Foreign investors begin flight from India's anti-avoidance rule (GAAR)

As expected, the Indian federal Government's new retrospective general anti-avoidance rule is frightening private investment funds away from their traditional base of Mauritius, according to press reports.

The anti-avoidance rule (GAAR) was announced in the federal Budget in March. It was clearly inspired by the Indian tax Authority's defeat in the Vodafone case, in which the Supreme Court accepted that Vodafone's disposal of an Indian operating business via the Cayman Islands and Mauritius companies exempted it from paying a US$2.2 billion capital gains charge.

The UK's Chancellor George Osborne has also expressed disquiet about the retrospective taxation of overseas investments, saying it could damage India's investment climate. India's economic boom is heavily dependent on foreign direct investment, which jumped by 13 per cent to US$51 million in 2011, according to figures released in January. The USA is the leading investor, followed by Japan and the UK.

Now some of these prophecies are coming true. Private Equity (PE) funds that invest in India are often domiciled in Mauritius, because the island has no Capital Gains Tax (CGT). But some now fear they cannot rely on the India-Mauritius double taxation treaty to exempt them from Indian CGT too.

Early de-campers are said to include 3i, the largest quoted PE firm in Europe. Its Mauritius arm was in the process of raising a US$1.2 billion fund for direct investment into India, but now it will take the fund to Singapore instead, according to insiders.

Other funds said to be preparing a change of domicile are CX Partners and Edelweiss Capital.

Several foreign institutional investors, including the big broker CLSA, have announced they will no longer offer participatory notes on India (so-called P-notes) from Mauritius, and will issue them from Singapore instead. India has a bilateral tax treaty with Singapore.

Previous week the Australian investment fund Macquarie also announced that it was cutting back its activities in India, thanks to the country's new tax policy. Instead of trading Indian securities and derivatives in India, the firm's Asia Alpha Fund will trade on the Singapore exchanges. It fears the fund might have to pay CGT on unrealised gains on derivatives.

Foreign investors in India have a standing guarantee against double taxation of their earnings, but the GAAR has put this in doubt. However, according to the Times of India, tax officials in India have now promised explicitly that foreign institutional investors will be immune to the GAAR, and will not have to disclose their clients to the Indian Tax Authority when paying CGT on gains.

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