

Private Client Wrap

July 07, 2014

PRIVATE CLIENT WRAP: QUARTER 2, 2014 IN REVIEW

- **Change in government:** leads to market upswing – substantial tax reforms anticipated in the budget to be announced on 10 July 2014
- **Higher cap on outward remittance and investment:** Indian resident individuals can now remit up to USD125,000 annually outside India – real estate investments continue to be restricted; outward investment by Indian entities restored to 400% of net worth
- **FATCA compliance:** Indian banking regulator instructs financial institutions to be registered with US authorities and obtain the Global Intermediary Identification Number (GIIN) by 31 December 2014
- **CSR:** Statutory heads of permissible CSR activities to be liberally interpreted but expenditure for one-off activities not eligible to be considered CSR expenditure
- **Trusts:** Supreme Court holds that income of a discretionary trust cannot be taxed in the hands of a beneficiary unless distributed to the beneficiary
- **Family settlements:** Allahabad Tribunal holds that transfer of shares of a closely-held company from family members to such company under a family arrangement is a transfer subject to capital gains tax.

Dear Reader,

Our **Q1 wrap** ended on an expectant note in anticipation of the elections to be conducted in May. Now, a new Indian government comprising of the BJP-NDA coalition has been voted into place. Their win by an overwhelming majority makes this government more stable than any that India has had since its liberalisation in the 1990s. This means that there would now be sufficient political will for key legislative and developmental action points which were stalled over the last few years. The party's pro-business manifesto and a prime minister with a reputation for decisive CEO style of functioning, have also **led to much optimism** about the Indian economy in the recent past.

There is no denying the challenges, of course. The first important test will be the release of the annual budget on 10 July 2014, which will need to boost a sluggish economy and improve investor perception as well as bring down the current account deficit and inflation. We will be examining budget proposals separately in a detailed analysis on **15 July 2014**.

While we wait, here's a brief round-up of key events in Q2:

1. HIKE IN CEILING ON OUTWARD REMITTANCES

Despite the liberalisation of the Indian economy, exchange control norms continue to regulate the inflow and outflow of money from the country. One such measure, the Liberalised Remittance Scheme (LRS) restricts the purposes for and extent to which resident individuals can remit money outside India. Since the introduction of the LRS in 2004, the ceiling for remittances by an individual has been progressively increased and had remained steady from the year 2007 to 2013 with an upper limit of USD 200,000 per individual per year. However, in August 2013, reflecting the poor economic position of the rupee, capital controls were introduced and this ceiling was reduced to USD 75,000 with further restrictions being added to the use of outward remittances for acquisition of immoveable property outside India (directly or indirectly).

In view of the recent stability that the rupee has seen in the foreign exchange market, the Reserve Bank of India (RBI) has on 3 June 2014, enhanced this ceiling to USD 125,000 per individual per year. This minor revision provides very little relief as it was widely expected that the upper limit of USD 200,000 would be restored and that the added restrictions (including restrictions relating to the acquisition of foreign immovable property) would be removed after the stabilization of the economy.

Along with increasing the cap for offshore remittances by individuals, the RBI has also restored the cap for overseas direct investment by Indian corporates to pre-2013 limits. Indian corporates can invest offshore upto 400% of the net worth as per the last audited balance sheet. However, any investment greater than USD 1 billion in a financial year (even if within the 400% cap) will require prior RBI approval. Please [click here](#) for further details on this measure. One can only hope that these changes are a part of a progressive revision with the aim to ultimately disband capital controls. Indian exchange controls are a determinative factor in private wealth structuring and opening up of capital controls will provide much more flexibility in terms of global wealth planning for modern day HNIs who are likely to have multi-jurisdictional wealth.

2. INDIAN REGULATORS BEGIN TO ENFORCE FATCA COMPLIANCE

The Foreign Account Tax Compliance Act ("FATCA") is an anti-tax evasion law in the US, which came into effect from 1 July, 2014. FATCA empowers US tax authorities to seek information from foreign financial and non-financial institutions in relation to individuals and entities who are liable for tax in the US (including US citizens residing

Research Papers

Handbook on New Labour Codes

April 29, 2024

Compendium of Research Papers

April 11, 2024

Third-Party Funding for Dispute Resolution in India

April 02, 2024

Research Articles

Private Client Insights - Sustainable Success: How Family Constitutions can Shape Corporate Governance, Business Succession and Familial Legacy

January 25, 2024

Private Equity and M&A in India: What to Expect in 2024?

January 23, 2024

Emerging Legal Issues with use of Generative AI

October 27, 2023

Audio

Third-Party Funding: India & the World

April 27, 2024

IBC allows automatic release of ED attachments: Bombay HC reaffirms

April 15, 2024

The Midnight Clause

February 29, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

[Click here to view Hotline archives.](#)

Video

Q&A 2024 Protocol to the Mauritius India Tax Treaty

April 22, 2024

Boost to India's Space Potential: India Liberalizes Foreign Direct

outside the US and US-owned foreign entities). Institutions that do not comply with FATCA could face 30% withholding tax on payments received from US sources.

While India has not signed a formal intergovernmental agreement or IGA with the US, an 'in-substance' agreement was signed between the countries on and with effect from 11 April, 2014. Due to this, financial institutions in India are now required to make FATCA disclosures (through the Central Board for Direct Taxes) to the US Internal Revenue Service – this would primarily relate to investments by account holders liable to tax in the US.

India's market regulator, the Securities and Exchange Board of India ("SEBI") plans to issue guidelines to help financial institutions in India to identify accounts of persons liable to tax in the US, for the purpose of compliance with FATCA. Indian financial institutions receiving funds from offshore sources might have to undertake thorough searches of high-value individual accounts to identify the nationality or residence of the account holders involved. According to news reports, SEBI plans to put in place a quantum-based system categorization — balances up to \$50,000; between \$50,000 and \$1 million; and those exceeding \$1 million – with the lower category likely to be exempt (along with products related to retirement) and the degree of scrutiny being the highest for the last category. SEBI might require financial institutions to complete identification of high-value investors before December 2014 and thereafter, report to SEBI on an annual basis. The review of relatively lower-value accounts could be extended to next year.

The RBI, India's banking regulator, also issued a notification (on 27 June, followed by SEBI's circular of 30 June on similar lines) requiring financial institutions in India to be registered with US authorities and obtain the Global Intermediary Identification Number (GIIN) by 31 December 2014. However, the notification also refers to requirements applying only once a formal IGA has been signed, on which more details are expected from the regulators soon. The notification and circular also contain rules for Indian institutions with overseas branches in jurisdictions which have IGAs with the US or do not.

Individuals impacted: In the Indian context, these compliances are likely to be problematic for non-resident Indians ("NRI") or Indians with investments in the US. A common issue faced by NRIs relates to the concept of a Hindu Undivided Family under Hindu succession laws. Under this concept, the eldest son of a family comes into the possession of a pool of ancestral property upon the demise of his father – however, his right is more akin to that of a trustee than an owner, which can create issues from a US characterisation perspective. An alternative scenario is where the HUF is managed by an Indian manager (also known as "Karta"), but has US citizens as substantial beneficiaries. In the latter case, the Indian Karta may often not even be aware that US compliances are required for the Indian HUF.¹

3. CLARIFICATIONS ON THE CSR REGIME

We had previously discussed the changes brought about in India's mandatory regime for corporate social responsibility (CSR) by the notification of the Companies (Corporate Social Responsibility Policy) Rules, 2014 ("CSR Rules").

On 18 June, the Ministry of Corporate Affairs issued certain clarifications in response to feedback received from stakeholders. The Ministry has clarified that:

- CSR activities must be relatable to the permissible activities listed in Schedule VII of the Companies Act, 2013 and must be interpreted liberally so as to capture the essence of the subjected listed. The clarification provides certain illustrations. For instance, the activity of 'promoting education' on a liberal interpretation would encompass projects for promoting consumer education and awareness, renovation of school buildings but would not cover training of personnel for enforcement of road safety as that is an established Government function.
- Eligible CSR expenditure includes: (i) expenditure on activities carried out in the form of a 'project/programme'; (ii) salaries paid to CSR staff of the company and volunteers in proportion to the company's time spent on CSR; and (iii) contribution to the corpus of a trust, society, or a not-for-profit company provided (a) such recipient entity is created exclusively for undertaking CSR activities or; (b) where the corpus is created exclusively for a purpose directly relatable to a subject covered in Schedule VII; (iii) expenditure incurred by a foreign holding company for CSR activities in India will qualify as CSR spend of the Indian subsidiary if, such expenditures are routed through the Indian subsidiary and if the latter is required to do so as per Section 135 of the Companies Act, 2013.
- Expenditure which is not eligible to be counted as CSR expenditure are those incurred on: (i) one-off activities such as marathons, charitable contributions, TV programme sponsorships; and (ii) fulfilling statutory obligations, e.g., those under the labour laws.
- Trusts registered under the Income Tax Act are eligible to carry out CSR activities in case they are located in States where registration of a trust is not mandatory.

The CSR provisions are estimate to result in CSR expenditure of around INR 20,000 crore in 2014-2015

alone² (around USD4 billion). The ripple effects of such investment are expected to change the dynamics of philanthropy in India. This is an opportune time for the Government to understand philanthropy as an initiative wider than just charity and relook tax and regulatory provisions that have stifled the growth of philanthropy in India.

4. TAXATION OF DISCRETIONARY TRUSTS

Indian trust jurisprudence is dated and does not contemplate modern trust structures involving institutional trustees, protectors and the like. Therefore, the decision of the Supreme Court in *Commissioner of Wealth Tax, Rajkot v Estate of Late HMM Vikramsinhji of Gondal*³ is significant as being one of the few recent cases dealing with trust issues. The Supreme Court held that income of a discretionary trust cannot be taxed in the hands of a beneficiary unless distributed to the beneficiary. The Supreme Court has thus reiterated the primary basis for difference in taxation of discretionary trusts versus determinate (or specific) trusts in respect of an offshore trust.

The dispute centred on determining the nature of two UK trusts on the basis of the terms of the trust deeds. The Revenue had argued that the trusts were specific trusts because under the clause (in dispute) the trusts' income were payable in specific shares to identified beneficiaries and that as per the trust deeds, this clause had been triggered when additional trustees were not appointed to exercise their discretion as to distributions. The Supreme Court did not accept this argument of the Revenue. It considered the wording of the clauses and the working of the trustees in practice and held that where trustees have clearly retained the income of the trust and brought it forward year to year without disbursing it to the beneficiaries, the trust is discretionary.

This judgment highlights that beneficiaries of a discretionary trust should not include any part of the trust's income in their individual returns unless it is actually received by them. One key issue that has not been addressed is the treatment of distributed income in the hands of the beneficiaries, particularly when the distribution is in the nature of capital. Under the erstwhile regime, capital distributions were not considered taxable – however, with the introduction of S. 56 of the Income Tax Act, 1961, there is ambiguity as to whether such a tax should apply and whether there should be a difference between offshore trusts (which may not be taxable in India) and onshore trusts (which are likely to be).

5. TAXATION OF FAMILY ARRANGEMENTS

In *ACIT vs. Bilakhia Holdings P. Ltd.*⁴, the Allahabad Bench of the Income Tax Appellate Tribunal ("Tribunal") has held that if a closely-held company receives shares from shareholders who belong to the family pursuant to a family arrangement among such shareholders, the receipt will not be considered a gift, but will be considered a transfer.

This characterisation is crucial because: a) gifts between specified relatives are not taxable in India; and b) Indian capital gains apply differential rates for assets held for a short term (up to 40% tax) and long term period (up to 20% tax). Gifted assets are allowed the benefit of the predecessor's holding period in determining the applicable right while transferred assets are not.

In *Bilakhia*, family members entered into a family arrangement in furtherance of which, shares held by other members of the family and other companies were transferred without any monetary consideration to the holding company. The issue before the Tribunal was whether the transfer was to be considered a gift. For a gift, two considerations had to be satisfied as per the Transfer of Property Act: (a) the transfer must be without monetary consideration; and (b) the transfer must be voluntary.

The Tribunal, relying on an earlier decision of the Supreme Court of India held that a family arrangement cannot be considered as being "without consideration", as that would render it unenforceable under Indian contract law. It clearly was the intention of the family to enter into a binding, enforceable agreement. The taxpayer company argued that the transfer of shares was voluntary since it was made pursuant to an agreement that was voluntarily entered into. To this, the Tribunal held that since the transfer was made for monetary consideration, i.e. for equalization of wealth and to avoid family disputes, it could not be stated that the transfer was voluntary or capable of being characterised as a gift.

This decision assumes importance when entering into family arrangements by the members of a family, including a Hindu Undivided Family as capital gains tax may now be imposed (as well as stamp duty of about 1-2%) on the family settlement arrangement. Contrast *Bilakhia* with the decision in *CIT v Nagaraja Rao*⁵ in which the Karnataka High Court had held that a family arrangement is not a transfer but a crystallisation of respective interests in family property. On that basis, the High Court held that the transfer of shares in a private company and of partnership interests from one family member to another pursuant to a settlement directed by the arbitrator of the family dispute is not a 'transfer' for the purposes of imposing capital gains tax on such transaction.

IN PARTING

In the run-up to Budget 2014, there have been quite a few wishlists and predictions being reported in the news. Although the Government is keeping its cards close to its chest, it is expected that the Government will tackle retrospective taxation and set a target to implement the Direct Taxes Code (DTC) and the Goods and Services Tax which have been repeatedly put on the backburner due to a lack of political consensus.

On the personal wealth front, it is being increasingly acknowledged that the Government will move towards increasing the tax exemption limit to boost household savings (as also suggested in the DTC). The Government has not given clear indications on its policy towards taxation of HNIs⁶ but the state of the country's finances suggest that the 10% surcharge imposed on HNIs with income exceeding 10 million may be here to stay⁷ and that an additional income tax bracket may be implemented to tax the super-rich.⁸

On the tax planning front, the Government is also likely to defer implementation of the GAAR provisions by a further one year to April 2017 and proposes to set up a Directorate of Risk Assessment to enhance effective scrutiny. This directorate would go through tax returns⁹ to identify those where the revenue risk and chances of recovery are high. This step has been suggested after the low success rate of the Government before the Income Tax Tribunals and the higher judiciary.

That's all for Q2, folks. Watch this space for further updates in the next action packed quarter.

The Private Client practice

Nishith Desai Associates

(Sriram Govind, T.P. Janani, Abhinav Harlalka, Megha Ramani and Shreya Rao of NDA's Private Client practice contributed to this edition.)

¹ The characterization of the HUF for purposes of foreign law has been an issue. For instance, see the decision of the England & Wales High Court (Chancery Division) in *Bal Mohinder Singh v. Jasvinder Singh and Herinder Singh* ([2014] EWHC 1060 (Ch)) where the court looked at whether property, if held as an HUF was then held, as a matter of English law, subject to a constructive trust. Although HUFs are not trusts under Indian law, it is easier to understand them if the national law recognizes trusts. HUFs present more interpretational issues in non-common law jurisdictions which do not recognize the concept of trust.

² http://articles.economictimes.indiatimes.com/2014-01-29/news/46782747_1_csr-policy-csr-committee-new-companies-act

³ Civil Appeal No. 2312 of 2007.

⁴ I.T.A Nos. 981-985 & 1034-1038/Ahd/2009

⁵ TS-222-HC-2012 (KAR)

⁶ The previous Government was showing an indication of leaning towards DTC-like measures. The DTC Bill which was again released to the public for comments in April has remained unchanged on its earlier proposal of a 35% tax bracket for income exceeding INR100 million and a 10% tax on recipients whose dividend income exceeds INR 100 million.

⁷ <http://indianexpress.com/article/business/economy/tax-on-super-rich-may-continue-for-another-year-to-aid-slowness-economy/>

⁸ <http://businesstoday.intoday.in/story/budget-2014-15-govt-may-raise-it-exemption-limit-to-rs-3-lakh/1/207251.html>.

⁹ Changes to the tax returns were also announced in June: closely-held domestic companies must specifically report all shares that were bought back from its shareholders in a financial year; Individuals and HUFs who have income from a proprietary business or profession are now required to separately disclose in their tax returns specific sums paid to non-residents e.g. commission, royalty; all transactions with persons located in Cyprus (or other countries notified as non-cooperative jurisdictions) need to be disclosed.

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. [View detailed disclaimer.](#)

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.