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Private Equity Investment in India

Foreign Private Equity investing in India through debt may provide new opportunities for the Mauritius jurisdiction

Last May, India signed the protocol amending the Double Tax Avoidance Agreement (DTAA) with Mauritius giving India the right to tax capital gains arising from sale or transfer of **shares** of an Indian company acquired by a Mauritian tax resident from 1st April 2017. Earlier, only Mauritius could levy tax on capital gains and since there is no capital gains tax in Mauritius, a large number of foreign entities routed their investments in India through Mauritius. In fact, between April 2000 and December 2015, Mauritius accounted for $93.66 billion or 34% of the total foreign direct investment of $278 billion in India.

At the same time, withholding taxes on interest have been lowered to a 7.5% tax rate. Therefore, while equity investments may need to factor in additional Indian tax costs, debt investments will likely get a boost from the treaty amendments. Indeed, the amendments made to Article 2 provides for a revision of the tax rate to Mauritius resident entities on interest arising in India, further stating that such streams of income shall be subject to withholding tax in India at the rate of 7.5% in respect of debt claims and loans made after 31 March 2017 – a rate which is more attractive than competing jurisdictions such as Cyprus (10%).

Last week India signed a new tax treaty with Cyprus and the 10% withholding tax in India on interest was not changed. According to experts, many private equity funds with investments in Indian real estate and infrastructure are looking to realign investments and shift base to Mauritius mainly to save at least 2.5% in taxes paid in India.

Securities, such as Compulsory Convertible Debentures (CCD), Non-Convertible Debentures (NCD) and other debt instruments, should not fall under the purview of 'shares.' As a result, sale of debt securities should continue to enjoy the Indian capital gains tax exemptions. This is an added incentive for debt investments. Coupled with a lower withholding tax rate, a tax friendly exit would certainly make debt investments and mezzanine debt a lucrative option for foreign investors.

Despite optimistic experts viewing CCD as still being eligible for claiming residence-based taxation, the 'quasi-equity' nature of a CCD increases the likelihood of such an instrument to subsequently fall under the capital gain provision, causing the source country to apply its taxation rights. The revised Article 13 of the Protocol would then seem to encompass any instruments, including derivatives, which have derived their capital gain value out of India.

NCD, on the other hand, have the clear advantage of being viewed as a 'pure debt' instrument, providing certainty that it will fall outside the ambit of Article 13 of the Protocol. The relaxation of the Indian Laws in 2012, allowing Private Equity Funds to invest in Rupee denominated Non-Convertible Debt (so long as these NCDs are listed on recognised stock exchanges in India), coupled with the new withholding tax regime for interest on debts, will provide excellent structuring opportunities for the Mauritian jurisdiction.

Investing in NCDs provides further appealing features for foreign investors:

- Guaranteed return on investment through interest and redemption at a premium. While the redemption at a premium can mirror the equity upside to the NCD holders, it remains to be seen and clarified whether redemption at a premium will be considered to fall within the provisions of Article 13 and therefore be taxed at source;
- Interest payments are a deductible expense for the borrower;
- Unlike dividends, which can only be paid out of retained earnings, interests may be paid out of any source of the borrower;
- It is a privileged instrument for developers in the real estate sector as they do not want to share or dilute their equity interest in the project;
- NCDs can be issued, with investors benefitting from corporate governance rights similar to that of equity, such as limited veto rights and board seats.

Foreign investors have been the primary source of capital for most private equity funds investing in India and are expected to thrive further. With the amended Protocol, foreign investors will be judiciously looking at the cost associated with investing in India via equity instruments. Investment in NCDs may provide a viable alternative.

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