

Mauritius issues regulations on substance requirements and computation of income for CFC purposes

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Executive summary

On 16 August 2019, the Mauritius Government issued the Income Tax (Amendment No. 2) Regulations 2019 (the Regulations). The Regulations set forth provisions on the following:

- a. Substance requirements insofar as it concerns the partial exemption regime (PER) introduced by section 35 (bc)(ii)(V) and (VII) of the *Finance (Miscellaneous Provisions) Act 2018* (FMPA 2018) and section 26 (ac) (ii)(B)(IV) of the *Finance (Miscellaneous Provisions) Act 2019* regarding certain income streams
- b. The computation of the income attributed to a Controlled Foreign Company (CFC)
- c. Substance requirements for a freeport operator or developer to benefit from the preferential tax rate of 3%

The Regulations are effective as from 1 July 2019.

Substance requirement in the context of the PER

The substance requirement is based on Action 5 of the Organisation for Economic Co-operation and Development (OECD)/G20 Base Erosion and Profit Shifting Project (BEPS) (*Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*). The PER only applies if all of the following requirements are satisfied:

- a. The company carries on its core income generating activities (CIGA) in Mauritius.
- b. The company employs, directly or indirectly, an adequate number of suitably qualified persons to conduct its CIGA.
- c. The company incurs a minimum expenditure (ME) proportionate to its level of activities.

Computation of income for CFC purposes

The taxable profit of the CFC should be computed in accordance with the *Income Tax Act* (the Act): the financial statements of the CFC are converted to the Mauritian Rupee (Rs) using the average exchange rate between Mauritius and the other country. Any future dividend income of the CFC that is subsequently included in the tax base of the Mauritian resident company is reduced by any income that has already been taxed under the CFC rule. The Regulations allow for a foreign tax credit (FTC) for any tax paid by the CFC.

Substance requirements for a freeport company taxed at the corporate rate of 3%

Irrespective of the size of the company, the corporate tax rate of 3% can only apply if the company employs at least five individuals and its yearly expenditure is at least Rs3,500,000.

Detailed discussion

Substance requirement for PER

The Regulations also provide the substance requirement in the context of the PER as it applies to: a Collective Investment Scheme (CIS); a Closed-end Fund; a CIS Manager; a CIS Administrator; an Investment Adviser or Asset Manager; a company engaged in reinsurance and reinsurance brokering activities; a company engaged in leasing and international fiber capacity; and a company engaged in the sale, financing arrangement, asset management of aircraft and its spare parts and aviation advisory services related thereto.

The PER only applies if all of the following requirements are satisfied:

- d. The company carries on its CIGA in Mauritius.
- e. The company employs, directly or indirectly, an adequate number of suitably qualified persons to conduct its CIGA.
- f. The company incurs a ME proportionate to its level of activities.

The Regulations specifically provide that a company may outsource any relevant activities to third-party service providers, provided all of the following conditions are met:

- a. The company is able to demonstrate adequate monitoring of the outsourced activities.
- b. The outsourced activities are conducted in Mauritius.
- c. The economic substance of service providers is not counted multiple times by multiple companies when evidencing their own substance requirements in Mauritius.

Insofar as the CIGA is concerned, the Regulations provide a list of activities that are supposed to be conducted by the company. The list is summarized below.

Interest income

Agreeing on funding terms, setting terms and duration of any financing, monitoring and revising any agreements, and managing any risks.

Income from ship and aircraft leasing

Agreeing on funding terms, identifying and acquiring asset to be leased, setting out the terms and duration of any leasing, monitoring and revising any agreements, and managing any risks.

Income of a CIS

Investment of funds in portfolios of securities, or other financial assets, real property or non-financial assets; diversification of risks; redemption on the request of the holder.

Income of a closed-end fund

Investment of funds collected from sophisticated investors, in portfolios of securities, or in other financial or non-financial assets, or real property.

Income of a CIS manager

Management of a CIS; taking decisions on the holding and selling of investments; calculating risks and reserves; taking decisions on currency or interest fluctuations and hedging positions; and preparing relevant regulatory or other reports for Government authorities and investors.

Income of a CIS administrator

Providing services with respect to the operations and administrative affairs of a CIS including accounting, valuation or reporting services.

Income of an investment adviser or asset manager

Advising, guiding or recommending to other persons, or holding himself out to advise, guide or recommend to other persons, whether personally or through printed materials or by other means, to enter into securities transactions; managing or holding himself out to manage, under a mandate, whether discretionary or not, portfolios of securities; giving advice on corporate finance advisory matters concerning securities transactions.

Income of a company engaged in reinsurance and reinsurance brokering activities

Predicting and calculating risk, reinsuring against risks, administrating clients' cell, providing related services, preparing regulatory reports, and providing clients technical advice in respect of reinsurance of liabilities.

Income of a company engaged in leasing and international fiber capacity

Agreeing on funding terms, identifying and acquiring capacity to be leased or otherwise provided, setting out the terms and duration of any leasing or right to use contracts, monitoring and revising any agreements, and managing any risks.

Income of a company engaged in the sale, financing arrangement, asset management of aircraft and its spare parts and aviation advisory services related thereto

Negotiating the terms of purchase and sale of aircraft and its spare parts, arranging for sale and leasing of aircraft, agreeing on funding terms and providing advisory services in aviation-related services.

The substance requirements on interest and leasing income from ships and aircrafts were the subject matter of Regulation 23D that was introduced by the Income Tax (Amendment No. 2) Regulations 2018, with an effective date of 1 January 2019 and have not changed.

Computation of income for CFC purposes

The CFC rule was introduced by section 26(r) of the FMPA 2019 and may apply where a Mauritian resident company carries on business through a CFC and the Mauritius Revenue Authority considers that the non-distributed income of the CFC arises from non-genuine arrangements that have been implemented for the essential purpose of obtaining a tax benefit.

An arrangement is considered to be non-genuine where the CFC would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it was not controlled by a company where the significant people functions, relevant to its assets and risks, are carried out and instrumental in generating the income of the CFC. "Tax benefit" is defined as the avoidance or postponement of the liability to pay income tax or the reduction of the amount of income tax.

For any year, the CFC rule does not apply under any of the following instances:

- ▶ The accounting profit is less than €750,000 and non-trading income is not more than €75,000.
- ▶ The accounting profit is less than 10% of its operating costs; for this purpose, operating cost does not include the cost of goods sold outside the country of residence and payments to associated enterprises.
- ▶ The tax rate in the country of residence of the CFC is more than 50% of the Mauritian tax rate.

Section 90A of the Act provides that a CFC is a company in which more than 50% of its total participation rights are held directly or indirectly by the Mauritian resident company. To determine the 50% threshold, the shareholding of associated enterprises should also be considered. Associated enterprise is defined as an entity or individual in which the Mauritian resident holds directly or indirectly a participation in terms of voting rights or capital ownership of at least 25% in the profits of that entity.

The Regulations provide that the income to be included in the tax base of the Mauritian resident company is limited to amounts generated through assets and risks linked to significant people functions carried out by the controlling company. The Regulations further provide the following:

- ▶ The income attributable to the CFC should be consistent with the arm's-length principle.
- ▶ The taxable income is determined in accordance with the Act.
- ▶ The financial statements of the CFC are converted into Rs based on the average rate between Rs and the reporting currency of the CFC.

The amount that is taxed under the CFC rule reduces the subsequent taxable dividend income from the CFC. Irrespective of the fact that the CFC may be resident in a country with which Mauritius has a tax treaty, the FTC applies to any foreign tax paid by the CFC.

Substance requirements for the 3% tax rate

Section 26(i) of the FMPA 2019 introduced a tax rate of 3% for a freeport operator or private freeport developer engaged in manufacturing activities in a freeport zone as from the year of assessment 2020/2021: the 3% rate applies to goods destined for the local market and is also subject to prescribed substance requirements. In that respect, Regulation 23F was inserted by the Regulations and provides that the 3% rate only applies if the company employs a minimum of five staff members and incurs annual expenditure of more than Rs3,500,000.

Implications

Substance requirements in the context of the PER

- a. The CIGA should not in itself be a burden for any business; it is in fact embedded in any business model and should logically precede the income in question.
- b. The CIGA is also a legal requirement for a holder of a Global Business License (GBL) further to the amendment made by section 29(q) of the FMPA 2018 to section 71 of the FSA; it was not a requirement of the FSA for a company with a Category 1 Global Business License. The CIGA for the purposes of the FSA applies to the company, notwithstanding the fact that the company may not apply the PER.
- c. With the amendment made by section 21(l) of the FMPA 2019 to section 71(3)(a) of the FSA, the CIGA requirement is the subject matter of the Act as from 25 July 2019. The Act does not define CIGA in the context of a company as a whole: compliance with the CIGA for the purposes of the income that qualifies for the PER does not necessarily imply that the CIGA for the purposes of section 71(3)(a) of the FSA are satisfied.
- d. The circular issued by the Financial Services Commission on 12 October 2018 was issued in the context of section 71(3)(a) of the FSA; with the amendment made by section 21(l) it has automatically been repealed.
- e. As the requirement for the CIGA to be in Mauritius applies to any Mauritian resident company, the PER may be denied for a domestic company if its underlying rationale is not understood. An entity may not have adequate resources at its disposal and a low level of recurrent expenditure: yet its CIGA is in Mauritius.
- f. A company can only demonstrate that it can monitor the outsourced activities, if it has the requisite resources and expertise to undertake such monitoring. "Monitoring" is, in itself, an activity that warrants a minimum skill and competence in the business in question.

Attribution of income for CFC purposes

- a. To determine whether an entity is a CFC, any indirect ownership should also be considered: furthermore, the 25% threshold to ascertain whether a person is an associated enterprise includes direct and indirect participation in terms of voting rights and capital ownership. Section 90A of the Act does not provide that the associated enterprises have to be resident in Mauritius so that the shareholding of any associated enterprises resident outside of Mauritius should also be considered.
- b. The treatment of tax losses has not been prescribed in the Regulations. This appears to be an oversight that should be addressed as soon as possible, unless it is clarified that the relevant portion of the tax loss can be utilized by the Mauritian resident company. The manner in which the CFC losses are dealt with is the subject matter of Chapter 5 of Action 3 of the OECD/G20 BEPS Project. The suggested approach is to allow CFC losses to be utilized against CFC profits to prevent manipulation of tax losses: further details on the manner of how the loss is utilized is provided at paragraph 103 of Chapter 5.
- c. The fact that the Regulations refer to income that is generated through the assets and risks related to significant people functions carried by the controlling company is subjective: this applies to the controlling company and not to the CFC. Furthermore, the Regulations provide that the attribution exercise should be based on the arm's-length principle: at the same time the Regulations provide that financial statements of the foreign company should be converted to Mauritian Rupee to compute the taxable profit of the CFC.
- d. The Regulations do not provide for cases where the Mauritian resident company submits its tax return in a foreign currency in Mauritius. This may for example be the case where the Registrar of Companies has agreed that the reporting currency can be a foreign currency under section 213 of the *Companies Act*.

- e. Foreign dividend income may qualify for the PER; under the Regulations it is the amount that is included in the taxable profits in a year of the Mauritian resident company that is reduced by the income that has already been taxed under the CFC rule in the previous years. To the extent, that the undistributed income of the CFC can only be repatriated by way of dividends, the application of the PER would imply that there will be the risk that income will be taxed more than once in Mauritius.
- f. It is not certain if the tax sparing credit would apply to the income attributed to a Mauritian resident company under the CFC rule. The Regulations refer to tax paid, but also provide that the FTC would be the subject matter of section 77 of the Act. The tax sparing credit is the subject matter of the FTC Regulations; the FTC Regulations do not qualify the income that may be eligible for the tax sparing credit.

Substance requirements for 3% tax rate

- a. The 3% tax rate does not apply to the provision of services.
- b. Unlike, the substance requirements for the PER, the Regulations do not appear to have any conditions on the duties of the staff members.
- c. The minimum level of expenditure of Rs3,500,000 appears to apply irrespective of the size of the company, which may have been determined in accordance with the turnover, number of employees or assets of the company. There also does not appear to be any conditions on the nature of the expenses the company has to incur to satisfy the threshold of Rs3,500,000.

For additional information with respect to this Alert, please contact the following:

Ernst & Young (Mauritius), Ebene

- ▶ Ryaad Owodally ryaad.owodally@mu.ey.com
- ▶ Aveenash Ramtohul aveenash.ramtohul@mu.ey.com
- ▶ Assad Khoosee assad.khoosee@mu.ey.com

Ernst & Young Advisory Services (Pty) Ltd., Africa ITS Leader, Johannesburg

- ▶ Marius Leivestad marius.leivestad@za.ey.com

Ernst & Young LLP (United Kingdom), Pan African Tax Desk, London

- ▶ Rendani Neluvhalani rendani.mabel.neluvhalani@uk.ey.com
- ▶ Byron Thomas bthomas4@uk.ey.com

Ernst & Young LLP (United States), Pan African Tax Desk, New York

- ▶ Brigitte Keirby-Smith brigitte.f.keirby-smith1@ey.com
- ▶ Dele Olagun-Samuel dele.olaogun@ey.com

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