Inbound-Outbound Investments from India - Practical Issues and Experiences

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Introduction

In order to sustain competitive advantage amidst the rising competition, the corporates are compelled to structure their business in the most efficient manner. When the multinationals look at business opportunities beyond the boundaries of their countries, they are faced with the crucial question of structuring. This is where the professionals like us can offer our expertise and guide the corporates in putting together a structure, which is tax-optimum and legally compliant.

Tax systems are neutral when they do not influence the economic choices of the taxpayers on cross-border transactions[1]. They may be tax neutral either on capital export or on capital import. The developed countries tend to favour capital export neutrality, under which the taxpayers' choices between investing at home and abroad remain unaffected (i.e. world efficiency). On the other hand, the developing countries generally prefer capital import or competitive neutrality to ensure that the investment decisions of domestic and foreign investors in their country are on par (i.e. national efficiency).

It is common in cross-border structuring to use offshore financial centers. These offshore centers allow taxpayers to form tax-beneficial intermediary entities in a foreign jurisdiction.

[1] International Tax Planning by Roy Rohatgi

They can serve a wide range of business objectives. They may be used either as a "treaty haven" or conduit in a country with a treaty network or as a "base haven" for capital accumulation in a low-cost and tax-beneficial offshore center.

The global flow of capital, investment and trade in a fast changing world today requires businesses to respond quickly to meet international competition, and to exploit emerging opportunities. Onshore set-ups have various limitations that restrict their ability to react quickly to these international market changes. The offshore industry fulfils this international business need, and has witnessed rapid growth in recent years. Over half the world's financial transactions today take place offshore and this trend is likely to continue. Besides tax mitigation, flexibility and speed of operation are the prime considerations in devising an offshore structure.

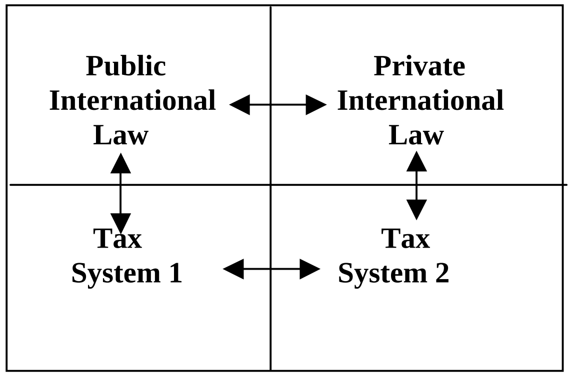
Business Structuring

What is business structuring? It is a conscious effort to structure one's business. 'Structuring' could be either by way of construction or by fracturing. Structuring means construction of one or more layers of structures or routes to make a transaction more efficient. Whereas fracturing could mean breaking up a single transaction into several small parts to make the whole structure more efficient. While structuring an international or multi-jurisdictional transaction, care should be taken to avoid double taxation. Double taxation has been defined as "the imposition of comparable taxes in two (or more) states on the same tax payer in respect of the same subject matter and for identical periods"[2]. The main reason for the double taxation to occur is that the taxpayer is a resident in one country but has his source of income in the other country. Double taxation could also arise if the taxpayer is resident in more than one country or has source of income in more than one country. Different countries use different criteria for taxation e.g. residence, control and management, source, situs of property, domicile, etc. For these reasons, it becomes essential to use and to ensure that the taxpayer is entitles to the benefits of DTAA between the countries involved in the transaction.

The structuring of a transaction could be influenced by tax as well as non-tax factors. Before commencing the act of structuring any international transaction, it is very important to build up database of general information regarding tax and business laws and practices in foreign countries. The database could consist of facts of the proposed transaction and business and relevant circumstance. It should also consist of the domestic internal tax systems of the countries involved in the transaction and the manner in which the general rules embodied in such systems are affected by the juxtaposition of the other systems. It may also be necessary to include some non-tax factors like exchange controls, political environment, investment incentive programmes, legal systems etc. in the database.

While structuring a transaction, one has to keep a number of factors in mind. This can be explained by way of the following matrix :

[2] OECD Model Convention (1977) and UN Model Convention (1980)



As one may observe from the above, for structuring any international transaction, one must understand the basic concepts of Public and Private International Law as they influence the international transactions and interpretation of international agreements. It is also important to understand the domestic tax systems of both or all the countries which are involved in the transaction.

The Indian tax system provides for unilateral as well as DTAA relief in respect of foreign taxes suffered by Indian residents. The DTAAs provide tax relief wither by tax exemption or by way of tax credit. Under such DTAA arrangements, to the extent one of the countries say, the country of source of income gives up its right to levy tax on such income, by exemption from tax, reduction of withholding tax or through a refund of an imputation credit, the other country i.e. the country of residence gains at the cost of the country of source.

What is globalization?

Global or international business means business activities that cross national boundaries, whether they be movements of goods, services, capital, or personnel; transfer of technology, information, or data; or even the supervision of employees. The globalization of business is nothing but a business response to the globalization of markets as products and factors of production become increasingly mobile, less country specific.

Strategies for Globalization[3]

A strategy can be defined as an element in a consciously devised overall plan of corporate development that, once made and implemented, is difficult (i.e. costly) to change in the short run. An organizational vehicle or the “the decision circle”, is simply an interrelated set of strategic choices forced upon any firm faced with the internationalization of its markets. This internationalization of markets forces a company to devise its own strategies for globalization or internationalization of its business. These strategies can be broadly classified as:

1. Basic Strategies
2. Input Strategies
3. Structural Strategies

[3] Internationalization of Business: An Introduction – Richard D. Robinson

These strategies can be further broken down to more elementary strategies. These elementary strategies and the factors that need to be considered while formulating them are as follows:

1. BASIC STRATEGIES

(a) Marketing strategy

- *Substance of marketing* - What the firm intends to market? Only goods or goods along with the services. In the foreign markets, the return to be realized from the sale of services, valuable rights, used machinery, and investible funds (for debt or equity in a portfolio sense) may be substantially greater than the profit to be made on the export of goods.
- *Marketing Target (Geographical)* - How do you target the market you want to cater to? There are two ways to doing it. One, from a list of detailed market analysis of different national markets, eliminate those markets with which the domicile country does not have favorable accord and the government has imposed certain trade restrictions. Second, try to enlist the range of goods, rights, and services within the firm's capability and attempt to relate to the market of each to certain aggregated national statistical measures like the GNP, Income parity, Degree of socialization, etc.
- *Study and penetration of selected market* - Market Research is an important method to get a feel of the demand for your company's products. Various methods for on-site market surveys are:

1. Measuring response to exhibition at local trade fairs, professional meetings, etc.
2. Sampling customer response by questioning
3. Pre-testing the market via free samples or a concerted sales effort for a short period of time
4. Consulting other market analysts or other experts

- *Time horizon for determining the return from overseas venture* - It is important to decide on a time horizon that the company will use in determining the return from company resources committed to the exploitation of that market. If period is short, a minimum resource commitment is justified for doing the market research.
- *Choice of channels to reach a foreign markets* - While making a decision, the following issues need to be considered:
    1. Availability of export skills within the organization
    2. The likelihood of eventual assembly or manufacture within the Country X
    3. The possibility of supplying Country X from a third source, and
    4. The cost of developing internal exporting expertise
- *Pricing* - Three alternative pricing strategies:
    1. Standard Worldwide Price - The standard worldwide base price is most likely to be looked upon by management as full-cost pricing, including an allowance for manufacturing overhead, general overhead, and selling expenses.
    2. Dual Pricing - Different pricing for domestic and export market. Generally, export pricing is lower than the domestic market as marketing cost are external to the company.

3. Market-Differentiated Pricing - Head office can set a price floor and the local management free to price beyond that.
4. Transfer pricing and dumping restraint - Transfer pricing norms should be considered for tax purposes and also the antidumping legislations should be carefully assessed.

(b) Sourcing Strategy

- *Trade relationships of the target market with other markets of the world* – It is important to know the trade relationships between the target market and other countries from which that market might reasonably be supplied. For e.g. most-favored-nation (MFN) status, exporters' clubs like The Hague Club, defense group like North Atlantic Organization (NATO), regional cooperation for development like South Asian Association for Regional Cooperation (SAARC), etc.
- *Acquisition of facilities and existing player in the market* - The facilities in the target market can be acquired either through a joint venture or merger or takeover. However, careful assessment of prevailing anti-trust laws and laws relating to acquisitions is needed.

(c) Labor Strategy

- Attracting the best talent in the industry and matching the local standards
- Training and development
- Deputation of staff from the domestic market

2. **INPUT STRATEGIES**

(a) Managerial Strategy

- *Selection of overseas management* - Two important decisions:
    1. Prerequisite of nationality: If cultural distance is perceived as significant, parent corporation may prefer to install its own people abroad.
    2. Validation for individuals: How does one increase the probability of selecting an individual who will perform most effectively in a different culture?
        - Preparation for overseas assignment
        - Promotion of overseas management
        - Remuneration
        - Selection of Managerial style

(b) Ownership Strategy

- Varieties of ownership i.e. 100 percent ownership versus joint venturing versus contracting
- Assets owned by the international firm
- Assets owned by the local firm
- Selection of foreign associates

(c) Financial Strategy

- Choice of profit center whether a function, product, division, subsidiary or the entire corporation
- Profit route - through transfer pricing
- Investment centers- may or may not coincide with the relevant profit center
- Type of financing - debt, participating debt, convertible securities and shares in equity. Multinational debt could be parallel financing, unit-of-account financing, and the Eurocurrency loan.
- Substance of investment - if investment could be in the form of cash, services intangibles, or real estate. For the purpose of capitalization in a foreign enterprise, which exchange rate should be used, a free rate or a controlled rate?
- Sources of financing - Choices are (i) national origin i.e. local, parent country, third country, or a mix of these (ii) multinational and (iii) the choice between debt and equity in each case.
- Legal instrumentality to be used- holding companies for tax planning and for incorporating an additional shield to protect the parent company.
- Protecting claims on earnings stream - Managing risks :
  - *Political risk*
  - *Currency related risk*

3. STRUCTURAL STRATEGIES

(a) <u>Legal Strategy</u>

- *Corporate legal organization* - Depending upon local law, alternative types of legal organizations are :
  - *Branch*
  - *Partnership*
  - *Limited partnership*
  - *Limited partnership with shares*
  - *Cooperative*
  - *Closed corporation*
  - *Public corporation*
  - *Business trust*
- *Antitrust laws*
- *Protection of valuable rights*
- *Tax law* - Several factors such as :
  - *Aggregate level of taxable income*
  - *Burden on the firm/company*
  - *Taxation of capital gains*
  - *Type of income*
  - *Progressiveness of corporate tax*
  - *Dual corporate taxation*
  - *Purpose of taxation*
  - *Inobservance*
  - *Basis for jurisdiction*
  - *Jurisdiction claimed*
  - *Recognizing costs*

- *Timing of tax*
- *Tax Sparing*
- *Degree of adherence to the principle of tax neutrality*
- *Recognizing tax exemption*
- *Flexibility*
- *Providing tax incentives*
- *Number of jurisdictions claiming taxes*
- *Taxation of foreign source income*

(b) <u>Control Strategy</u>

- Location of Authority for strategy selection
- Evolution of the firm/company
- Internal structure
- Corporate planing
- Location of tactical decision-making authority
- Methods of communicating decisions
- Means of reporting performance
- Evaluation of performance
- Enforcement of decisions (Maintenance of control)

(c) <u>Public Affair Strategy</u>

- Choice of profile
- Choice of mode
- Choice of vehicle for developing public relations
  - *Subsidized research*
  - *Lobbying*
  - *Advocacy advertising*
  - *Corporate philanthropy*
  - *Restructuring the corporation*
  - *Volunteering corporate skills*
- Business environmental analysis
  - Monitoring issues
  - Political risk assessment
  - Forecasting function
- International codes for conducting business

Selection of a Legal Entity

While structuring a new entity in any jurisdiction, one may choose from the following options which are generally available :

- Liaison Office
- Branch
- Wholly Owned Subsidiary
- Partnership
- Trusts

- Sole-proprietorship
- Other entities

A liaison office or a project office is set up initially, when the objective is to collect information or marketing and publicity. Most countries do not allow the liaison office to carry out commercial activities. A branch is preferred in certain businesses. The advantage of having a branch is that the initial losses can be set off against the profits of the parent company in the home country. Once the branch starts generating profits, there may be an incidence of branch-profit tax in foreign countries. This is a dividend equivalent tax, which is levied by countries like US on the surplus profits of the branch, whether or not these profits are distributed to the parent company. A profitable branch can be converted into subsidiary.

A Company is generally preferred where it is crucial to limit the liability of the investors. It is a distinct legal entity from its shareholders. It is also a better structure to establish proper tax residency in a country, for claiming the benefits of a DTAA. Characterization of a partnership is normally a function of the domestic law. In some jurisdictions, partnerships may carry a corporate form. The form and preference may depend upon the tax system of each jurisdiction. In the U.S., partnerships are not taxed in respect of their income. Instead, the partners are taxed. Limited Life Companies (**LLCs**[4]) are very popular with the US multinationals. LLCs are companies which are treated as partnerships for US tax purposes. However, how the other countries will recognize these entities is an open question. Trusts are used worldwide for setting up funds or for private properties. Besides these common entities, there are some other entities which are unique to each legal system. Liechtenstein for example, has *Anstalt* or the establishment, which is a very flexible form of entity. It is set up by founders who may be non-residents, who have a right to appoint beneficiaries. There is also another entity called *Stiftung* or the Foundation, which is used primarily for the management and investment of family property or for charitable purposes, though it may also have a commercial purpose.

Is structuring legal?

'Structuring' is often looked at with suspicion. It is perceived that using offshore structures to minimize the tax implications with an intricate interplay of domestic tax system and a DTAA is a sinful deed. There is a larger school of thought in favour of structuring. While domestic tax is an obligation, foreign tax is cost. Therefore, a tax payer is free to use all legal means to organize his affairs in a manner so as to minimize this cost. Whenever a national or resident of a third country avails of the benefit of the DTAA between two countries, by setting up a conduit resident company or otherwise, 'Treaty shopping' arises. The issue of Treaty shopping raises the question of interpretation of DTAAs. The OECD interpretation[5] of this issue is that 'conduit' company is a resident of that country and has to be granted benefits of DTAA.

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[4] LLCs fail on 2 out of 4 corporate characteristics viz. limited life, limited liability, free transferability of shares and centralized control and management.

[5] OECD Conduit Company Reports in International Tax Avoidance and Evasion - Four Related Studies, 1987

Under a treaty, the Contracting States mutually undertake the obligation to respect and apply the treaty provisions. This is the principle of *'pacta sunt servanda'*. This is one of the fundamental principles of the law of treaties. It has been codified in the preamble and on Article 26 of the Vienna Convention. The principle of 'Treaty Override' implies that a country, by legislature provides that the domestic law will override the international law and thus refuses to fulfil some of its contractual obligations with the other country under the pretext that the treaty obligations conflict with the domestic law. 'Treaty Override' can be avoided if a country specifically provides in its domestic law, that the DTAAs will override the domestic law. India is one of the countries, which has done this by inserting sub-section 2 in section 90 of the Income-tax Act, 1961.

Business Structures in Global Environment

International business structures are exposed to the risk of double taxation, whereas, on the other hand they also offer opportunities for tax avoidance or evasion. While tax evasion may be illegal, structured tax avoidance within the four corners of law is not. In response to tax evasion, the countries react by providing certain 'poison pills' within its DTAAs or domestic tax systems. Few examples of such poison pills are as follows :

<u>‘Substance over Form’ Rule –</u>

Most countries have wide ranging anti-avoidance rules under the domestic law or judicial practices. These measures include "substance over form" doctrine to prevent sham transactions, and the commercial justification rule under the "business purpose test." In particular, they require that transactions should not have tax savings as the only or dominant purpose. Under this doctrine, the tax officers can lift the ‘corporate veil’ to look at the real transaction or structure.

<u>Transfer pricing -</u>

In view of the different tax systems and difference in rates of taxation, the multinational organizations are tempted to undertake a transaction at a price which may not be the price if the transaction is undertaken on an 'arm's length' basis. This is done with the objective of shifting the profits from a ‘high-tax’ country to a ‘low-tax’ country. Most of the developed countries today have strict rules for transfer pricing. The revenue authorities are given power to investigate the pricing and to use their own judgement to apply tax on the price at which the transaction would have been undertaken if executed on an 'arm's length' basis. India has recently joined the band wagon with its own set of transfer pricing regulations which are very stringent.

<u>Tax havens -</u>

Tax havens are countries with nil or low rate of taxation. They are often used to route a transaction between two countries with a high rate of taxation. Many countries have announced a list of countries which they consider as 'Tax havens'. This list is known as *'black list'*. The revenue authorities may be given the power to examine the transactions in more detail, when it involves a tax haven country. In Australia, wherever a foreign exchange transaction involves a listed country, the transaction must be referred to the Commissioner of taxation who may cancel or modify such transactions if they appear to involve tax avoidance or evasion, or if they represent a from of capital flight[6]. Some countries have also announced a list of countries which they do not consider as 'tax havens'. This list is known as 'white list'. U.K. has announced a 'grey list' which consists of countries which may be considered as 'tax havens' at some times and not at some other times. OECD has conducted a study of countries and have come out with its own black list of countries which do not have a certain standard rate of tax or have some other features which are akin to a tax haven.

Thin capitalization rules -

These rules prevent financing structures with high debt-equity ratios. Interest expense is tax deductible, whereas dividend payments are not. Therefore, high debt-equity ratios can reduce taxation on business profits. The interest payments in thinly capitalized companies are disallowed and may be taxed as constructive dividends.

Limitation of Benefits -

Many DTAAs include anti-abuse or anti-treaty shopping provisions which prevent the non-treaty partner country residents to take advantage of the DTAA. For example, the India-U.S. tax treaty provides an article on 'Limitation of Benefits', which restricts the benefits of the DTAA only to residents of both India and the U.S.

Exchange of information -

Tax treaties provide for the exchange of information between the tax authorities of Contracting States. They allow the tax information to be shared by them in suspected cases of tax avoidance and evasion. Most countries today have such an arrangement in order to curb money laundering and financial terrorism. In particular, post-September 11, this has become a crucial requirement and many countries have set up Financial Intelligence Units.

Cross-border Structures

Domestic tax is an obligation whereas foreign tax is a cost. Hence, it is only natural for the companies to structure their cross-border transactions in a tax efficient manner. Due to the provisions related to CFCs and PFICs etc. corporates are very rarely able to get away without paying tax anywhere. Even if they do not pay tax in the country of source, they may still end up paying tax in their country of residence. This is particularly true with countries like US. Even in these situations, it still makes a logical sense to structure their investments using holding company jurisdictions. This is because often full tax credits are not captured due to domestic tax law restrictions. Further, induction of appropriate offshore jurisdiction provides insulation from potential tax consequences on restructuring. Also, it helps in achieving certainty in tax costs associated with cross-border transactions.

[6] Research Report on Tax Havens and Their Uses by Caroline Doggart

Inbound Investments

For foreign companies investing in India, Mauritius has become like Mecca. Especially for portfolio investors, who earn capital gains from portfolio investments in India, setting up a holding company in Mauritius is inevitable. A holding company in Mauritius helps them achieve capital gains tax neutrality. Most countries around the world do not levy capital gains tax on non-residents investing in shares in their country. If a foreign company holds shares in Indian company directly, it will end up paying 21% tax on long term capital gains and 42% tax on short term capital gains. In case of most countries, the maximum rate is below 35%. Therefore, in case of short term gains, the foreign company will not get the full credit for the taxes paid in India. Further, in case of FIIs and venture capital funds, most of the investors are pension plans, which are otherwise tax exempt entities in their home countries. Therefore, they do not have taxable income to offset the tax paid in India. This is the reason many inbound investments have flown into India via Mauritius.

A substantial chunk of foreign direct investment has gone into IT and ITES industries. Most of the companies set up for IT services and BPOs enjoy a tax holiday under section 10A/10B. It is very common for the founders to start the business with minimum seed capital, to take the companies to a reasonable maturity stage and than invite private equity investors to invest in these companies. At this stage, invariably the shareholding changes. By virtue of provisions like S. 10A(9), often these companies loose the tax holiday at the time new investors join in. This is derogatory to the main objective of providing the tax incentive to these units set up in STPs for development of software industry and encouraging their expansions. Often, provisions like this compel foreign investors to induct holding companies so that they are neutral to changes in foreign law or internal restructurings.

Besides Mauritius, Cyprus and UAE also have a tax treaty with India, which gives similar capital gains tax exemption on sale of shares in Indian company. However, UAE is generally not preferred due to political instability. Cyprus has certain domestic tax implications and hence often, Mauritius remains the first choice for foreign investors contemplating investments in India.

Outbound Investments

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.

Exchange Control:

Current exchange control regulations require an Indian company, which is not eligible to avail of the automatic route for investing in foreign entities, to obtain approval of the Reserve Bank of India (“**RBI**”) every time it makes investments in ventures overseas.

Automatic approval route is available for the investments to be made in wholly owned subsidiaries or joint ventures abroad up to a maximum of USD 100 million in one financial year, subject to the following conditions:

1. Investment is made in a foreign entity engaged in the same core activity carried on by the Indian company;
2. The Indian company is not on the caution list of the RBI or under investigation of the Enforcement Directorate; and
3. All the investment transactions are routed through one branch of the authorized dealer

Subject to the fulfillment of the aforesaid conditions, an Indian company can make investments abroad out of one or more of the following sources:

- out of the balance held in the Exchange Earners Foreign Currency ("**EEFC**") account of the Indian company;
- drawal of foreign exchange not exceeding 50% of the net worth of the Indian company as on the date of last audited balance sheet;
- utilization of amount raised by the issue of ADRs/GDRs by the Indian company.

If the investment abroad is out of the balance held in the EEFC account, the condition at 1 above is not applicable

Further, the automatic route is not available if the Indian company is proposing to set up a holding company or a special purpose vehicle abroad, which would in turn set up one or more down line subsidiaries or joint ventures as operating units. Where the above automatic route is not available, a special approval of the RBI has to be sought for investing abroad.

To save the time that would be spent in obtaining these approvals (if required) every time investments are made abroad and complying with other regulatory requirements, an OHC can be set up as fully owned operating subsidiary of the Indian company. Further, even though the norms regarding repatriation of income into India from the overseas subsidiary companies are relaxed, once the overseas subsidiary company declares dividends, it is required to bring the same into India. It would therefore provide some flexibility if an OHC is set up, wherein the dividends declared by the down line subsidiaries or joint ventures are collected and redeployed for expansion of new subsidiaries or joint ventures elsewhere in the world.

Taxation:

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 36.75%[7]. Therefore dividends received by an Indian company from an overseas company will be subject to tax in India at the rate of 36.75%. 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 36.75%.

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., Netherlands etc. are close contenders for location of OHC out of India for holding investments worldwide.

Country-wise Summary

The following section describes the domestic tax position in some of the select countries which are often considered for location of the holding company for inbound or outbound investments from India. This section gives a general overview of taxation in each of these countries and does not necessarily represent the complete summary of the relevant provisions.

Ireland

At present, corporate income tax rate on trading income in Ireland is 16% [8] and on non-trading income is 25%. Dividend received by an Irish company from its foreign subsidiary is subject to tax in Ireland. However, under the Irish local laws underlying tax credit is provided for taxes paid by foreign dividend paying subsidiary. Capital gains realized by an Irish company from sale of shares of its subsidiaries are subject to tax in Ireland at the rate of 20%. There is no dividend withholding tax on dividends paid to companies not controlled by Irish residents that are resident in a EU member country or a DTAA country. Since India has recently entered into a DTAA with Ireland there would not be any withholding tax in Ireland on dividends paid to the Indian company. However, in India the dividend income would be subject to tax at the rate of

[7] Rates mentioned in this note in relation to the ITA are inclusive of currently applicable surcharge of 5%.
[8] To be reduced to 12.5% from January 1, 2003

36.75%. There is a withholding tax of 20% on interest and royalties paid from Ireland, which is applicable to both payments to residents and nonresidents.

Mauritius

Mauritius has a favourable tax treaty with a number of asian countries including India. Mauritius companies are subject to tax on the profits at the rate of 15%. Mauritius gives deemed tax credit on foreign source income to the extent of 80%[9] of taxes payable in Mauritius or the actual withholding and underlying taxes paid by the foreign subsidiary, whichever is higher, subject to a maximum of Mauritius tax liability. Hence, Mauritius company would get tax credit for 80% of Mauritius tax liability on dividends received by it from its subsidiaries, or the actual withholding and underlying taxes paid on such dividends, whichever is higher. At present, Mauritius does not levy any tax on capital gains. Mauritius does not impose any withholding tax on dividends, royalties and interest paid by a Mauritius company to a non-resident company.

Upon distribution of this income to India, as per Article 23 of India-Mauritius DTAA, underlying tax credit would be given in India for 'taxes payable' in Mauritius. Thus, even when no tax is actually paid in Mauritius, India may give credit for the taxes, which are otherwise payable in Mauritius. As discussed above, Indian companies are currently taxed at the rate of 36.75% on dividends received from a foreign company. Thus, as per the provisions of the India-Mauritius DTAA, Indian company may be able to claim an underlying tax credit in India for taxes payable in Mauritius (i.e. 15%). If such credit for taxes payable would not available to the Indian company under India-Mauritius DTAA then, Indian company would have to pay tax at the rate of 36.75% on dividends received from Mauritius company against which it can claim tax credit of 3% (taxes actually paid in Mauritius).

Netherlands

The corporate tax rate in Netherlands is 34.5%. Subject to fulfillment of prescribed conditions under the participation exemption rules, when a Dutch company receives dividend from its subsidiary or transfers shares of its subsidiary, there would be no tax liability for such dividend and capital gains in Netherlands. However there would be a 25% withholding tax on payment of dividends by a Dutch company, which could be further reduced by a DTAA with recipient country. Under the India-Netherlands DTAA, the dividend withholding tax is reduced to 10%. When the Indian company receives the dividend, it will be subjected to tax at the rate of 36.75%, but the Indian company will get a tax credit for the 10% withholding tax paid in Netherlands. Under the local Dutch tax laws there is no withholding tax on payments of interest, royalties etc.

United Kingdom

Companies that are resident in the UK are subject to corporation tax on their worldwide income. Further, a UK company will be taxed on the total amount of income earned from all sources including any chargeable capital gains at the rate of 30%. Dividend received by a UK company from its subsidiary will be taxed in UK at normal tax rates. However, if the UK company receives dividend from a foreign company in which it holds at least 10% voting

[9] Prior to 1st July 2002 deemed tax credit was allowed to the extent of 90%.

power, in addition to tax credit for taxes withheld on such dividend, it may also obtain tax credit for the underlying taxes paid on the profits out of which such dividends are paid.

Capital gains on chargeable assets are taxed at the normal corporation tax rate in UK. However, a tax exemption for disposals of substantial shareholdings (minimum of 10%) has been introduced from April 1, 2002. Under these provisions, gains realized by a trading company (or member of a trading group) from disposal of substantial shareholding of another trading company (or holding company of a trading group) that has been held at least for a period of 12 months would be exempt from tax. Thus, subject to fulfillment of conditions laid down under these rules, gains realized by the UK OHC from sale of investments in subsidiaries would not be subject to tax in UK.
Capital gains tax is not generally levied on nonresidents from sale of shares of UK companies. Consequently, no tax would be levied on a gain realized on the sale of shares in a UK subsidiary by the foreign parent company. However, the same will be subject to capital gains tax in India at the rate of 21% in case of long-term capital gains or 36.75 % in case of short-term capital gains.

Subject to the thin capitalization rules, the interest paid by a UK company to a foreign lender may be allowed as a tax deductible expense. However, the UK company would be liable to deduct withholding tax at the rate of 20% from interest paid to the foreign lender, which gets further reduced as per the provisions of the applicable DTAA. Although thin capitalization rules do not prescribe any specific debt-to-equity ratio, highly leveraged UK subsidiaries of overseas companies having debt-to-equity ratio in excess of 1:1 are usually subject to scrutiny by the Inland Revenue.

China

The income tax is levied in PRC at two levels, one at the national level and the other at the state/local level. Different tax computation rules apply to business operations carried on by foreign invested enterprises ("**FIE**") [which includes Sino-foreign equity joint ventures, cooperative joint ventures and wholly foreign owned enterprises and other forms of business activities and operations carried out by foreign companies] and domestic companies.

As PRC residents FIEs are required to bear full tax liabilities and pay income tax on all income derived from sources inside and outside PRC. However, taxation of foreign enterprises ("**FE"**), which are not residents of PRC, will depend on whether they have a permanent establishment ("**PE**") in PRC or not. FEs are subject to tax only on PRC source income and further if they do not have a PE in PRC, then they are subject only to withholding taxes in PRC on such incomes.

FIEs and FEs that have a PE in PRC have to pay corporate income tax at the rate of 30% and an additional local tax of 3% on incomes from business operations, on profits (dividends), interest, rentals, royalties and other income derived from sources both inside and outside PRC that are effectively connected with such establishments or venues. On the other hand, FEs that do not have a PE in PRC or in cases where the income derived inside PRC are not effectively connected to the PE, have to pay income tax in the form of withholding tax at the rate of 20%. FIEs operating in PRC could avail of certain concessions and exemptions.

Further, PRC taxation law allows carry forward of losses for a period of 5 years which is not lost/withdrawn even in a situation where the shareholding of the loss-making company undergoes substantial change after the loss has been incurred.

Withholding taxes

- Under the PRC domestic tax laws, dividends are subject to a withholding tax at the rate of 20%. This could get reduced according to the provisions of DTAA that PRC has entered into with other countries *e.g.* under the DTAA that PRC has signed with India, the withholding tax rate gets reduced to 10% while with that under Mauritius it is only 5%. However, due to tax incentives available to FIEs and FEs, the profits of FIEs and FEs (having a PE in PRC) that are distributed either as dividends or branch profits, respectively, are not subject to any withholding tax when remitted outside PRC;
- Interest and royalties are subject to the usual withholding tax rate of 10 to 20%, depending on the facts of the case, which could stand reduced further under certain DTAAs signed by PRC.
- Capital gains from sale or transfer of movable or immovable property situated in PRC is subject to withholding tax at a flat rate of 10%. However, according to the provisions of the DTAA between PRC and Mauritius, there is no capital gains tax in PRC if shares are sold by a Mauritius company.

Singapore

Singapore companies are subject to tax at the rate of 25.5% in Singapore. Singapore has adopted the imputation system for the taxation of dividends, whereby income tax paid by a Singapore resident company is imputed to the dividends paid to its shareholders such that the shareholders are deemed to have paid the tax equivalent to the underlying tax paid by the company. This obviates double taxation of dividends – once at corporate level and again at shareholder level. However, if the Singapore company has not paid taxes at the full corporate tax rate of 25.5% on its profits, dividend declared by Singapore company will be subject to further tax at the difference between the full rate of 25.5% and tax already paid by the Singapore company on its profits. Dividends received from overseas subsidiaries will also be subject to tax in Singapore. However, dividends received from overseas subsidiaries may not be subject to tax in Singapore due to the availability of foreign tax credits (including underlying tax credits). If Singapore company is in a position to claim underlying tax credit at the rate of 25.5% then the dividends may be distributed to its shareholders free of any additional tax in Singapore. On the other hand, capital gains are generally not subject to tax unless the gains are derived from the disposition of real estate that has been owned for less than 3 years or shares of private companies whose assets consist substantially of real estate.

Singapore too has a favourable tax treaty with India. As per Article 25 of the Indo-Singapore DTAA, the Indian company would be able to claim underlying tax credit in India for the *taxes paid* in Singapore on the profits from which such dividends are declared. As discussed above, Indian companies are currently taxed at the rate of 36.75% on dividends received from a foreign company. Thus, as per the provisions of the India-Singapore DTAA, Indian company may be able to claim an underlying tax credit in India for taxes payable in Singapore (i.e. 25.5%) and consequently could reduce the tax liability in the hands of the Indian parent to 11.25% as opposed to 36.75% in case of direct investment. However, as no actual tax has been paid in Singapore, there could be uncertainty whether such credit would be available in India.

Cyprus

A series of amendments to the tax laws have been introduced in Cyprus on 1 July 2002. The main feature is the integration of corporation and withholding taxes with income tax on distributed profits.

A uniform corporation tax rate of 10% would be applicable to any local and international business company ("**IBC**") with effect from January 1, 2003 (corporation tax rate of 4.25% is applicable to IBCs before January 1, 2003). Active IBCs already operative in Cyprus may continue to retain the 4.25% rate until 2005 if their income in the year 2001 came entirely from sources outside Cyprus and continues to be derived from such sources for the following four years. The IBCs which opt to retain the 4.25% corporation tax rate until 2005, cannot carry forward any tax losses incurred up to 2000, beyond 2005.

A company incorporated in Cyprus would be considered to be a resident Cyprus company only if its management and control is established to be in Cyprus. Companies registered in Cyprus but managed and controlled from abroad will be taxed in Cyprus only on their Cyprus-source income. They will enjoy exemption from tax of foreign dividends and interest and income from any permanent establishment abroad as well as all foreign tax credits and offsets of losses incurred abroad. However, they will not be entitled to benefits under the DTAAs entered into by Cyprus with any other country.

Dividends received by a Cyprus Company from its subsidiary or joint venture company abroad will be exempt from tax in Cyprus if the Cyprus Company holds more than 1% in the company paying dividend.

The new system provides a change from the credit method to the exemption method, which will allow IBCs to pay dividends without having to withhold tax. Accordingly, dividends paid by a Cyprus Company to foreign corporations and foreign individuals will be exempt from withholding tax in Cyprus.

When capital gains are derived by a Cyprus Company from divestment of its holding in a foreign subsidiary or joint venture company it will not be subject to tax in Cyprus. In other words there should not be any tax on the profits from the disposal or sale of securities for all the companies that are tax residents in Cyprus. When a foreign company divests its holding in a Cyprus Company, the capital gains will be exempt from tax in Cyprus, provided the Cyprus Company does not have any immovable property in Cyprus.

UAE

The federal government of the United Arab Emirates does not impose any taxes. Taxes have been imposed only on oil and gas producing companies and petrochemical companies at rates set forth in their government concession agreements, and on branches of foreign banks at rates fixed in agreements with the Rulers of the Emirates. Withholding taxes are not imposed.

Conclusion

The primary object of a structuring exercise using the tool of international tax planning is to minimize or defer global taxes lawfully to meet the desired business and other objectives of such transactions. It is the duty of professionals to encourage legitimate tax planning and dissuade clients from tax evasion. Lastly, cross-border structuring is a very interactive exercise. It necessitates discussions with foreign country professionals to ensure that a structure, which achieves tax efficiency in India also works in the other country and does not lead to any adverse tax consequences. Judge Learned Hand in a famous tax case in the United States commented: "there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everyone does so, rich or poor; all do right. Nobody owes any public duty to pay more than the law demands; taxes are enforced exactions, not voluntary contributions."

Case Study

A US insurance company wishes to set up BPO operations in India. There are two individuals resident in India, who will be the co-founders. There is also a strategic investor, which is a private equity fund based in Mauritius. Please advise on the appropriate structure.

The contents of this paper should not be construed as legal opinion or professional advice.

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