INTERNATIONAL TAXATION IN INDIA - RECENT DEVELOPMENTS & OUTLOOK (PART - II)

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OUTLOOK FOR 2017-18

Introduction

Necessary steps have been taken in the recent past to gain confidence of the investors over Indian tax system and implementation of tax laws. The tax issues are foremost in the mind of the investors, both domestic/international, and confidence in the Indian economy will get dampened by adverse tax environment in the country.

Over the past few years, the government has improved its engagement with taxpayers and have also provided clarity on various controversial issues. The present economic and global environment offers huge opportunity to the government and the budget for 2017 can be a platform for the government to announce and implement long term systematic reforms that could also assure stability, certainty and predictability in the Indian regime. There are various controversial issues which can be revisited and revised in order to provide taxpayer friendly and effective policy implementation.

In the backdrop of developments of year 2016, both at India and outside India, economic activities in year 2017 will have many tax issues that would require adequate consideration. We have provided in the subsequent paragraphs, a broad overview of tax issues and challenges for selected activities/transactions.

A. Cross Border M&A

Introduction

- Tax issues arise in cross border deals when two different jurisdictions seek to tax the same sum of money or income or the same legal person thereby resulting in double-taxation. Many countries are aware that double taxation acts as a disincentive for engaging in any cross border trade or activity. Therefore, with the primary view to encourage mutual cooperation, trade and investment, the countries enter into bilateral Double Taxation Avoidance Agreements ("DTAA") to limit their taxing jurisdictions voluntarily through self-restraint.

- The availability of such benefits and the ultimate tax liability often drives or breaks cross border transactions. Particularly in the Indian context, where the tax administration is perceived to be aggressive and the laws uncertain, any protection offered by a treaty jurisdiction is important. It is important for the buyer in the context of whether there is any withholding obligation while making a remittance to the seller.

Diagram Explaining Cross Border M&A

- The Diagram below depicts a Cross Border M&A where a Foreign company and domestic company expands its operations by merger/acquisition

Provisions for Cross-border Mergers

- The merger of two foreign companies involving the transfer of shares of an Indian company, is normally tax exempt provided that the merger satisfies the criteria for an amalgamation and, at least 25% of the shareholders of the merging company remain shareholders in the merged company, and such transfer does not attract capital gains tax in the country in which the merging company is incorporated.
- The demerger involving the transfer of shares of an Indian company by a demerged foreign company to the resulting foreign company is also tax exempt provided that,
  - The shareholders holding not less than 3/4 of the shares in the demerged foreign company remain shareholders in the resulting company and
  - Such transfer does not attract capital gains in the country in which the demerged foreign company is located. The merger of an Indian company with a foreign company is also tax exempt, provided the resulting company is an Indian company.

Current/Likely Tax Issues

- India now levies a tax on the gains arising on the transfer of shares or an interest in a foreign company, if the share or interest derives its value substantially from assets (tangible or intangible) located in India. This tax on indirect transfers of Indian assets is one of the most important tax challenges that investors will have to factor.

- **Withholding Tax**
  The Finance Act, 2016 has introduced a tax at the rate of 10% on dividends in excess of INR 1 million (approx. USD 15,000) declared by a domestic company and received by a resident individual, LLP or partnership firm. This is in addition to the DDT paid by the distributing company. Such tax will affect the ability of non-residents to claim foreign tax credit in its home jurisdictions on DDT paid by the distributing company. The normal withholding tax rate on royalties and fees for technical services is 10%, and lower rates may apply if provided for in a tax treaty.

  Under Section 195 of the ITA, any person making a payment of a sum to a non- resident that is chargeable to tax under the ITA (read with relevant provisions of the applicable DTAA) would be required to withhold tax on such sum at the appropriate rate. Such withholding is required to be made either at the time of payment or at the time of credit of income to the account of the non-resident. However, if the amount paid is not taxable in India, there is no requirement to withhold tax on such payments. However, if the amount paid has an element of income that is taxable in India, then even a non-resident who making such remittance is obligated to withhold as per the ITA.

- **Credit for Taxes**
  The normal withholding tax rate on interest is 40%. However, more beneficial rates (ranging from 5% – 20%) of withholding are available to non-resident creditors depending on the nature of the security involved, the status of the non-resident creditor, etc.

- **Treaty Benefits**
  India levies a tax on capital gains arising from the transfer of an asset located in India. In the case of capital gains arising from the transfer of shares of an Indian company, the tax on such gains is typically eliminated through the use of structures involving a Mauritian or Singaporean holding company, since under the provisions of erstwhile DTAAs in place between India and the aforementioned countries, subject to certain criteria being fulfilled (e.g., absence of a permanent establishment in India) only the country of residence of the transferor is entitled to levy a tax on capital gains arising from the transfer of shares of an Indian company, and importantly, these countries do not tax capital gains.

- **LOB Article**
  In certain scenario, eligibility to claim relief under a DTAA may be conditional upon the satisfactions of certain "substance" requirements. For example, the India- Mauritius/Singapore DTAA incorporates a "Limitation on Benefits" clause, which requires a Mauritius/Singapore resident company to demonstrate the following, before it can claim benefits under the DTAA. The primary purpose of its incorporation in Mauritius/Singapore should not be to take advantage of the treaty benefits. It should not be a shell/conduit company and it must have bona fide business activities. It will be deemed not to be a conduit company if: Its total annual expenditure on operations in Singapore is at least $200,000 during 2 years prior to share transfer, or it is listed on a stock exchange in Singapore.

B. Foreign Portfolio Investor (FPI)

Introduction

- In the year 2016, considerable developments have taken place on the Foreign Portfolio Investors ("FPI") front. There have been changes to the norms governing FPIs that have impacted the permitted investments by them in India.
- The changes/amendments made in DTAAs & Indirect Transfer rules, the Foreign Portfolio Investors are expected to face challenges, whereby making them liable to pay higher tax.

Diagram Explaining how Foreign Portfolio Investor (FPI) invest in India

- Foreign Portfolio Investors (FPI) makes investments in India by acquiring shares/assets of the Indian company, Know-how, Technology & Management etc and earns by the way of Profit, Royalty & Fees.

Current/Likely Tax Issues

- **Clarification on Indirect Transfer of Shares:**
  A High Level Committee to be constituted which would be chaired by Revenue Secretary and will consist of CBDT chairman and an expert from outside to oversee fresh cases where assessing officer applies retrospective amendment in relation to indirect transfer of shares. However, the CBDT constituted a working group on 15 June 2016, after it received queries about indirect transfer provisions raised by offshore funds registered as FPIs. After considering the comments of the working group, CBDT issued clarification through a set of 19 questions and answers depicting various scenarios under which offshore

funds may have invested in companies in India. For example, in case a fund is set up in an offshore jurisdiction pools money from retail/institutional investors and invests in shares of Indian listed companies, if the fund on request of its unit holders/shareholders, redeems their units/shares, then CBDT clarified that it will be liable to pay taxes in India.

- **Treaty Amendments:**
  Recently India has also amended the DTAA with Mauritius and Singapore. While this allows India to tax capital gains on investments in the nature of shares, made by an FPI, this will not impact investments made by them in debentures & derivatives in India.

  However, further rationalization can be done by the government with respect to the taxation of derivatives; FPIs should be given the option of categorizing their income from derivative transactions as business income, if this is more beneficial to them. The short-term capital gain tax on derivatives should be made on a par with that on equities.

  Under the Indian income tax law, shares of listed Indian companies held by FPIs are deemed to be capital assets irrespective of the holding period or the frequency of trading equity carried out by the concerned FPI. As such, income from sale of shares results in capital gains and at present, FPIs enjoy the benefits of the capital gains provisions under the Singapore Treaty. Since investments until March 31, 2017 have been exempted from capital gains tax, there is no risk of an immediate outflow of funds. However, the amendment impacts all prospective investments with effect from April 1, 2017.

  As per the amended India – Mauritius treaty, FPIs (including P-note holders) who invest in securities listed on the Indian stock exchange but exit before 12 months from the date of purchase will be impacted since they will be required to pay short term capital gains tax in India @ 15%. During the transition period (i.e. during 01.04.2017 to 31.03.2019), and subject to the satisfaction of the limitation of benefits clause, this rate may be reduced to 7.5%. However, gains accruing to the investors who invest in listed securities for more than 12 months will continue to remain exempt since long-term capital gains tax from sale of listed securities is exempt in India, where the transaction is effected on Stock Exchange in India.

- **General Anti-Avoidance Rules:**
  The Finance Minister announced in his budget speech that General Anti-Avoidance Rules (GAAR) will be effective from April 1, 2017. The current Rules contain subjective tests around commercial substance, main purpose, misuse / abuse, etc.. As per the Memorandum to the Finance Bill, 2015, investments made up to March 31, 2017 would be protected from the applicability of GAAR provisions.

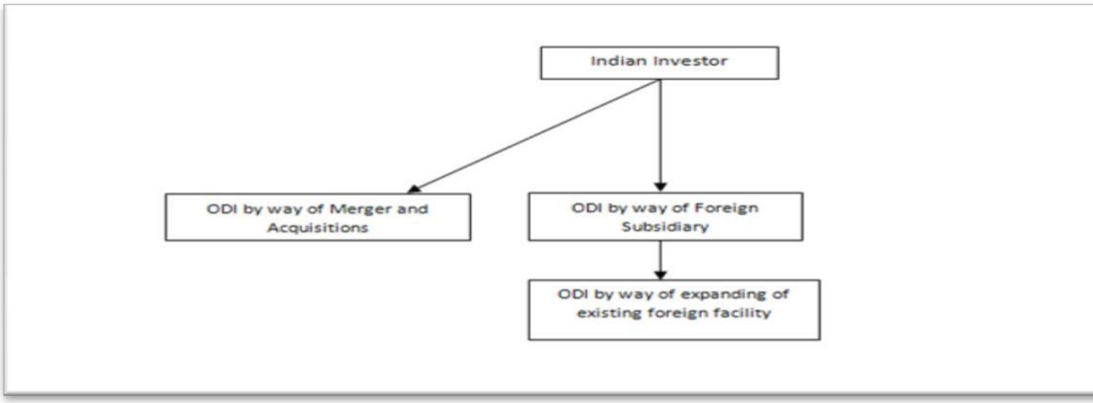
C. Outbound Investments

Introduction

- Outbound investments from India have undergone a considerable change not only in terms of magnitude but also in terms of geographical spread and sectoral composition. Analysis of the trend in direct investments over the last decade reveals that while investment flows, both inward and outward, were rather muted during the early part of the decade, they gained momentum during the latter half.
- There has been a perceptible shift in Overseas Investment Destination (OID) in last decade or so. While in the first half, overseas investments were directed to resource rich countries such as Australia, UAE, and Sudan, in the latter half, OID was channelled into countries providing higher tax benefits such as Mauritius, Singapore, British Virgin Islands, and the Netherlands.
- Indian firms invest in foreign shores primarily through Mergers and Acquisition (M&A) transactions. With rising M&A activity, companies will get direct access to newer and more extensive markets, and better technologies, which would enable them to increase their customer base and achieve a global reach.
- For countries like India, which have exchange control restrictions and tax their residents on worldwide income, the relevance of an Offshore Holding Company (OHC) is very significant. An OHC gives an Indian company sufficient amount of flexibility and speed in structuring and expanding its overseas operations by setting up subsidiaries or joint ventures in other jurisdictions.

Diagram depicting Outbound Direct Investments

- The Diagram below depicts a typical Outbound Direct Investment where a domestic firm expands its operations to a foreign country either via a Foreign Wholly Owned Subsidiary, merger/acquisition and/or expansion of an existing foreign facility.



Current/Likely Tax Issues

- **Credit for Foreign Tax**
From taxation point of view, direct investment from India completely distorts the dividend repatriation back into India. In many cases, only 40 to 45 percent of the earnings of the foreign company are available to the Indian parent. There is double taxation of the same income: once in the hands of the foreign company and then in the hands of Indian company. In order to address such situation, many countries and tax treaties allow tax credit for the corporate taxes paid on profits in the country of source against taxes payable on dividends in the country of residence of the recipient company. Under these provisions, the recipient of dividend could claim tax credit, for taxes paid in the other countries by the subsidiary companies on profits from which such dividends are distributed. Such tax credit is known as "underlying tax credit". Underlying tax credit is over and above tax credit for taxes withheld on dividend distributed by the subsidiary companies. It reduces the final tax incidence by eliminating double taxation of the same income in the country of source as well as residence. Since underlying tax credit is not available in India, except under some tax treaties like India - Mauritius, the net result is higher incidence of tax.

  As per existing provisions of the Income Tax Act, 1961 ("ITA"), income of an Indian company is subject to tax at the rate of 30% in addition to 3% cess, subject to 12% surcharge if income exceed 1 crore.. Therefore dividends received by an Indian company from an overseas company will be subject to tax in India at the rate of 30% in addition to 3% cess, subject to 12% surcharge if income exceed 1 crore. ITA does not provide for underlying tax credits, however, an Indian company could claim such underlying tax credit if the double taxation avoidance agreement ("DTAA") that India has entered into with the country of residence of the company paying such dividends provides for the same. Indian company can claim tax credit in India for the taxes that have been withheld by the foreign company on such distribution. Long- term capital gains realized by an Indian company from sale of shares of a foreign company will be subject to tax in India at the rate of 21%, whereas short-term capital gains would be subject to tax at normal corporate tax rates of 30% in addition to 3% cess, subject to 12% surcharge if income exceed 1 crore. As such, there is no golden rule for a preferred structure for outbound investments as it depends on the country in which the investment is sought. However, countries like Mauritius, U.K., and Netherlands etc. are close contenders for location of OHC out of India for holding investments worldwide.

- **Place of Effective Management**
The parties most impacted by the amended PoEM rule shall be Indian individuals and companies which have set up foreign JV's and or WOS and routinely take decisions for such entities from India, also affected will be groups where the executives of the Indian entity are also on the board of the foreign subsidiary. These companies shall soon see that their legitimate foreign companies are now deemed to be Indian residents and are subject to taxation in India, this imposes a huge cost in the form of taxes (incomes of foreign companies are taxable at 40% in India) on such companies and the group as a whole.

  The consequence of this provision, unless amended or clarified, is going to be a large uptick in tax disputes, where the department will invariably look at a foreign entity owned by Indians and tax it at the maximum marginal rates. That there is no established jurisprudence on this matter in India also means that litigation on this matter will only increase. Start-ups and established Indian players have few options by way of recourse, one option would be to decouple ownership and management/Control and ensure that such management is situated only outside of India and no overlaps exist. This is easier said than done and will certainly be a challenge for all businesses looking to go global.

D. Payment to Foreign Collaborator

Introduction

- The globalisation of economic reforms throughout the world has led to an increasing degree of inter-dependence between countries in the field of technology, manpower, finance, etc. The Indian economy too has been and is continuing to be liberalised by successive Governments through the mode of reducing custom duties and of other levies, relaxing foreign exchange regulations and by encouraging boost in exports.
- The survival and growth of the industrial sector depends to a great extent upon technological advancement. This is possible through collaborations with developed countries to import their expertise and aid. While drafting foreign collaboration agreements both parties have to necessarily take into consideration the tax laws in the respective countries.
- This is necessary so as to ensure, on the one hand, that the statutory requirements under the various tax laws in India and the other country are met, as also, on the other hand, to minimise the burden of tax which falls on the income, profits and gains arising from the collaboration.

E. Sensitivity Analysis

The Table below summarizes the sensitivity analysis on the identified economic activity having regard to the relevant provisions of Income tax law

Parameters	Provision of GAAR	Impact of BEPS	Provision of Treaty	Impact of POEM	Transparency and Exchange of Information
Cross Border M&A	High	High	Moderate	High	High
Foreign Portfolio Investors	High	Moderate	High	Low	Low
Outbound Investments	Moderate	High	High	High	High
Payment to Foreign collaborator by way of Dividend, Royalty and Fees for technical service	Low	Moderate	High	High	Moderate
Financing by way of Debt	High	High	High	Low	High
Provision on Indirect Transfer	High	High	Low	High	High

Conclusion

The government has announced number of initiatives that will change the future of the investment, tax and regulatory landscape in India. The opening up of the commodities market to institutional investors and permitting of FPI investments in unlisted debt securities as well as securitized debt instruments are being actively considered.

We can expect from the government further steps in this direction of providing the adequate direction and certainty in tax policy/regulation &it's implementation. Budget 2017 would offer one opportunity to government in this regard. In the post BEPS environment, MNEs would welcome unambiguous, transparent & clear tax rules and policy from the government. Such positive steps by the government will further support its ambitious and inclusive growth oriented schemes like Make in India, Digital India, etc.