Paying Their Fair Share

Amendments to India-Mauritius treaty aim to plug tax loopholes

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TAX TREATIES ARE integral to cross-border investment relations as they define the treatment of incomes that arise in one country accruing to a resident of another country. Their design is also a reflection of the underlying power equation. Developing countries often negotiate treaties that cede greater taxing rights in the hope of higher investments. Whether it is legitimate for third countries to avail of such benefits by routing investments through the preferential jurisdiction has been discussed widely. In the *Union of India v Azadi Bachao*, the Court was of the view that treaty shopping is a necessary evil for a developing economy. Two decades on, the norm and legal frameworks have changed dramatically.

The Base Erosion and Profit Shifting programme was to end the use of low-tax jurisdictions for tax avoidance. Since then the OECD — tasked with the redesign of international tax laws to push forward such reform — has developed a set of best practices. Among these was the multilateral instrument (MLI) that allowed countries the option to select tax treaties and provisions therein that would be amended suitably and swiftly. The instrument received wide support.

One of the key reforms it initiated was the inclusion of a provision for prevention of treaty abuse as a minimum standard and an amendment of the preamble to the treaties. The latter is to prevent non-taxation or reduced taxation through tax evasion, including treaty-shopping arrangements that provide benefits to residents of other jurisdictions and anti-abuse rules that will enable tax administrations to deny treaty benefits in certain circumstances. In more than 1,100 treaties signed by countries, a broad anti-avoidance rule or principal purpose test (PPT) has been opted for. India is among the signatories to the MLI and in line with its position, the recent amendment to the India-Mauritius treaty signals the keenness to plug the well-known loophole.

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The amending protocol to the India-Mauritius treaty may ensure that treaty benefits, which include lower withholding rates, will not be granted where it can be reasonably concluded that obtaining the benefit is one of the principal purposes of the transaction. The language ensures that the tax administration can probe based on intent. This has been a particularly thorny issue with respect to financial flows from Mauritius. It is often suggested that taxpayers from other jurisdictions route their investments through Mauritius.

The question often posed before courts is whether the tax residence certificate is enough to grant the benefit. Legal changes were necessary to examine the purpose of a transaction. It is expected that the amendments to the treaty allow the authorities to move beyond the residency certificate and assess the principal purpose of an arrangement. Given that 16 per cent of FDI inflows in 2021-22 were from Mauritius, the reform will impact the composition of flows, as was observed after the amendments in 2017 when capital gains became taxable at source.

Indian tax law too includes a general anti-avoidance rule that was introduced in 2017 to ensure that the spirit of the law is respected. To allay fears that it would lead to overreach by the tax department, a series of backstops including a panel-based approach to trigger GAAR was operationalised. The rarity of its invocation suggests that the authorities have been reasonable. Thus, for treaty matters now, the concern may be if a similarly restrained approach may be adopted. This is particularly important since the principal purpose test (PPT) in the treaty expands the situations to which the anti-avoidance rule is applicable in treaty-related transactions. Moreover, when the amendments to the Mauritius treaty and GAAR were introduced, the investments made prior to 2017 were grandfathered. There is doubt if that is also true for the PPT.

International tax law is turning a new page as treaties with serious revenue implications are being reformed. There is also growing support for the global minimum tax that includes a proposal on the subject to tax rule (STTR). STTR is a treaty-based rule that ensures a top-up tax on low-taxed intra-group transactions that are subject to corporate tax rates below the minimum of 9 per cent. These changes could further impact the current practices of using treaties to avail benefits. As India changes its tax treaties, this amendment is proof that the BEPS programme has indeed shifted the direction of policy to ensure investment decisions are not all about tax.

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