offshore authority and the tax authorities in Mauritius at the time of applying for a Certificate of Tax Residence the following:

(1) That it has two resident directors.

(2) That it will hold its board meetings in Mauritius. Teleboard meetings are permitted, provided they are chaired and initiated in Mauritius.

(3) That it will open a bank account in Mauritius through which all funds for investment into and out of India will flow.

(4) That it has a local company secretary.

(5) That it has a local qualified auditor.

Armed with the Certificate of Tax Residence the Mauritian investor company can apply for the treaty relief in India. In the case of a sale of shares, the relief given by specific dispensation on the basis of representations made to the Indian tax department is not applicable. In the case of a dividend payment, most paying companies will accept a certificate of a chartered accountant that the shareholder is eligible for the reduced rate of withholding tax. In some cases the distributing company will insist upon a specific dispensation from the Indian tax department.

Experience shows the treaty relief is being obtained on the basis of case by case representations. The concern that some people had from the start - that a liability to pay Mauritian tax at zero per cent was no liability at all - seems not to have raised difficulties at the Indian end. Nevertheless, the zero tax regime is being scrutinised by the Mauritian authorities and may be the subject of review when changes to the Mauritian tax code are effected later this year.

Despite the absence of any Indian objection, there are those who feel more comfortable with electing to pay a rate of corporate income tax above zero per cent. This is apparent both in the case of funds and in the case of direct investment vehicles.

Capital Gains - Fund Companies

The complete exemption from Indian capital gains tax on the alienation of shares in India has been the magnet that has drawn the fund managers to Mauritius.

A common tax decision for a Mauritian fund company is to elect to pay Mauritian corporate income tax at 16%, on the basis that dividend withholding tax at 15% will be payable in India.

Article 23(4)(a) of the Treaty is the normal credit provision which allows the 15% payable in India as a credit against the 16% payable in Mauritius. The Mauritian fund company therefore pays only 1% Mauritian corporate income tax on what is likely to be a minimal dividend stream.

The capital gain arising on the sale of the Indian securities, which is the important element, is exempt from Indian taxby reason of Article 13 of the Treaty , and is not taxable in Mauritius. This is, of course, the big attraction of the Mauritian Treaty for portfolio investment vehicles.

The effect of the election, at little cost to the fund company, is an added insurance that the Mauritian Offshore Company is well and truly eligible for the treaty benefits. As the majority of funds which are enjoying the treaty benefits are not incorporated in Mauritius, but are accessing the treaty through Mauritian subsidiaries, the election to pay Mauritian tax has the additional benefit of adding substance to their presence in Mauritius.

Indeed, it is interesting to observe that the Indian authorities seem to be tolerating the use of Mauritian subsidiaries or, in some cases, branches, by fund companies established in, for example, Luxembourg, Dublin or Bermuda. A Bermuda fund company can register as a foreign company in Mauritius, in effect opening a branch and applying for offshore status. By shifting management to Mauritius it can also obtain a Tax Residence Certificate.

A further means by which substance is added is the holding of full board meetings in Mauritius at least once a year, if not quarterly. The European directors of the Indian Emerging Markets Mauritius Fund Company seem particularly concerned that these should take place.

One final point on funds in terms of establishing some substance in Mauritius is the ability now for foreign-formed funds to be listed on the Mauritian Stock Exchange. The Lazard Birla India Investment Trust Plc, a UK-incorporated investment trust, was the first to be listed in November 1994.

At this point, whilst on the subject of capital gains provision this article will investigate another route into India, that is, the route through the United Arab Emirates.

It was with a certain degree of consternation that Mauritius observed the signing and coming into effect of the Indian-UAE Treaty, for the treaty duplicates, and, in some cases, improves on, the "big-selling" features of the Indian-Mauritian Treaty. In the context of portfolio investment the UAE competes with a similar exemption on Indian capital gains tax.

As far as I am aware, the UAE Treaty is the only other treaty which so competes with Mauritius on capital gains: the capital gains tax provisions of other treaties either specifically do **not** exempt the gain arising from the alienation of shares in an Indian company from Indian capital gains tax or provide no exemption where the property of the Indian company consists principally of immoveable property in India.

The UAE-India Treaty

The UAE-India Treaty may have a capital gains tax exemption clause as good as the Mauritian-Indian Treaty, but the UAE does not offer a valid alternative to the Mauritius route into India for fund investment vehicles.

Under the laws of the UAE, a UAE limited liability company which is resident for the purposes of the treaty cannot have majority foreign ownership, although total management can be vested in the foreign owners.

There is no UAE Offshore Company akin to the Mauritian Offshore Company which can access the treaty.

The use of a UAE subsidiary for a Luxembourg company is unlikely to be attractive to the European fund manager or investor, unfamiliar with the legal system in the UAE.

Where the UAE Treaty does pose a threat to Mauritius's primacy is in relation to the NRI market in Dubai. There has been a recent ruling by the Authority for Advanced Rulings in India that an Indian citizen with a UAE work permit, but whose centre of vital interests was still in India, was a resident of the UAE for the purposes of accessing the UAE-Indian Treaty.

Although the Ruling binds only the person concerned, it is an important indication of the thinking of the Indian authorities. NRIs resident in Dubai will be eligible for the UAE-Indian Treaty benefits for investments in India held in their own names without the need to use a UAE company with the attendant trust arrangement because of the majority ownership by UAE citizens.

The Hungarian-Indian Treaty has a capital gains tax clause, which, while not being as attractive as the Mauritian or UAE clause in that it contains the restriction on capital gains tax exemption for the alienation of shares in an Indian company owning immoveable property, does exempt the alienation of shares in other Indian companies from capital gains tax.

The Hungarian route into India may have potential because of the offshore regime in Hungary which has been in existence since 1994.

Hungarian Limited Liability Companies (KFTs) and Hungarian Corporations (RTs) which are wholly-owned by non-Hungarians can be incorporated as offshore companies. They receive an 85% tax credit from the normal corporate tax rate of 18%, which means the effective rate is 2.7%, and an 85% tax credit from the withholding tax of 23%, which means an effective tax rate of 6.06%. If the Company, instead of paying out a dividend decides to increase its share capital with its after tax profits, after three years it can pay out this amount with no additional withholding tax.

The Hungarian offshore company can access Hungary's series of Double Taxation Agreements. A saving on Indian capital gains tax and a minimal corporate tax of 2.7% in Hungary may provide an alternative to Mauritius.

Dividend Withholding Tax Reductions - Direct Investments

Direct Investment Vehicles

As stated earlier, a number of large corporations are holding their joint venture interests in India through Mauritius. These include power projects for the construction and running of combined cycle oil and gas turbines in excess of 500 megawatts, and telecommunication projects for the installation of cellular and fixed line telephone networks in many of the states of India.

Where an income stream is intended, then the ability to obtain a reduction of dividend withholding tax from 20% to 5% under the treaty is very attractive. An election to pay 5% Mauritian corporate income tax is a sensible step for the reasons mentioned in the context of funds and capital gains. The 5 per cent Mauritian tax would be credited against the 5% paid in India, and there would be a 5% credit available upon repatriation to another treaty partner.

A variation on the Mauritian route for direct investment is the addition of a Dutch holding company. If the Dutch company's holding in the Mauritian company qualifies for the Dutch participation exemption then there will be no Dutch tax on the dividends or capital gains arising from the shareholding in the Mauritian company.

A recent development is the signing by the Minister of Finance of Luxembourg and Mauritius of a tax treaty.

The UAE-India route is unlikely to be attractive to the multi-national investor for the same reasons that it is unlikely to be attractive to foreign institutional investment. For investment by NRIs in the Gulf it may, of course, prove useful.

Still on the subject of direct investment, the Mauritian-Indian Treaty has another edge over its UAE rival in terms of amenability of the Mauritian Offshore Company to be characterised as a partnership for US tax purposes; the income of the Mauritian company can then be attributable to its partners, and can be pooled in the USA with other partnership income, so making most efficient use of available credits.

The US tax authorities have identified four criteria, the presence of any two of which permit the vehicle to be characterised as a partnership:

(1) unlimited liability;

(2) limited life;

(3) restrictions on the transfer of shares;

(4) decentralised management.

Until recently, that characterisation was achieved by forming the Mauritian company as an unlimited liability company and imposing restrictions on the transferability of its shares. The exposure implicit in the unlimited liability of the company was undesirable, but there was no other way of achieving the partnership characterisation.

However, there is now another way: it is now possible to form a Mauritian offshore company as a limited life company ("LLC"), whose existence will terminate automatically upon the happening of a certain event, such as the bankruptcy, death, withdrawal, expulsion or dissolution of a member.

By the Mauritius Offshore Business Activities (Companies) Regulations 1995 which were signed by the Minister on 2nd February 1995, Mauritian offshore companies which are eligible for treaty benefits can apply for designation as LLCs at the time of applying for continuation, or at any other time after incorporation. The regulations have retroactive effect from 1st July 1993. There is one major power project in India which has been waiting for this addition to the legislation to initiate its Mauritian holding structure. For US investment into other countries with which Mauritius has a tax treaty, the Mauritian Offshore LLC will be a very compelling vehicle.

As a side note there is also, in Mauritian law, a Limited Partnership Vehicle, the "société en commandite simple" which is available under Code Civil, which we owe to our French colonial history. The possibilities for using this vehicle offshore are largely unexplored but in theory it can exist offshore and is covered by the treaty.

For investment where there will be a substantial deficit and large unused tax credits the Mauritian route into India may not be so important. But besides the capital gains and dividend provisions, there are other features of the Mauritian treaty with India which are worth considering.

Permanent Establishment

One of these is the Permanent Establishment Article 5 which is of interest because of the nine months' time limit after which a building site or construction or assembly project becomes a permanent establishment. The parallel in the US-India treaty and the Singaporean-India treaty, for example, is 183 days (6 months). The UAE-India Treaty has the nine months provision as in the Mauritian treaty.

Interest

Another provision is Interest: Article 11 paragraph 3(c) provides for a complete exemption from Indian withholding tax on interest where the lender is a bank in Mauritius.

Paragraph 4 also provides for an exemption from Indian withholding tax on interest where the Mauritian beneficial owner of the interest is not a bank, provided the debt-claim has been approved by the Government of India. It is understood that investments in Indian debentures by Foreign Institutional Investors are covered by this exemption.

There is a procedure for obtaining approval in advance from the Reserve Bank of India but in cases of doubt other treaties, such as the India-Singapore Treaty, for example, provides a 15% reduction. The 15% tax can be used as a deduction against interest paid out of Singapore to the ultimate lender. Also in cases of doubt, back-to-back arrangements using a Mauritian bank can be effected so that the total exemption can be obtained.

Royalties

Another feature which deserves consideration is the Royalties Article 12. The rate of royalties withholding tax is 15%, not as low as it could be.

Does the Mauritian Treaty's Royalties provision cover payments for technical services? There is a 20% Indian tax on payments for technical services. Article 12, paragraph 3 defines the term "royalties" to mean payments of any kind received as consideration for the use of, or the right to use industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

Does this definition cover fees for technical services that are ancillary and subsidiary to the enjoyment of the industrial, commercial or scientific equipment for which royalties are covered? If the definition doesn't so cover, where does that leave us? Does the 20% Indian tax on payments for technical services apply? Or does the silence of the treaty mean that the services are taxable as business profits under Article 7?

The Indian-Singaporean Treaty makes no bones about it and specifically states that technical services fees paid in relation to industrial, commercial or scientific equipment are taxable at the rate of 10%.

Tax Sparing

Another interesting use of the Mauritian Treaty is in the Elimination of Double Taxation Article 23.

In the instances where the Indian company is exempted from corporate income tax under one of the special incentive measures listed in paragraph 5 of Article 23, the Mauritian tax authorities will deem the Indian company to have paid the full amount of tax which would have been imposed were it not for the exemption.

If the Mauritian company owns more than 10% of the equity of the Indian company, then this deemed amount of Indian tax will be available as a credit against Mauritius tax payable in respect of the profits or income.

So for example, if the Indian company is exempted from paying 30% corporate income tax in India and then pays a dividend to its Mauritian shareholder of all its distributable profits, the 30% deemed tax will be available as a credit against any tax payable in Mauritius.

If the Mauritian shareholding company has elected to pay Mauritian corporate income tax of 30% in Mauritius, then it will not have to pay any tax to the authorities in Mauritius.

It will, in addition, have a 30% per tax credit available for use by its shareholder upon repatriation if the country of repatriation is one of those with which Mauritius has a favourable tax treaty. These include the UK, France and Germany.