Measuring Tax Treaties: Why India gets investment from Mauritius

October 9, 2020

Karan Gulati
Shubho Roy

karan.gulati@nipfp.org.in
shubho.roy@uchicago.edu

Most of India's foreign investment comes from Mauritius. This has given Mauritius a bad name. The prevalent belief is that the India – Mauritius tax treaty is a *bad treaty*; it is too investor-friendly. It allows foreign investors to avoid taxes unfairly. This belief became so prevalent that India insisted on amending the treaty is 2016. Is this belief true? This paper deploys a novel strategy to measure tax treaties, especially India's tax treaties. While the India – Mauritius tax treaty was India's most investor-friendly treaty, it was not especially investor-friendly. Compared to similar developing countries and even developed countries; all of India's tax treaties are more investor unfriendly. The India – Mauritius treaty was not especially investor-friendly; all of India's other treaties are especially investor unfriendly. The change in 2016 made India worse for investors when compared to other jurisdictions.[a]

[a]The Authors are thankful to Nipun Dave and Rajat Srivastava for their assistance in grading the tax treaties.

Contents

1 Introduction

Economic theory predicts that foreign investment in a country will come from countries with close ties. It will usually be the same set of countries with which a country trades. This theory is the *gravity model of trade and finance*, and it also makes intuitive sense. Foreign investment is risky, and the flow of information is not perfect. Therefore, countries with closer contact with the host nation (receiving foreign investment) will have better information about domestic conditions and be more comfortable making investments. There is empirical evidence in support of this theory. However, the theory does not hold for India. Countries investing in India do not trade much with India, and conversely, countries that trade with India do not invest much with India. Unlike India's trading partners (which follow the gravity model), there should be little information flow with the countries investing in India. They do not share language, culture, colonial history, or the other generally accepted markers of information flow. Why is this so? In this paper, we try to explore the common explanation for this anomaly: *tax loopholes* and *tax havens*.

While it is true that substantial foreign investments are routed through tax havens, India is still an outlier when it comes to the proportion of foreign investments coming from countries *not predicted* by the gravity model. The public discourse has concentrated on the provisions of Double Tax Avoidance Agreements (DTAAs) (tax treaties) with Mauritius and Singapore. The common perception is that these treaties provide *too favorable* provisions on capital gains by foreign investors. The fact that these jurisdictions have no capital gains tax on domestic investments helps foreign investors. This allows foreign investors to *treaty shop*, where foreign investors from third countries set up post-box entities (without any substantial operations) in these jurisdictions. These entities (investment companies or trusts) are then used to route money from other countries to India via these tax havens (Mauritius, Singapore, or Cyprus).

We try to test this explanation by developing a method to evaluate tax treaties. We shortlist the provisions which apply to investors. These clauses allow investors to recover returns from their investments– the provisions governing: *permanent establishment*, *capital gain*, *interest*, *royalties*, and *dividends*. We develop a grading method to score each of the five provisions from *least investor-friendly* (0) to *most investor-friendly* (5). Each provision is graded on multiple factors. The grading is based on the observed variances in these provisions across treaties. We

then deploy two independent reviews to grade the treaties. We not only grade India's tax treaties but extend the grading mechanism to countries in a similar position to India, and Organisation for Economic Cooperation & Development (OECD) countries (as examples of successful capital flow integration). This gives us a way to place India's treaties from a global perspective.

We find that India does sign *relatively* more favorable treaties with *tax havens* like Mauritius and Singapore. However, India's treaties are more investor unfriendly than countries with which India may be competing for foreign investment. Compared to OECD countries (which have a relatively free flow of investments between them), India's treaties are significantly more anti-investor. Even India's treaties with the tax havens are substantially more investor unfriendly than what most countries sign with each other. The reason for investment flows through these tax havens is not because they are too investor-friendly. It is because all the other tax treaties of India are highly investor unfriendly. The ones with the tax havens are only relatively better. We also find that India has a wider variation between its treaties than the other countries (developing and OECD). This variation explains why foreign investors treaty shop and route investments through other jurisdictions. Even with the same treaty, India varies withholding taxes across the four main methods of obtaining returns. This creates further arbitrage opportunities. Investors can minimize tax liability in India by changing the composition of their investments (across equity, debt, and intellectual property), thereby distorting investments.

We feel that the tax havens have been wrongly blamed for the diversion in India's foreign investment sources. India's extreme taxation policy of foreign investors, coupled with an inconsistent tax policy, has created the present system. India needs to re-evaluate its international taxation policy to make it more investor-friendly and consistent.

2 The problem in India's foreign investment sources

The *gravity model of finance* predicts that international financial transactions follow the gravity model of trade.[1] The *geography of information* theory predicts that the ease of information flows should determine capital flows. In addition to the size of the economy, historical ties, colonialism, cultural ties, and language should be factors that determine the main trading *and* investing partners of a country.[2] This theory predicts that most of India's inward investments should come from countries with which India has strong trading relationships.

[1] See, Richard Portes and Helene Rey. "The determinants of cross-border equity flows". In: *Journal of international Economics* 65.2 (2005), pp. 269–296.

[2] See Richard Portes, Hélène Rey, and Yonghyup Oh. "Information and capital flows. The determinants of transactions in financial assets". In: *European economic review* 45.4-6 (2001), pp. 783–796.

Table 1 India's trading partners

India's trading partners are not India's foreign investment partners.

Countries India imports from			Countries India exports to		
Country	**% of imports**	**Rank**	**Country**	**% of exports**	**Rank**
China	19.056	1	United States	19.118	1
Saudi Arabia	7.016	2	United Arab Emirates	12.957	2
United States	6.781	3	Hong Kong, China	5.767	3
United Arab Emirates	6.732	4	China	5.150	4
Switzerland	5.575	5	Singapore	3.998	5
Iraq	4.309	6	United Kingdom	3.940	6
Indonesia	4.280	7	Germany	3.357	7
Korea, Rep.	4.127	8	Saudi Arabia	3.041	8
Germany	3.652	9	Bangladesh	2.849	9
Australia	3.271	10	Vietnam	2.801	10
India's trade with main sources of foreign investment					
Mauritius	0.008	137	Mauritius	0.384	50
Singapore	2.418	18	Singapore	3.998	5
Netherlands	0.707	34	Netherlands	2.594	11
Cyprus	0.011	130	Cyprus	0.030	133

Percentage of import and export is the average over the years from 2014 to 2018.
*Source:*World Integrated Trade Solution, World Bank

However, in reality, this does not play out. Table 1 shows India's main trading partners and the ones from whom India receives investments. As shown in Table 2, the countries investing in India are not its major trading partners, and they do not have the traditional information flows out of shared history or language. Mauritius, Netherlands, and Cyprus, which contribute more than 44%

of investment into India, do not share language, history, or culture with India. What explains this divergence from the established economic theory? Why does Japan, with little cultural ties with India, invest more than the U.K. with whom India shares a long colonial history, and London is a global financial center?

Table 2 Country-wise Foreign Direct Investment (FDI) flows into India

India receives its foreign investments from tax havens

Country	2013-14	2014-15	2015-16	2016-17	2017-18	Total	Percentage
Mauritius	3695	5878	7452	13383	13415	43823	34.83
Singapore	4415	5137	12479	6529	9273	37833	30.07
U.S.A.	617	1981	4124	2138	1973	10833	8.61
Netherlands	1157	2154	2330	3234	2677	11552	9.18
Japan	1795	2019	1818	4237	1313	11182	8.89
U.K.	111	1891	842	1301	716	4861	3.86
Cyprus	546	737	488	282	290	2343	1.86
Germany	650	942	927	845	1095	4459	3.54
U.A.E.	239	327	961	645	408	2580	2.05
Others	2828	3681	4646	3723	6207	21085	16.76
Total	16053	24747	36067	36317	37367	125804	100.00

Sources:

- *Annual Report*, Reserve Bank of India (RBI), 2017-18;
- *Bilateral FDI Statistics*, United Nations Conference on Trade and Development (UNCTAD)

The predominant explanation for this divergence from the gravity model of international finance has been two-fold: (i) These jurisdictions are *tax-havens*, and (ii) India's tax treaties with these jurisdictions create loopholes which encourage investors from other countries to route their investments to India and evade taxes. India's tax treaty with Mauritius has garnered special attention in public discourse and academic literature. Kotha had documented the entire history of

the *India - Mauritius Tax Treaty* since 1983.[3] The treaty was signed in 1983 when India was closed to foreign investment. Unlike other tax treaties of India, the *India - Mauritius Tax Treaty* provided no taxation of capital gains on the sale of shares, in Indian companies, for investments from Mauritius. Till 1991, when India opened up for foreign investment, this did not matter. Once India's capital controls were liberalized, tax attorneys *discovered* this provision by setting up entities to invest in India. This violation of the gravity model is not unique to India. Many multi-national corporations frequently use *treaty shopping*. This involves routing investments from one country to another via a third country to reduce tax liabilities. The routing of investments through the third country takes advantage of differences between the tax treaties that countries have and the rates of domestic taxation.[4] What is interesting for India was the extent of this diversion through Mauritius. While Brazil receives more than 20% of its FDI from the United States, only around 2% of investments comes from the Caribbean, home to multiple *tax havens*.[5]

As early as 1995, Indian revenue authorities were concerned about the unbalanced foreign investment coming through Mauritius. A Committee was constituted by India's government to renegotiate the treaty in 1996.[6] One of the points was to limit parties from Mauritius who could benefit from the treaty. The Indian government did not want foreign investors to set up post-box companies and take advantage of the limit on taxing capital gains.[7] Even the judiciary got involved in the dispute. Several tax disputes involved challenges to *benefits* from investments through Mauritius.[8] Subordinate legislation giving effect to the treaty was challenged in a public interest litigation. The court of first instance (Delhi

[3]For a detailed history of the treaty developments, See Ashrita Prasad Kotha. "The Mauritius Route. The Indian Response". In: *Saint Louis University Law Journal* 62 (2017), p. 203.

[4]See *Profitable Detours. Network Analysis of Tax Treaty Shopping*. Vol. 108. 2015, pp. 1–40. URL: https://www.jstor.org/stable/90023150.

[5]Authors' calculations from United Nations Conference on Trade and Development. *FDI Statistics*. Online Database. URL: https://unctad.org/en/Pages/DIAE/FDI%20Statistics/FDI-Statistics.aspx (visited on 02/02/2020).

[6]For details of the activities taken by the government till 2002 to revise the treaty, See generally The Joint Parliamentary Committee. *Report on Stock Market Scam and Matters Relating Thereto*. Dec. 19, 2002. URL: http://loksabhaph.nic.in/writereaddata/InvestigativeJPC/InvestigativeJPC_635612541266248975.pdf.

[7]See The Joint Parliamentary Committee, *Report on Stock Market Scam and Matters Relating Thereto*, paragraph 8.86 at pg. 184.

[8]See disputes between tax authorities in India and Mauritius based investors in Kotha, "The Mauritius Route", at pg 209-211.

High Court) ruled to nullify the protections (effectively the treaty) in 2002.[9] The Supreme Court settled the issue in "Delhi High Court Blocks Mauritius Tax Relief". The court held that treaty benefits were political negotiations that would not be subject to judicial review. The protections were then restored.[10]

Since the Supreme Court judgment, till 2016, when the treaty was finally amended, there would be multiple demands to renegotiate the treaty because of its perceived loopholes.[11] The primary loophole being the exemption on capital gains tax, on sale of shares, in Indian companies. Indian revenue authorities saw this as a source of revenue loss.[12] Indian media similarly treated the treaty with Mauritius as a loophole for investors. Even India's supreme audit institution, the Comptroller and Auditor General of India, noted this problem in a report to the Parliament. It observed that the treaty had " *...led to the establishment of conduit companies in Mauritius through which investors of third countries routed their investment.*"[13]

Not surprisingly, the government of Mauritius was reluctant to change the provisions. Since a legal entity had to be created in Mauritius to route investments, transaction attorneys and accountants in Mauritius earned from setting up and running such post-box companies. This fee was a revenue source for Mauritius,

[9] See, KR Girish. "Delhi High Court Blocks Mauritius Tax Relief". In: *International Tax Review* 13 (2002), p. 35.

[10] *Union of India v. Azadi Bachao Andolan* (2003), , S.L.P.(C) Nos. 20192-20193 and 22521-22522 of 2002.

[11] This issue would be raised multiple times between the countries Deepshikha Sikarwar. "Double taxation avoidance agreement. Mauritius ready to plug loopholes". In: *The Economic Times* (July 8, 2013). URL: https://economictimes.indiatimes.com/news/economy/policy/double-taxation-avoidance-agreement-mauritius-ready-to-plug-loopholes/articleshow/20963507.cms (visited on 01/11/2020); Shweta Rajgopal Kohli. "Will plug all loopholes in tax treaty. Mauritius Foreign Minister Arvin Boolell". Interview. In: *NDTV Profit* (July 6, 2012). URL: https://www.ndtv.com/business/will-plug-all-loopholes-in-tax-treaty-mauritius-foreign-minister-arvin-boolell-307462 (visited on 01/11/2020); Manish Tiwari and Jayanth Jacob. "New Pact. Cash plug for tax hole in Mauritius". In: *Hindustan Times* (June 20, 2010). URL: https://www.hindustantimes.com/business/new-pact-cash-plug-for-tax-hole-in-mauritius/story-khjbDkIfDXPXUD5KbEPtOI.html (visited on 01/11/2020).

[12] See Amelia Schwanke. "India's Renegotiated DTAs Creating Investment Diversions". In: *International Tax Review* 28 (2017), p. 32.

[13] See Comptroller and Auditor General of India. *Report for the period ended March 2004 Performance Audit of - System Appraisals*. Tech. rep. Report No. 13 of 2005. 2005. URL: https://cag.gov.in/content/report-no-13-2005-perriod-ended-march-2004-performance-audit-system-appraisals (visited on 07/03/2019).

even if it did not charge any capital gains taxes on investments routed through Mauritius. Finally, in 2016, India prevailed, and the treaty with Mauritius was amended. From then on, capital gains from equity investments into India from Mauritius would be taxed in India. Similar amendments were carried out with Singapore and Cyprus. This was seen as plugging a loophole and celebrated in policy circles.[14]

While literature and legal policy have concentrated on the *India - Mauritius Tax Treaty* and found it investor-friendly, is it the case? How good *or bad* was the treaty? This requires us to compare the treaty with other treaties. How to compare tax treaties? In the next section, we show a method to compare tax-treaties to answer this question.

3 Methodology

To measure and compare tax treaties, we need a framework for grading treaties. Since our objective is to measure investor friendliness, we use the traditional measure of *source-based* versus *residence-based*. We identified clauses that apply to investors and ignored other provisions of the tax treaties. The identified clauses were then rated by two independent reviewers, based on a detailed rating criterion. In the event of variation between the reviews, a third review was done. We compared India's treaties, other developing countries, and treaties between OECD members to make comparisons.

When a resident of one country earns income in another, both countries have a claim to tax such income. However, a tax by both countries leads to double taxation. Tax treaties thus aim to resolve these contending claims. There are two methods of doing so: (i) *Source-Based Taxation*; and (ii) *Residence-Based Taxation*. Source-based taxation attempts to tax all income of the residents of the nation. In addition, any income of a non-resident that is attributable to any activity in the

[14] This was hailed as a positive move of plugging loopholes See, Bureau Reporter. "India, Mauritius plug loopholes in tax treaty". In: *The Hindu, BusinessLine* (May 10, 2016). URL: https://www.thehindubusinessline.com/economy/india-mauritius-plug-loopholes-in-tax-treaty/article8581477.ece (visited on 02/20/2020); and Staff Reporter. "Government plugs another loophole on blackmoney. India, Singapore sign revised DTAA treaty". In: *Financial Express* (Dec. 30, 2016). URL: https://www.financialexpress.com/economy/after-mauritius-cyprus-india-signs-third-protocol-for-amending-double-taxation-with-singaore/491412/ (visited on 02/20/2020).

nation where the tax is applied is also included in a source-based taxation model. On the other hand, residence-based taxation follows the principle of only taxing the residents of a nation for their income (irrespective of where such income arises) and exempting all non-residents from taxation. From as early as 1923, economists have argued that the entire world should move to a residence-based taxation model. This would reduce the distortion of the allocation of investment in the global market while allowing each nation to continue to choose its taxation rate.[15] This is based on the principle of Capital Export Neutrality (CEN).[16] The underlying idea is that under residence-based taxation, the residents of a capital-exporting country will be subject to the same tax burden regardless of the location of their investments. Therefore, a pure residence-based model will not affect decisions as to the location of investments.[17]

However, countries see residence-based taxation as a loss of revenue. While developed countries (part of the OECD) have adopted a *mostly* residence-based model,[18] developing countries generally lean towards *more source-based tax treaties*. Therefore, source-based tax treaties usually lead to double taxation for international investors: once in the country where the investment is made, and then again in the country where the investor resides. This discourages international investors.[19] Therefore, the more *source-based* a treaty(or a specific provision) is, the more investor unfriendly it is. Conversely, more *residence-based* treaties are more investor-friendly.

To rate the investor-friendliness/residence-based preference of tax treaties, a rating method was developed for the five articles. The articles analyzed were: (i) *permanent establishments*, (ii) *dividends*, (iii) *interest*, (iv) *royalty*, and (v) *capital gains*. These provisions cover the traditional ways in which a foreign investor

[15] Bivens et al. *Report on Double Taxation. Submitted to the Financial Committee.* Tech. rep. Doc E.F.S.73 F.19. League of Nations (LoN).

[16] For an explanation of the general acceptance of CEN as an optimal model, see Michael Keen and Hannu Piekkola. "Simple rules for the optimal taxation of international capital income". In: *Scandinavian Journal of Economics* 99.3 (1997), pp. 447–461.

[17] Peggy B Musgrave. *United States taxation of foreign investment income: Issues and arguments.* Harvard Univ Harvard Law School, 1969.

[18] See generally Brian J Arnold, Jacques Sasseville, and Eric M Zolt. "Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century". In: *Bulletin for International Fiscal Documentation* 56.6 (2002), pp. 233–245.

[19] See Victor M Gastanaga, Jeffrey B Nugent, and Bistra Pashamova. "Host country reforms and FDI inflows: How much difference do they make?" In: *World development* 26.7 (1998), pp. 1299–1314, which finds that taxation has a significant effect on investment decisions.

makes returns on her investment. An investor may receive dividends or interest on her equity or debt investments. If the investor licenses intellectual property like trademarks or patents, she may receive a royalty. When the investor exits an investment by selling her shares/equity in a firm, capital gain liabilities will arise. Permanent establishment provisions are used to determine if a foreign investor will be considered *foreign* for tax treaties. This affects the ability of an investor to claim benefits under the treaty. Tax treaties have other provisions in them. They cover other sources of income like apprenticeships, teachings, athletic and sporting events, pensions, and annuities. Since these provisions do not affect investment, they are excluded from the analysis.

For the five clauses, a rating method was developed. Each clause was analyzed across multiple treaties and given a grade in the range of 0 - 5. A score of '0' denoted a completely source-based treaty; therefore, *most investor-unfriendly*. A score of '5' denoted that the clause is most residence-based/foreign *investor-friendly*. The rating was carried out by using the scoring criteria highlighted in Appendix 7.

Our method is similar to some of the attempts to rate tax treaties. Hearson created a similar rating system for tax treaties of developing countries. However, the method emphasizes on binary coding. If a treaty is source-based, it is graded as 0, and residence-based is graded as 1. While some weights are assigned to rates, other features are ignored. While Das-Gupta has rated India's tax treaties, they did not provide a scoring system that allowed comparison between treaties. Our method codes for provisions other than the rate of taxation. Provisions like the number of days an entity has to operate to be considered to have a permanent establishment. Types and numbers of exceptions to source or residence-based taxation. The method was derived by studying several similar provisions across treaties, identifying the variations found in each sub-clause of a provision, and then ranking them from most investor-friendly to least investor-friendly. This method allows us to consider more factors and derive the scoring pattern from existing treaties.

The degree of agreement in the rating method was measured based on two blind markings. Two law students read the entire text of the concerned clauses and marked the treaties as per the rating method. Information on ratification, coming into force, and amendments were recorded. This exercise was done by the reviewers twice. The reviewers were trained on the scoring criteria with other

treaties. An input system was deployed to prevent the reviewers from comparing their scores. If the two reviewers scored a clause differently, one of the authors reviewed and scored it. The blind test aimed to evaluate the friendliness of the DTAAs. The reviewers were first tested on sets of sample treaties before commencing with the entire process. Based on this approach, we found a variance of 5.51% between the two reviews.

3.1 Sampling

A pool of 73 treaties was selected for analysis. These treaties were grouped into three categories: (i) India and its investor countries, (ii) between OECD countries, and (iii) between other similar developing countries (Brazil, China, South Africa, South Korea, and Turkey (BCSST)) and their main investors.[20]

To select the main investors for a country, we used OECD and UNCTAD data for the inward flow of FDI.[21] For India, this was supplemented with data published by the RBI.[22] Sources of investment in a nation for the last five years were ranked and sorted to identify the top jurisdiction investing in a country. The treaties between the source country and its top-ranking investors and treaties with global exporters of capital (as per the International Monetary Fund (IMF)) were selected. This ordinarily accounted for more than 80% of the investment in such a country. For example, though we analyze only 17 of India's 90 treaties, they accounted for 94% of the FDI between 2012 and 2017.

Some treaty pairs were excluded from the sample due to the FDI partners not having entered into a tax treaty, or the treaty's text not being available in English. Finally, we were able to collect 69 treaties from our pool of treaties. Table 3 shows the breakup of the treaties analyzed.

[20]These countries have a similar legal and political landscape as India's. For a detailed analysis of the choice of these countries, *see* Upendra K Sinha. "Working group on foreign investment". In: *Committee report, Department of Economic Affairs, Ministry of Finance* (2010)

[21]United Nations Conference on Trade and Development. *Bilateral FDI Statistics*. 2012. URL: https://unctad.org/en/Pages/DIAE/FDI%5C%20Statistics/FDI-Statistics-Bilateral.aspx (visited on 07/03/2019).

[22]Reserve Bank of India. *Foreign Direct Investment Flows to India: Country-wise and Industry-wise*. 2018. URL: https://rbi.org.in/Scripts/AnnualReportPublications.aspx?Id=1249 (visited on 07/03/2019).

Table 3 Sample Size

We measure five clauses in each treaty, namely, Permanent Establishment, Dividends, Interest, Royalty, and Capital Gains.

Block	**Treaties** (n)	**Clauses** (n * 5)
India	17	85
BCSST	30	150
OECD	34	170
Total	69	345

Treaties including South Korea and Turkey are included in both the BCSST and OECD block.

3.2 Limitations

The selection of the sample and the marking criteria entail choices that have certain limitations. The analysis of the friendliness of DTAAs does not take into consideration the domestic tax rates. For example, where dividends are taxable by the source jurisdiction at 10% per annum, the grading methodology only considers this rate and not whether the source jurisdiction provides any exemptions while taxing dividends under its domestic law. However, since domestic tax rates are more prone to change than rates mentioned under the treaties, we believe that the treaty rates reflect an accurate measure of treaties' friendliness. Further, some clauses that may indirectly affect on investor friendliness (like payments to directors) have not been considered while measuring the friendliness of the treaties. This may marginally affect the overall taxing rights of countries.

4 Results

India competes with several countries for attracting FDI from exporters of capital. The BCSST countries are similar to India with respect to their GDPs and

accompanying factors and have similar governance structures.[23] They hence act as India's competitors in attracting FDI. These countries have entered into several DTAAs, which are one of the means of attracting FDI. However, studies on the impact of DTAA on FDI have treated a tax treaty between countries as a binary variable. They have not considered whether heterogeneity in the treaty content may lead to varying effects on investment flows.

In this section, we analyze the content of the tax treaties of India and its competitors (BCSST) with exporters of capital. We study these in light of tax treaties entered into by OECD members with their investors and among themselves. We find that India signs more source-based treaties than global standards. This section also measures the variance in India's treaties, which is higher than its competitors. Such variance leads to more residence-based treaties with entrepots such as Mauritius and Singapore, instead of source-based treaties with capital exporters like the United States and the United Kingdom.

4.1 More Source-Based Treaties

Overall, India's treaties are more source-based (foreign investor unfriendly) than the three groups studied. Table 4 shows that not only is India worse off on average for the five clauses, but it scores the lowest in terms of foreign investor friendliness for *each* clause. Compared with its peer group (BCSST), India has the second most investor unfriendly approach from its main sources of foreign investment. As Table 5 shows, only Brazil has an overall score lower than India. Brazil signs more investor unfriendly treaties in *interest*, *royalty*, and *capital gains* provisions. Turkey scores less on *interest* clauses, and China scores lower on capital gains.

[23] The World Bank Governance Indicator Database measures several factors such as the Regulatory Quality, Rule of Law, and Government effectiveness. World Bank. *Worldwide Governance Indicators*. 2018. URL: https://datacatalog.worldbank.org/dataset/worldwide-governance-indicators (visited on 07/03/2019)

Table 4 Extent of Residence-Based Taxation: Global Blocks

India signs more source-based treaties than its competitors (BCSST) and OECD countries.

Country	PE	Div.	Int.	Roy.	CG	Average
India	2.06	3.00	3.59	3.59	3.03	3.05
BCSST	3.47	3.61	3.80	4.00	3.08	3.59
OECD	4.16	3.77	4.01	4.39	3.90	4.05
OECD Model	5.00	4.00	4.00	5.00	4.00	4.40

Authors' Calculation

Table 5 Extent of Residence-Based Taxation: India's Competitors

India's competitors in attracting FDI sign friendlier treaties. These countries have a higher propensity of only taxing the residents of their country, and exempting all non-residents from taxation.

Country	PE	Div.	Int.	Roy.	CG	Overall
India	2.06	3.00	3.59	3.59	3.03	3.05
Brazil	3.20	3.10	3.00	3.10	1.10	2.70
China	3.13	3.50	4.00	4.00	2.44	3.41
South Africa	4.83	4.00	4.75	5.00	4.00	4.52
South Korea	3.31	3.69	3.75	3.81	3.88	3.69
Turkey	3.00	3.67	3.33	4.00	3.58	3.52

Authors' Calculation

On clauses governing *permanent establishments*, India has an average score of

2.06 out of 5. BCSST countries score an average of 3.47, and OECD countries score 4.16. Unlike the definition of a permanent establishment under the OECD or United Nations (UN) model conventions, India has adopted a broader definition in most tax treaties. Apart from including a place of management, branch, office, factories, it also includes farms, plantations, warehouses, stores, installations or structures used to explore natural resources, and furnish services through employees or other personnel.[24]

Permanent establishment clauses have a disproportionate effect on foreigners' tax treatment compared to the other four clauses analyzed. Tax treaty benefits are available to non-residents, i.e., entities that are not set-up in or are residents of the host country. The question of who qualifies to be a resident is determined by the *permanent establishment* clause of a tax treaty. If a treaty has a narrow permanent establishment clause, more foreign investors will not meet the legal requirement. This will allow such foreign investors to claim benefits under the tax treaty.

On the other hand, a *wide* permanent establishment clause makes more foreign investors *resident* for the purposes of a treaty. Once a person is a resident of the host country (for tax purposes), they cannot benefit from the treaty. Therefore, a broader *permanent establishment* clause denies an investor from all the tax protections under the other clauses.

An example of this is India's position on e-commerce websites. India has taken the position that maintaining an e-commerce website for India constitutes a permanent establishment of a foreign business. This makes e-commerce websites residents of India and unable to benefit from tax treaties.[25] Developed countries do not take such a position on permanent establishment clauses.[26] As a consequence, an e-commerce company is neutral between providing services to other

[24] *See* for example, *Agreement between the Government of India and Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, and *Agreement between the Government of India and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[25] Yariv Brauner. "What the BEPS". in: *Fla. Tax Review* 16 (2014). Highlights the developing debate on modes of international taxation in consonance with neutrality theories, p. 55. URL: https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1652&context=facultypub (visited on 12/28/2018).

[26] Office of Tax Policy. "Selected Tax Policy Implications of Global Electronic Commerce". In: *U.S. Department of Treasury* (Nov. 1996). URL: https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Global-Electronic-Commerce-1996.pdf (visited on 06/24/2019).

countries (in either event, its tax burden is the same), but will have to re-consider when providing such services in India, as it may be taxable as a permanent establishment.

For *dividends*, *interest*, and *royalties*, India scores less than its peers and OECD countries. India's average on these three is 3.00, 3.59, and 3.59, respectively. For BCSST, it is 3.61, 3.80, and 4.00. In comparison, OECD has an average of 3.77, 4.01, and 4.39 for *dividends*, *interest*, and *royalty* provisions, respectively. For these three provisions, the main taxation clause is the *withholding tax* rates. Withholding tax is the maximum rate at which the host country can tax foreign investments for specific transactions.[27] This puts an upper limit on what the host country can collect from the foreign investor, irrespective of what the host country tax legislation states.

India's withholding tax rates are usually higher than its peers and OECD countries. For example, the *India - USA Tax Treaty* allows source-based taxation of dividends up to *25 percent*.[28] This is not the case in other treaties of the United States. The *South Africa - USA Tax Treaty* only allows source taxation up to *15 percent*.[29] India similarly taxes interest up to *15 percent* in its treaties with Belgium, Canada, Italy, Spain, Turkey, United Kingdom, and the United States, among others. The *Italy - India Tax Treaty* and *India - Spain Tax Treaty* tax royalties up to *20 percent*.[30] This is not the case with other treaties of these countries.

On capital gains, like other provisions, India has a more source-based approach to taxation. India's average score on this clause is 3.03, BCSST scores 3.08, and OECD scores 3.90. Capital gains taxation has an especially adverse effect on portfolio investments. Such investors seek to make returns by first investing in securities and then selling them later at a higher price. Many countries, including India, exempt most domestic structured portfolio investors from capital gains. For example, mutual funds, private equity funds, and pension funds are exempt from capital gains tax. However, most jurisdictions do not make that distinction

[27] See art. 10-13 *Model Tax Convention on Income and on Capital: Condensed Version 2017*,

[28] *Agreement between the Government of India and USA for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[29] *Convention between the South Africa and USA for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains*,

[30] *Agreement between the Government of India and Italy for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, and *Agreement between the Government of India and Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

for foreign investors. This does not affect foreign investors if the host country generally exempts portfolio investment from capital gains tax.

Agreements among capital exporters provide that gains from the alienation of shares that derive more than 50 percent of their value from immovable property situated in a State may be subject to source taxation. In all other cases, the host country does not tax portfolio investment. However, Indian treaties do not include such a cap of 50 percent. While Article 13 of the *Germany - India Tax Treaty* imposes capital gains tax on portfolio investments from Germany to India at the full Indian capital gains tax rate,[31] the *Italy - USA Tax Treaty* exempts share transfers from capital gains.[32] Similarly, the *Belgium - Norway Tax Treaty* exempts such transfer from taxation by the host country.[33]

Since India does not follow the conventional approach, foreign portfolio investors (like pension and mutual funds) must pay taxes in the host country. There is no exclusion based on the value of shares that are alienated. Thus, all capital gains from such alienation are taxable in India. This makes their return from India lesser than what can be achieved from India's peer countries and adds to the additional tax compliance cost in India.

4.2 Variance among treaties

In addition to signing more investor *unfriendly* treaties, India shows more variance in its treaties than its peers and OECD countries. As Table 6 shows, while India's treaties have a standard deviation of 0.62, South Africa has a standard deviation of 0.27. This implies that India's position on tax treaties varies more than other countries.

[31] *Agreement between the Government of India and Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[32] *Convention between the Government of the United States of America and the Italian Republic for the Avoidance of Double Taxation with respect to taxes on Income and the Prevention of Fraud or Fiscal Erosion*,

[33] *Convention between The Kingdom of Norway and the Kingdom of Belgium for the Avoidance of Double Taxation with respect to taxes on Income and for the Prevention of Fiscal Evasion.*,

Table 6 Standard Deviation in Treaties

We measure the standard deviation in our markings. India signs more varying than its competitors, even when such competitors do not have a model treaty to follow.

Country	PE	Div.	Int.	Roy.	CG.	Average
India	0.66	0.50	0.51	0.69	0.74	0.62
Brazil	0.45	0.74	0.00	0.22	0.22	0.33
China	0.83	0.53	0.00	0.00	1.45	0.56
South Africa	0.41	0.00	0.42	0.00	0.55	0.27

Authors' Calculation

Such variance may encourage foreign investors to relocate their *revenue jurisdiction*. This is done by a foreign investor, with which India has a relatively more unfriendly treaty, setting up a subsidiary in a country with which India has a friendlier treaty. The investor then routes their investment through the latter jurisdiction.[34] The cost of setting up and managing the subsidiary reduces the net foreign investment into India without any offsetting gain to Indian revenue or economy. Such relocation of revenue jurisdiction merely increases the *transaction cost* of doing business in India. Odari predicts a similar outcome for the *Kenya - Mauritius Tax Treaty*.[35] If jurisdictions differ in terms of the applicable tax rates, it creates an incentive to reduce one's tax liability by transferring revenue to jurisdictions that prescribe a lower tax rate.

A standard test for a *permanent establishment* is the number of days a foreigner operates in the host country. If a foreign investor operates for more than a specified number of days in a year, it is deemed to have a permanent establishment.

[34] Alfons J Weichenrieder, Jack Mintz, et al. "What determines the use of holding companies and ownership chains". In: *Centre for Business Taxation Working Paper WP08/03. Oxford University, Oxford, UK* (2008).

[35] Edgar Odari. "Tax Drainage Kenya/Mauritius DTA and its potential impact on tax base erosion in Kenya". In: *Tax Justice Network* (Mar. 2015). URL: https://taxjusticeafrica.net/wp-content/uploads/2016/02/Kenya-Mauritius-DTA-TJN-A-2015.pdf (visited on 06/24/2019).

The higher the required number of days to constitute a permanent establishment, the more residence-based the treaty since this allows the investor to operate for a longer period before it is liable to be taxed by the host nation. India's approach to determining permanent establishments is inconsistent. While the *India - USA Tax Treaty* sets the bar at 120 days in a year to constitute a *permanent establishment*, the *India - Mauritius Tax Treaty* sets it at 270 days.[36] This makes it more foreign investor-friendly.

In withholding tax rates, a similar variation between India's treaties is seen. In *dividends*, the *Italy - India Tax Treaty* allows source-based tax up to 15 percent if the person receiving dividends holds at least ten percent of the dividend distributing company and 25 percent in all other cases. However, the *India - Mauritius Tax Treaty* prescribes a tax rate of 5 percent for holdings up to 10 percent and 15 percent in all other cases. Similarly, in *interest* clauses, the *India - UK Tax Treaty* prescribes a maximum withholding tax of 15 percent on all interest paid.[37] However, for the same *interest* clause in the *Cyprus - India Tax Treaty*, the maximum withholding tax is only 10 percent.[38] In royalties, while the *India - Singapore Tax Treaty* imposes a maximum withholding tax rate of 10 percent, the same clause invokes a maximum 20 percent rate in the *Italy - India Tax Treaty*.

In capital gains, India shows variation by exempting capital gains from some countries while taxing others. For example, while the *Belgium - India Tax Treaty* taxes all capital gains from the sale of shares, at source; the *India - Netherlands Tax Treaty* exempts shares sold on stock exchanges from source-based taxation.[39] This difference does not create an advantage for India. Since Belgium and Netherlands are part of the European Union, capital can move freely between them. All that a Belgian investor has to do is set up a subsidiary in the Netherlands and benefit from the treaty.[40]

---

[36] *Agreement between the Government of India and Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[37] *Agreement between the Government of India and the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[38] *Agreement between the Government of India and Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[39] *Agreement between the Government of India and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, and*Agreement between the Government of India and Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[40] The free movement of capital in the European Union (EU) means that the subsidiary does not lead to any additional taxation in EU for the Belgian investor.

4.3 Variance within treaties

In addition to variance amongst different treaties, India also shows a higher variance between provisions of the same treaty. This is usually seen in the varying rates of withholding tax across the three clauses: *dividends*, *interest*, and *royalties*. While other countries usually impose a uniform rate of withholding taxes in the three clauses, India varies these rates.

For example, the *Belgium - India Tax Treaty* imposes a maximum withholding tax of 15 percent on dividend and interest payments, but caps taxes on royalties at 10 percent at the source. This provides arbitrage opportunities for foreign investors. A Belgian company setting up an Indian subsidiary may show less investment in equity and loans and increase royalties to be paid by the Indian subsidiary on trademarks and other intellectual property. This will allow the Belgian company to pay lesser taxes but obtain the same economic return. Grubert finds a positive relationship between the withholding tax rate on royalties and dividends, on interest payments, indicating substitutability between interest vis-a-vis royalties and dividends.[41]

The *Belgium - India Tax Treaty* is not a rare example. Indian treaties follow a pattern of varying tax rates. This is true for the *India - USA Tax Treaty*, *India - Spain Tax Treaty*, *Italy - India Tax Treaty*, etc. This only induces investors to manoeuvre their income from one head to another and does not result in gains for India.

5 Consequences

As seen in the previous section, India's international tax policy suffers from three features: (i) India has extreme source-based taxing, i.e. most investor *unfriendly* regime when compared to its peers and developed countries; (ii) India's tax policy is inconsistent and *favors* so called tax-havens over traditional exporters of capital, and (iii) Within the same treaty India is inconsistent about taxing various types of returns to investors (which are somewhat fungible).

India's extreme source-based taxation policy with a preference for some coun-

[41] Harry Grubert. "Taxes and the division of foreign operating income among royalties, interest, dividends and retained earnings". In: *Journal of Public economics* 68.2 (1998), pp. 269–290.

tries has adverse consequences. Investments in India from global pools of capital like the UK, US, and Germany lead to more taxation than from entrepots like Mauritius. As investors incur lower taxes when investing via such countries, it is only rational for them to do so. This explains India's sources of investment. As table 7 shows, India's investments come from countries with more investor-friendly tax treaties. India's international tax policy *discriminates against* the traditional exporters of capital who have trade relationships.

Table 7 Extent of Residence Based Taxation: Entrepots and Capital Exporters

India's signs more residence-based treaties with entrepots than actual exporters of capital like the UK and the U.S. This is not the case with treaties of other countries.

Country	Year	PE	Div.	Int.	Roy.	CG	Average	FDI percentage
Entrepots								
Mauritius	1983	3.0	4.0	4.0	3.0	4.0	3.6	35.24
Netherlands	1989	2.0	3.0	4.0	4.0	4.5	3.5	6.58
Singapore	1994	2.0	4.0	3.0	4.0	4.0	3.4	18.65
U.A.E	1993	4.0	3.0	4.0	4.0	3.0	3.4	1.53
Capital Exporters								
U.K.	1993	2.0	3.0	3.0	3.0	2.0	2.6	4.59
U.S.A	1989	1.0	2.0	3.0	2.5	2.0	2.1	6.73
Italy	1996	2.0	2.0	3.0	2.0	3.0	2.4	1.00

Authors' Calculation

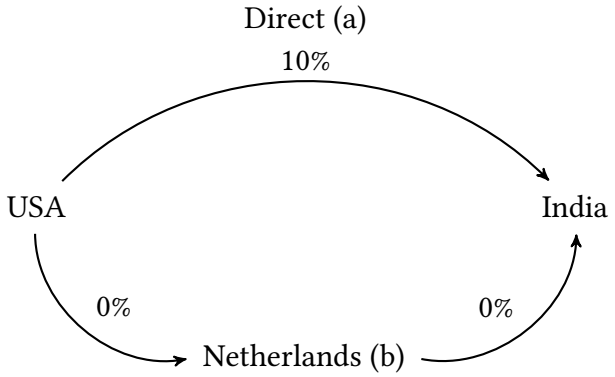
This inconsistent taxation approach creates rational arbitrage opportunities. It forces investors to go a circuitous route to invest in India. Consider Section 5. One of India's largest trading partners, bound by a common legal system, language, and commitment to similar democratic values, is the U.S. We should expect large capital flows from the U.S., which is also a traditional exporter of cap-

ital. However, *India - USA Tax Treaty* makes all capital gains from investments in India taxable in India (at the rate of 10%) and the U.S. On the other hand, the Netherlands, a country with which India has little in common, gets preferential treatment. If an investor in the Netherlands invests in Indian listed companies, they do not have to pay any capital gains in India.

Since the Netherlands and the U.S. follow the OECD model treaty, they have complete residence-based taxation between them. If an investor from the U.S. invests in a Netherlands company, the U.S. investor has to pay no taxes. Therefore, all a U.S. investor has to do is create a subsidiary in the Netherlands and then invest in India. This has nothing to do with whether the Netherlands is a tax haven or not. This also explains some of the anomalies we see in the investment sources. While the UK has much closer ties with India, it invests less in India than Japan, with lesser ties. However, the *India - UK Tax Treaty* scores 2.6 on investor friendliness, while the *India - Japan Tax Treaty* scores 3.2. This may explain the higher investments from Japan.

Figure 1 Consequence of inconsistent treaties

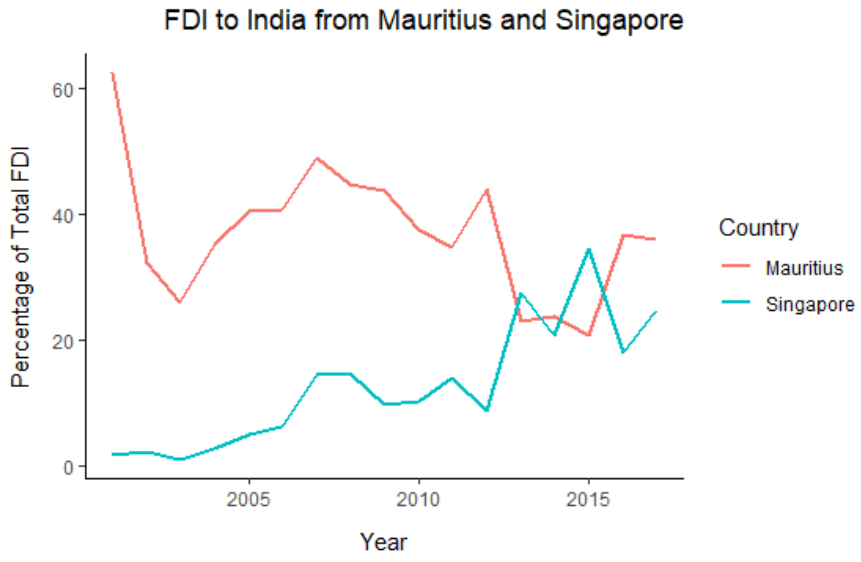
Inconsistent treaties create two routes for an investor: (a) Direct Investment into the host country and pay extra taxes in India or, (b) Investment via in intermediary to lower the tax burden. This encourages indirect investments in India



The Long Term Capital Gains in India for securities listed on a recognised stock exchange is 10%

Another indirect evidence of tax treaties determining the source of the investment is the rise of Singapore as a source of FDI to India. While Singapore has been considered a *tax haven* for many years, its rise as an investment source for India indicates the importance of tax treaties. The *India - Singapore Tax Treaty* was signed in 1994. However, unlike the *India - Mauritius Tax Treaty*, the *India - Singapore Tax Treaty* provided *source-based* taxation for *capital gains*, i.e. investors from Singapore had to pay capital gains tax in India. In 2005, Singapore and India amended their tax treaty as part of a broader economic cooperation agenda.[42] One amendment was the change in the capital gains taxation policy. The amended treaty explicitly stated that the investments from Singapore would get the *same treatment* as investments from Mauritius. Consequently, this clause made investments from Singapore immune from capital gains taxation in India, like Mauritius. Figure 2 shows, foreign investment from Singapore (as a percentage of total foreign investment in India) rose after the amendment. In 2013-14 it even surpassed investments from Mauritius.

Figure 2 FDI to India from Mauritius and Singapore



The *India - Mauritius Tax Treaty* was amended in 2016. After the amendment,

[42]The *CECA* amended the *India - Singapore Tax Treaty* treaty and provided that gains from the sale of shares in India shall be modeled as per the *India - Mauritius Tax Treaty*.

capital gains from the alienation of shares may be taxed at the source. This rate would be limited to half the domestic rate till 1st April 2019. The amendment provides that shares acquired before 1st April 2017 shall be taxable as per the unamended treaty, even if they are alienated after such a date. It also inserted a limitation of benefits (LOB) clause, which prescribes that a resident is deemed a shell/ conduit company if its total expenditure on operations in Mauritius is less than Rs. 2.7 million ($ 39 thousand) Due to the *India - Singapore Tax Treaty* treaty's *co-terminus* clause, this led to the reconsideration of the treaty between India and Singapore. In 2016, the Singapore treaty was amended to provide that capital gains from the alienation of shares may be taxed at the source.

As to the impact of these amendments, FDI inflows for market access and production are unlikely to be affected. This is because the rates that are more relevant to them, namely royalties and interest, have not been made more source-based. The amended treaty now taxes interest payments at a lower rate of 7.5%. Before the amendment, income from interests was taxable at the domestic tax rates (usually 15%). This has potentially made Mauritius an attractive jurisdiction for debt investments in India. This is in contrast to the tax rate on such investments from capital exporters. The *India - USA Tax Treaty* and the *India - UK Tax Treaty* prescribe that interest payments may be taxed at the source up to 15 percent.

Further, there are still other jurisdictions that have similar capital gains provisions in their respective DTAAs. In Netherlands' case, capital gains from the alienation of shares are exempt from taxation by the source country if they are quoted on an approved stock exchange.[43] Unlike the Mauritius, Singapore, and Cyprus Agreement, this provision in the *India - Netherlands Tax Treaty* was not amended in 2016. Since then, investment from the Netherlands has grown. In 2015, investment from the Netherlands accounted for approximately 6.4 percent of the FDI in India. This had grown to 8.7 percent in 2018. These numbers are only likely to rise in 2019 when the amendments to the other treaties come into full force. This may be the reason why the Netherlands is the fourth largest investor in India.[44]

Till 2016, there were voices in India for moving to a more source-based model. It

[43] *Agreement between the Government of India and Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*,

[44] It also provides the benefit of having a vast network of tax treaties, see Francis Weyzig. "Tax treaty shopping: structural determinants of Foreign Direct Investment routed through the Netherlands". In: *International Tax and Public Finance* 20.6 (2013), pp. 910–937

was perceived that India's tax treaties with Mauritius, Singapore, and Cyprus were *too investor-friendly*. This resulted in India's treaties being amended to make them more *source-based*. The amendments came into force on 1st April 2019. As our analysis shows, this was an incorrect presumption. It arose from limiting comparison of these treaties with other tax treaties of India. Policymakers and academics did not compare India's tax treaties with its competitors or other developed countries that attract significant foreign investment. Our measurement shows that India was the outlier for all other treaties except the three, which India changed. India's treaties with Mauritius, Singapore, and Cyprus, far are from being too investor-friendly. They are investor-unfriendly when compared with other countries. Because all of the other tax treaties of India are highly investor-unfriendly, the foreign investors are choosing the lesser evil.

The 2016 amendments to the tax treaties with Mauritius and Singapore made matters worse. While it changed the provisions governing capital gains to allow India to collect taxes from foreign investors, they did not bring consistency. Unlike other treaties signed by India, neither treaty requires the gains to be from the alienation of shares of a company whose immovable property is directly or indirectly situated in the source country. Instead, the company has to be a resident of the source country. The mere presence of immovable property in the source country does not qualify that country to levy its taxes. This created a new variation between India's treaty with Mauritius and other governments.

The amendment to the Mauritius Treaty also provides a reduced tax rate of 7.5 percent on debt-claims. Before the amendment, income from interests was taxable at the domestic tax rates, the standard position in India's other tax treaties. In effect, by rationalizing provisions on capital gains, India opened up a new arbitrage opportunity in debt investments. As Table 8 shows, the changes did not substantially affect the average treaty score for both countries. Singapore has now become slightly more favorable and will, therefore, divert equity investments away from Mauritius. Mauritius similarly may be able to divert debt investments away from Singapore, under the new preferential treatment.

Table 8 Changes in treaty score after 2016

India's efforts to rationalize tax treaties has not achieved its purpose. While the arbitrage on capital gains may have been closed, a new one on interest repayments has been opened.

	Mauritius (Before)	**Mauritus (After)**	**Singapore (Before)**	**Singapore (After)**
PE	**3**	**3**	**2**	**2**
Dividends	4	4	4	4
Interests	3	4	3	3
Royalties	3	3	4	4
Capital Gains	5	4	5	4
Average	**3.6**	**3.6**	**3.6**	**3.4**

6 Conclusion

India does not seem to follow the traditional gravity model of finance. India's foreign investment does not seem to come from the countries with which it trades or has traditional connections. Most of India's foreign investment comes from countries that can be classified as *tax havens*. The traditional explanation for this has been that India's tax treaties with these *tax havens* provided loopholes, which foreign investors took advantage of. This allowed such investors to *unfairly* evade taxes. This view arose from observing the disproportional flow of investments from Mauritius (and later, Singapore) and comparing provisions in the tax treaties with India's other tax treaties. However, there was no systematic evaluation of India's tax treaties.

In this paper, we attempted a systematic evaluation of India's tax treaties. We develop a method of rating tax treaty provisions based on whether they are investor-friendly or not. We use the method to score provisions in tax treaties governing business transactions and investments. This allows us to compare In-

dia's tax treaties with each other. We expand the selection to include (i) other developing countries similar to India, and (ii) OECD member countries. Overall, India's treaties are more source-based (foreign investor-unfriendly) than the three groups studied. In addition, India shows more variance in its treaties than its peers and OECD countries, signaling a lack of consistency in its international tax policy. Even within treaties, the rate of withholding tax charged by India varies. The variation and *investor unfriendliness* are the highest for India (among the countries studied).

We think this explains the flow of investments from tax havens like Mauritius. It is not that these treaties are *especially investor-friendly* but that all of India's other tax treaties are *especially investor-unfriendly*. The lack of consistency in India's international tax policy has created multiple arbitrage opportunities and *encouraged* flows to be diverted through third tax havens. This has less to do with tax havens and more to do with inconsistent taxation policies. India's most investor-friendly treaties (with Mauritius, Cyprus, and Netherlands) are far more investor-unfriendly than the average treaties that other developing countries sign or that OECD countries use to tax financial flows between them. It is only when Indian treaties are systematically compared with other countries that the differences become visible.

The conventional notion for explaining large investments through *tax havens* is because of their low domestic tax regime. Our findings challenge this notion. We think that India tried to take a stance of extreme source-based taxation with traditional exporters of capital. Negotiating more *normal* treaties would have been seen as giving up. However, treaties with smaller countries did not attract such attention and, therefore, were more investor-friendly. When India liberalized foreign investment in 1991, these became a channel for investments into India. This, in turn, created a *false perception* of the treaties being too investor-friendly.

As India internationalizes, it needs to rationalize its international tax policy. Extreme source-based taxation that India follows would make India the most non-competitive from a taxation perspective, reducing net foreign investments. India's recent developments in renegotiating tax treaties with the tax havens are in the wrong direction. Instead, India should sign more investor-friendly treaties with traditional exporters of capital.

7 Evaluation Criteria

A conceptual basis for the taxation of foreign investments, geared towards a residence-based tax, rather than the policy of trying to tax all transactions related to the source, finds ground in literature as being a beneficial system. This current scheme hence tries to mark DTAAs on their propensity towards such a Residence Based System in-keeping with the OECD Model Convention with respect to Taxes on Income and Capital.

7.1 Permanent Establishments

A Permanent Establishment is a fixed place of business and said to exist in a country depending on the period that a building site et al. shall last in such a country. Upon crossing the minimum threshold of such time, the entity is said to be a permanent establishment and subject to the source country's taxation regime. Article 5 (3) of the OECD model convention prescribes that a building site et al. shall be termed a permanent establishment if it lasts more than *12 months*. However, Article 5 (3) of the UN model convention states that a building site et al. shall be termed a permanent establishment if it lasts more than *6 months*.

Hence, the minimum time requirement that a building site et al. must last in a State is the primary determinant of classification. However, some treaties include additional variants that are "included especially" to be termed a Permanent Establishment. For example, India ordinarily includes premises used as a sales outlet to be termed a permanent establishment in its tax treaties. We thus create a bi-variate scheme for analyzing a PE clause.

Step 1:

- 5 – A building site et al. must last 12 months or more to be termed a Permanent Establishment (Model Convention)
- 4 – A building site et al. must last 9 to 12 months to be termed a Permanent Establishment.
- 3 – A building site et al. must last 6 to 9 months to be termed a Permanent Establishment
- 2 – A building site et al. must last 3 to 6 months to be termed a Permanent Establishment

- 1 – A building site et al. must last less than 3 months to be termed a Permanent Establishment

Step 2:

- 1 or 2 Additional Variants: Deduct 0
- 3 or 4 Additional Variants: Deduct 1
- 5 or more Additional Variants: Deduct 2

7.2 Dividends

Dividends are the distribution of profits of a company to its shareholders. Dividends distributed the resident of a State are taxable by such State. However, they may also be taxed by the State of which the company paying the dividends is a resident. The OECD model convention prescribes two tax rates, contingent upon the holding of the company issuing the dividend by the receiver. Article 10 of the convention provides that the source jurisdiction may also tax dividends up to 5% if the beneficial owner of the dividends owns at-least 25% of the company issuing the dividends and up to 15% in all other cases. The UN model convention does not specify the rate at which dividends may be taxed at the source and leaves such a rate to be determined through bilateral negotiations.

Hence, the taxation rate on dividends forms the primary determinant of classification. However, some treaties provide a uniform rate at which the source jurisdiction may tax such dividends. For example, article 10 of the Agreement between India and Germany provides that the source jurisdiction may also tax dividends; however, such tax shall not exceed 10% of the gross amount of the dividends. We thus classify the tax treaties based on the form of taxation that they prescribe.

- 5 – Absolute Residence Based Taxation, i.e., there is no exception clause to the general rule of Residence Based Taxation
- 4 – Follows the OECD 'two variants' case, or has up to 5% increase in the source-based tax rate specified in the OECD Model Convention (Model Convention)
- 3 – Follows the Indian 'one variant' case, or has up to 5% increase in the source-based tax rate as per Indian Model
- 2 – Follows either variant with more than 5% increase in the source-based

tax rate
- 1 – No Residence Based Taxation

7.3 Interests

Interest is the amount paid by the borrower to the lender as the cost of borrowing. Interests paid to the resident of a State (the lender) shall be taxable by such State. However, they may also be taxed by the State of which the payer (borrower) is a resident. Article 11 (2) of the OECD model convention prescribes that the source jurisdiction's tax shall not exceed 10% of the gross amount of the interests. The UN model convention does not specify the rate at which interests may be taxed at the source and leaves such a rate to be determined through bilateral negotiations.

Hence, the taxation rate on interests forms the primary determinant of classification. However, during bilateral negotiations, some treaty-partners have prescribed exemptions of lower source-based rates for interests paid to banks, financial institutions, etc. For example, article 11 of the agreement between India and France prescribes that interest earned by the Government is exempt from taxation by the country in which such interest arises. For a uniform classification, we only consider the rates charges in *non-specific* cases, and subsequently, create our scale.

- 5 – Absolute Residence Based Taxation, i.e., there is no exception clause to the general rule of Residence Based Taxation
- 4 – Less than or equal to 10% Source-Based Taxation (Model Convention)
- 3 – Source-Based Taxation between 10-15%
- 2 – Source-Based Taxation higher than 15%
- 1 – No Residence Based Taxation

7.4 Royalties

A royalty is a payment made by a licensee for the right to use intellectual property owned by the licensor. A royalty paid to the resident of a State (the licensor) shall be taxable by such State. However, it may also be taxed by the State of which the payer (licensee) is a resident. The OECD model convention does not prescribe source-based taxation on royalties. However, article 12 (2) of the UN model convention provides that the source jurisdiction may also tax royalties

up to a bilaterally negotiated ceiling. Similarly, article 12 (2) of the agreement between India and Japan prescribes that royalties may be taxed at the source, but the tax so charged shall not exceed 10% of the gross amount of the royalties. Hence, the taxation rate on royalties forms the primary determinant of classification.

- 5 – Absolute Residence Based Taxation, i.e., there is no exception clause to the general rule of Residence Based Taxation (Model Convention)
- 4 – Less than or equal to 10% Source-Based Taxation
- 3 – Source-Based Taxation between 10-15%
- 2 – Source-Based Taxation higher than 15%
- 1 – No Residence Based Taxation

7.5 Capital Gains

Capital gains accrue by the alienation of capital assets such as shares etc. Most tax treaties follow a 'negative list' principle in delineating which gains shall be taxed in the State of the resident that acquires such gains, i.e., they mention an exhaustive list of gains that may be taxed at where they arise. Gains from the alienation of any other property shall be taxable by the State in which the alienator is a resident. Article 13 (5) of the OECD model convention prescribes that gains from the alienation of any property other than specifically mentioned in any other provision shall be taxed by the State of which the alienator is a resident. The UN model convention further includes shares of companies that do not own principally immovable property in the source jurisdiction in the negative list.

Some treaties vary the scope of the list that may be taxed at the source. For example, article 13 of the agreement between India and the United States prescribes that except in the case of shipping and air transport, each State may tax capital gains per the provisions of its domestic law. Due to such variance, we take under consideration a purposive and holistic reading of the article and subsequently create our scale. Hence, the scope of the negative list forms the primary determinant of classification.

- 5 – Substantially greater Residence Based Taxation than OECD model, for example, gains from the alienation of shares are taxed as per the Residence Based Model

- 4 – Residence Based Taxation with exceptions provided in the OECD model (Model Convention)
- 3 – Residence Based Taxation with more exceptions than provided in the OECD model
- 2 – Source-Based Taxation with some exceptions
- 1 – No Residence Based Taxation

8 List of Treaties

Table 9 List of Treaties in Sample

Country	**Treaties**
India	*Belgium, China, Cyprus, France, Germany, Italy, Japan, Mauritius, Netherlands, Norway, Singapore, South Korea, Spain, Switzerland, U.A.E., U.S.A, United Kingdom*
BCSST	
Brazil	*Japan, Netherlands, Norway, Spain, Switzerland*
China	*Germany, Japan, Norway, Singapore, South Korea, Switzerland, India*
South Africa	*Germany, Japan, Netherlands, Norway, Switzerland, U.S.A., United Kingdom*
South Korea	China, India, Japan, Japan, Norway, Switzerland, U.S.A., United Kingdom
Turkey	*Austria, Germany, Japan, Netherlands, Norway, Switzerland*
OECD	
Belgium	*France, United Kingdom, India*
France	*Belgium, India, Netherlands, Spain*
Germany	*China, India, South Africa, Turkey, U.S.A., United Kingdom*
Italy	*India, Switzerland, U.S.A., United Kingdom*
Japan	*Brazil, China, India, South Africa, South Korea, Turkey, U.S.A., United Kingdom*
Luxembourg	*Netherlands, Switzerland*
Netherlands	*Brazil, France, India, Luxembourg, Norway, South Africa, Spain, Switzerland, Turkey, U.S.A*
Norway	*Brazil, China, India, Netherlands, South Africa, South Korea, Turkey*
Spain	*Brazil, France, India, Netherlands, Switzerland*
Switzerland	*Brazil, China, India, Italy, Luxembourg, Netherlands, South Africa, South Korea, Spain, Turkey, U.S.A.*
U.S.A	*Canada, Germany, Netherlands, United Kingdom, India, Italy, Japan, South Africa, South Korea, Switzerland*
United Kingdom	*Belgium, Germany, India, Italy, Japan, South Africa, South Korea, U.S.A*

Table 10 Comparison of the OECD and UN Model Convention

The OECD and the UN Model Convention follow the same structure

Clause	OECD Model Convention	Clause	UN Model Convention
1	Persons Covered	1	Persons covered
2	Taxes covered	2	Taxes covered
3	General definitions	3	General definitions
4	Resident	4	Resident
5	Permanent establishment	5	Permanent establishment
6	Income from immovable property	6	Income from immovable property
7	Business profits	7	Business profits
8	International shipping and air transport	8	International shipping and air transport
9	Associated enterprises	9	Associated enterprises
10	Dividends	10	Dividends
11	Interest	11	Interest
12	Royalties	12	Royalties
	*NA**	12 A	*Fees for technical services**
13	Capital gains	13	Capital gains
14	*[Deleted]**	14	*Independent personal services**
15	Income from employment	15	Dependent personal services
16	Directors' fees	16	Directors' fees
17	Entertainers and sportsmen	17	Artistes and sports persons
18	Pensions	18	Pensions and social security payments
19	Government Service	19	Government service
20	Students	20	Students
21	Other income	21	Other income
22	Capital	22	Capital
23 A	Exemption method	23 A	Exemption method
23 B	Credit method	23 B	Credit method
24	Non-discrimination	24	Non-discrimination
25	Mutual agreement procedure	25	Mutual agreement procedure
26	Exchange of information	26	Exchange of Information
27	Assistance in the collection of taxes	27	Assistance in the collection of taxes
28	Members of diplomatic missions and consular posts	28	Members of diplomatic missions and consular posts
29	Entitlement to benefits	29	Entitlement to benefits
30	*Territorial extension**		*NA**
31	Entry into force	30	Entry into force
32	Termination	31	Termination

* These clauses represent the difference in the structure of the two treaties.

References

Musgrave, Peggy B. *United States taxation of foreign investment income: Issues and arguments*. Harvard Univ Harvard Law School, 1969.

Agreement between the Government of India and Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Agreement between the Government of India and Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Agreement between the Government of India and USA for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Agreement between the Government of India and Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Agreement between the Government of India and the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Agreement between the Government of India and Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Agreement between the Government of India and Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Agreement between the Government of India and Italy for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Tax Policy, Office of. "Selected Tax Policy Implications of Global Electronic Commerce". In: *U.S. Department of Treasury* (Nov. 1996). URL: https://www.treasury.gov/resource-center/tax-policy/Documents/Report-Global-Electronic-Commerce-1996.pdf (visited on 06/24/2019).

Agreement between the Government of India and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Keen, Michael and Hannu Piekkola. "Simple rules for the optimal taxation of international capital income". In: *Scandinavian Journal of Economics* 99.3 (1997), pp. 447–461.

Convention between the South Africa and USA for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains,

Gastanaga, Victor M, Jeffrey B Nugent, and Bistra Pashamova. "Host country reforms and FDI inflows: How much difference do they make?" In: *World development* 26.7 (1998), pp. 1299–1314.

Grubert, Harry. "Taxes and the division of foreign operating income among royalties, interest, dividends and retained earnings". In: *Journal of Public economics* 68.2 (1998), pp. 269–290.

Convention between the Government of the United States of America and the Italian Republic for the Avoidance of Double Taxation with respect to taxes on Income and the Prevention of Fraud or Fiscal Erosion,

Portes, Richard, Hélène Rey, and Yonghyup Oh. "Information and capital flows. The determinants of transactions in financial assets". In: *European economic review* 45.4-6 (2001), pp. 783–796.

Arnold, Brian J, Jacques Sasseville, and Eric M Zolt. "Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century". In: *Bulletin for International Fiscal Documentation* 56.6 (2002), pp. 233–245.

Girish, KR. "Delhi High Court Blocks Mauritius Tax Relief". In: *International Tax Review* 13 (2002), p. 35.

The Joint Parliamentary Committee. *Report on Stock Market Scam and Matters Relating Thereto*. Dec. 19, 2002. URL: http://loksabhaph.nic.in/writereaddata/InvestigativeJPC/InvestigativeJPC_635612541266248975.pdf.

Union of India v. Azadi Bachao Andolan (2003), , S.L.P.(C) Nos. 20192-20193 and 22521-22522 of 2002.

Comprehensive Economic Cooperation Agreement between India and Singapore,

Comptroller and Auditor General of India. *Report for the period ended March 2004 Performance Audit of - System Appraisals*. Tech. rep. Report No. 13 of 2005. 2005. URL: https://cag.gov.in/content/report-no-13-2005-perriod-ended-march-2004-performance-audit-system-appraisals (visited on 07/03/2019).

Portes, Richard and Helene Rey. "The determinants of cross-border equity flows". In: *Journal of international Economics* 65.2 (2005), pp. 269–296.

Agreement between the Government of India and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Weichenrieder, Alfons J, Jack Mintz, et al. "What determines the use of holding companies and ownership chains". In: *Centre for Business Taxation Working Paper WP08/03. Oxford University, Oxford, UK* (2008).

Das-Gupta, Arindam. *Economic Analysis of India's Double Tax Avoidance Agreements*. 2010. URL: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1632939 (visited on 01/03/2020).

Sinha, Upendra K. "Working group on foreign investment". In: *Committee report, Department of Economic Affairs, Ministry of Finance* (2010).

Tiwari, Manish and Jayanth Jacob. "New Pact. Cash plug for tax hole in Mauritius". In: *Hindustan Times* (June 20, 2010). URL: https://www.hindustantimes.com/business/new-pact-cash-plug-for-tax-hole-in-mauritius/story-khjbDkIfDXPXUD5KbEPtOI.html (visited on 01/11/2020).

Kohli, Shweta Rajgopal. "Will plug all loopholes in tax treaty. Mauritius Foreign Minister Arvin Boolell". Interview. In: *NDTV Profit* (July 6, 2012). URL: https://www.ndtv.com/business/will-plug-all-loopholes-in-tax-treaty-mauritius-foreign-minister-arvin-boolell-307462 (visited on 01/11/2020).

United Nations Conference on Trade and Development. *Bilateral FDI Statistics*. 2012. URL: https://unctad.org/en/Pages/DIAE/FDI%5C%20Statistics/FDI-Statistics-Bilateral.aspx (visited on 07/03/2019).

Sikarwar, Deepshikha. "Double taxation avoidance agreement. Mauritius ready to plug loopholes". In: *The Economic Times* (July 8, 2013). URL: https://economictimes.indiatimes.com/news/economy/policy/double-taxation-avoidance-agreement-mauritius-ready-to-plug-loopholes/articleshow/20963507.cms (visited on 01/11/2020).

Weyzig, Francis. "Tax treaty shopping: structural determinants of Foreign Direct Investment routed through the Netherlands". In: *International Tax and Public Finance* 20.6 (2013), pp. 910–937.

Agreement between Kenya and Mauritius for the Avoidance of Double Taxation,

Brauner, Yariv. "What the BEPS". In: *Fla. Tax Review* 16 (2014). Highlights the developing debate on modes of international taxation in consonance with neutrality theories, p. 55. URL: https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=1652&context=facultypub (visited on 12/28/2018).

Convention between The Kingdom of Norway and the Kingdom of Belgium for the Avoidance of Double Taxation with respect to taxes on Income and for the Prevention of Fiscal Evasion.,

Odari, Edgar. "Tax Drainage Kenya/Mauritius DTA and its potential impact on tax base erosion in Kenya". In: *Tax Justice Network* (Mar. 2015). URL: https://taxjusticeafrica.net/wp-content/uploads/2016/02/Kenya-Mauritius-DTA-TJN-A-2015.pdf (visited on 06/24/2019).

Profitable Detours. Network Analysis of Tax Treaty Shopping. Vol. 108. 2015, pp. 1–40. URL: https://www.jstor.org/stable/90023150.

Bureau Reporter. "India, Mauritius plug loopholes in tax treaty". In: *The Hindu, BusinessLine* (May 10, 2016). URL: https://www.thehindubusinessline.com/economy/india-mauritius-plug-loopholes-in-tax-treaty/article8581477.ece (visited on 02/20/2020).

Hearson, Martin. "Measuring tax treaty negotiation outcomes. the Actionaid tax treaties dataset". In: *ICTD Working Paper Series* 47 (2016). URL: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2744547 (visited on 08/04/2019).

Staff Reporter. "Government plugs another loophole on blackmoney. India, Singapore sign revised DTAA treaty". In: *Financial Express* (Dec. 30, 2016). URL: https://www.financialexpress.com/economy/after-mauritius-cyprus-india-signs-third-protocol-for-amending-double-taxation-with-singaore/491412/ (visited on 02/20/2020).

Agreement between the Government of India and Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,

Kotha, Ashrita Prasad. "The Mauritius Route. The Indian Response". In: *Saint Louis University Law Journal* 62 (2017), p. 203.

Model Tax Convention on Income and on Capital: Condensed Version 2017,

Schwanke, Amelia. "India's Renegotiated DTAs Creating Investment Diversions". In: *International Tax Review* 28 (2017), p. 32.

Reserve Bank of India. *Foreign Direct Investment Flows to India: Country-wise and Industry-wise*. 2018. URL: https://rbi.org.in/Scripts/AnnualReportPublications.aspx?Id=1249 (visited on 07/03/2019).

World Bank. *Worldwide Governance Indicators*. 2018. URL: https://datacatalog.worldbank.org/dataset/worldwide-governance-indicators (visited on 07/03/2019).

Bivens et al. *Report on Double Taxation. Submitted to the Financial Committee*. Tech. rep. Doc E.F.S.73 F.19. LoN.

United Nations Conference on Trade and Development. *FDI Statistics*. Online Database. URL: https://unctad.org/en/Pages/DIAE/FDI%20Statistics/FDI-Statistics.aspx (visited on 02/02/2020).