Cross-Border Taxation in Transition: The India-Mauritius Protocol, Service PE and Transfer Pricing in a Disrupted World

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Introduction

India's cross-border tax landscape is undergoing a period of transition, with significant developments affecting how businesses and investors structure their operations and assess their tax exposure. Three distinct but converging developments illustrate this shift. Firstly, the long-awaited ratification of the protocol amending the India–Mauritius Tax Treaty is finally set to take effect, incorporating the Principal Purpose Test (PPT) into the treaty framework. Second, recent judicial rulings have reaffirmed the importance of physical presence in determining the existence of a Service Permanent Establishment (Service PE), declining to extend the concept to a virtual PE under the Tax Treaty, even as digital and remote service models become increasingly prevalent. Third, against this backdrop of evolving treaty interpretation, global economic volatility and continuing supply-chain disruptions are reshaping transfer pricing outcomes, testing the resilience of traditional arm's length benchmarking in an increasingly uncertain environment.

Although these developments arise in distinct areas: treaty entitlement, PE characterisation and transfer pricing, collectively, they illustrate the shifting contours of cross-border taxation. They also highlight the need for businesses to reassess their tax structures, treaty positions and transfer pricing policies in light of evolving judicial approaches, treaty standards and economic realities.

India-Mauritius Tax Treaty Protocol: PPT on the Horizon

On 7 March 2024, India and Mauritius signed an amending protocol (Protocol) to incorporate the BEPS minimum-standard anti-abuse measures into the India-Mauritius Tax Treaty. The Protocol:

(i) replaces the treaty preamble to clarify that the elimination of double taxation is not intended to create opportunities for non-taxation or reduced taxation through tax evasion, avoidance or treaty shopping; and

(ii) introduces a new "Entitlement to Benefits" article containing the PPT, under which tax treaty benefits may be denied where obtaining those benefits is one of the principal purposes of an investment or transaction, unless granting the benefits would be in accordance with the object and purpose of the relevant treaty provisions.

Notably, Mauritius has pursued a bilateral route to implement these changes. Although India and Mauritius are signatories to the Multilateral Instrument (MLI), Mauritius did not designate the India-Mauritius Tax Treaty as a 'Covered Tax Agreement' under the MLI. Consequently, the MLI does not apply to this treaty.

Reportedly, Mauritius deferred ratification of the Protocol following concerns raised by stakeholders and investors in Mauritius and India regarding its potential impact on existing treaty benefits, including the scope and temporal application of the PPT. The highlights of the Mauritian Cabinet meeting held on 17 July 2026 record that India had assured Mauritius that it would not take action undermining Mauritius' benefits under the India-Mauritius Tax Treaty, and that a subsequent clarification by the Indian authorities was favourable to Mauritius.

This development marks an important step towards ratification. However, the Protocol provides that it will enter into force only on the date of the later notification by India and Mauritius confirming completion of their respective domestic procedures. Accordingly, the Protocol's effective date remains contingent upon the completion and exchange of these notifications.

Once in force, the PPT is likely to increase the importance of demonstrating commercial substance, appropriate governance and decision-making, genuine funding arrangements and contemporaneous documentation for Mauritius-resident taxpayers seeking treaty relief in India. The focus is likely to extend beyond the formal legal structure of an investment or transaction to the commercial rationale and circumstances surrounding it.

For the tax authorities, the Protocol provides a broad treaty-based anti-abuse mechanism to challenge arrangements that fall within the PPT. For the taxpayers, it increases the importance of demonstrating that access to treaty benefits is consistent with the object and purpose of the relevant treaty provisions, and is not principally driven by obtaining a tax benefit.

Service PE in the Digital Age: Presence Still Matters

The traditional framework for taxing the cross-border transactions of multinational enterprises rests on the concept of physical presence, referred to as 'Permanent Establishment' (PE) in the international taxation parlance. Where an enterprise conducts its business through a PE situated in another country, the profits of that enterprise attributable to such PE become taxable in that other country.

In the Indian context, several of India's tax treaties, including those with the United States, the United Kingdom and Singapore, contain a Service PE clause. These provisions are generally triggered when services are furnished within the source state through employees or other personnel for a specified threshold period. This wording is deliberate, and distinct from the Fixed Place PE test, which requires control and disposal of premises rather than the physical presence of personnel. The reference to services being furnished "within a Contracting State" through "employees or other personnel" contemplates the actual rendition of services in India by personnel physically present there, importing a physical nexus rather than a virtual or economic one. On this interpretation, the provision establishes a territorial nexus based on physical presence, rather than a virtual or purely economic nexus.

This distinction has assumed greater significance as technology has transformed the delivery of cross-border services. Employees can now provide services remotely through email, videoconferencing and digital collaboration platforms, without travelling to or maintaining a physical presence in the customer's jurisdiction. This raises a fundamental question: can such remote activity, in the absence of physical presence in the source state, constitute a Service PE under the existing treaty language?

This question has now been addressed twice in quick succession. In CIT vs. Clifford Chance Pte Ltd,[1] the Hon'ble Delhi High Court dismissed the tax department's appeal and held that Article 5(6)(a) of the India-Singapore tax treaty contemplated the rendering of services by employees present within the source country (i.e. India in this case). The Court held that Article 5 of the Treaty requires services to be 'furnished within' the Contracting State through employees 'present' in that state. It further observed that the concept of a 'Virtual Service PE' finds no place in the tax treaty and that courts cannot introduce new concepts into a treaty merely to bridge gaps caused by technological developments.

More recently, the Hon'ble Income Tax Appellate Tribunal (Tribunal) followed the Delhi High Court's decision in Ernst & Young (EMEIA) Services Ltd vs. ACIT,[2] rejecting the tax department's attempt to tax a UK enterprise on the same Virtual Service PE theory. The Tribunal reaffirmed that physical presence of employees or personnel remains a sine qua non for constituting a Service PE, regardless of how services are actually delivered.

In a digitally enabled economy, insisting on physical presence to trigger a Service PE may appear outdated. However, this is ultimately a matter of policy and treaty design, rather than one for judicial expansion of the treaty text. If the existing threshold no longer adequately captures modern modes of service delivery, the issue must be addressed through the applicable legal framework, including treaty negotiations or domestic legislative measures, subject to the limitations imposed by applicable tax treaties.

India has, in fact, already sought to address this gap through domestic legislative tools and introduced the provisions of Significant Economic Presence (SEP) to capture non-residents' digital footprints. However, the courts have consistently held that unilateral amendments carried out in domestic tax laws cannot override tax treaties.

Impact of Global Distress and Disruption on Transfer Pricing

While the Protocol and Service PE are concerned with whether treaty entitlement or a taxable presence exists in the first place, transfer pricing addresses the next logical question for international businesses: once a taxable presence or related-party transaction exists, how should the associated profits be measured? Global disruption, whether arising from geopolitical conflict, sanctions or supply-chain volatility, does not alter this threshold analysis, but it can materially affect the economic circumstances against which the arm's length price (ALP) is tested. In this sense, transfer pricing forms the third strand of the same broader theme running through this article: that substance, evidence and actual economic reality, rather than form, continue to influence tax outcomes across each stage of the cross-border tax analysis.

Under section 92C of the Income-tax Act, 1961 (corresponding to section 165 of the Income-tax Act, 2025), ALP is to be determined by applying the most appropriate method, having regard to the nature and circumstances of the transaction, the functions performed and other relevant factors, including the economically relevant characteristics of the transaction. Rule 10B of the Income-tax Rules, 1962 (corresponding to Rule 79 of the Income-tax Rules, 2026) requires, inter alia, consideration of functions performed, assets employed, risks assumed, contractual terms and market conditions. Accordingly, disruptions such as sanctions, international route closures, higher freight costs, energy-price shocks, tariff changes or loss of access to a market may constitute material differences affecting prices or profits.

1 [2025] 181 taxmann.com 254 (Delhi)
2 Ernst & Young (EMEIA) Services Ltd v ACIT, [TS-440-ITAT-2026(DEL)]

The Middle East crisis, including disruption and heightened security concerns surrounding the Strait of Hormuz, illustrates this issue. The Strait is a critical transit corridor for crude oil, liquefied natural gas, petrochemicals and bulk commodities. Disrupted shipping, increased war-risk insurance, higher freight costs, longer transit periods and elevated inventory-carrying costs may affect multinational enterprises across integrated supply chains. Businesses may respond by diversifying sources, holding additional inventory, changing procurement arrangements or relocating manufacturing. Although these measures may be temporary, they can alter the functions performed, assets employed and risks assumed (FAR) by group entities and must be reflected in the transfer-pricing analysis. For transfer-pricing purposes, the immediate questions would be: (a) which entity bears the higher fuel, freight, insurance, inventory-holding and rerouting costs; (b) whether the costs are temporary or structural; and (c) whether independent parties would have adjusted prices, delivery terms, volumes or payment terms in comparable circumstances.

There is no official guidance from the tax authorities on the transfer pricing analysis to be undertaken by multinational enterprises to address the issues that may arise or be exacerbated by prevalent global conflicts. However, the OECD's Guidance on the transfer pricing implications of the COVID-19 pandemic throws some light on the steps that can be undertaken by a taxpayer to minimise the risks arising from global level events like a pandemic. The guidance asserts that the arm's length principle remains robust during extreme economic conditions but requires pragmatic adaptations to address the information deficiencies.

First, MNEs may rely on the reasonable commercial judgment supported by contemporaneous information when determining an arm's length price, particularly where reliable comparable data is unavailable or becomes available only after the relevant period. Taxpayers should document available market evidence, including the impact of disruptions on demand, supply chains and industry conditions. Second, where feasible, authorities may permit an outcome-testing approach, allowing enterprises to use information that becomes available after the financial year-end to determine arm's length results. This may include mechanisms such as corresponding adjustments or amendments to tax returns, where permitted, to ensure that transfer pricing outcomes reflect the prevailing economic conditions and commercial realities.

Conclusion

These developments collectively signal a maturing, yet more demanding, cross-border tax environment. The Protocol rewards genuine commercial rationale over treaty shopping, while judicial precedents in the context of Service PE confirm that the tax treaty's text governs the scope of taxing rights. The transfer pricing implications of global distress and disruption reinforce the same theme, requiring taxpayers to substantiate, through contemporaneous evidence and economic analysis, that pricing outcomes reflect actual commercial conditions rather than assumed or historical norms.

As cross-border tax rules continue to evolve at the intersection of treaty interpretation, digital transformation and global instability, businesses that invest early in substance, documentation and governance will be better placed to navigate this shifting landscape and minimise the risk of tax controversy and tax litigation.

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