The Inward Investment and International Taxation Review

Fourth Edition

Editor
Tim Sanders

Law Business Research

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THE PRIVATE COMPETITION ENFORCEMENT REVIEW

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EDITOR'S PREFACE

The taxation of cross-border corporate structures is highly topical. Companies such as Starbucks, Google and Amazon have become the centre of a great deal of unwanted attention. Governments faced with depressed economies and falling tax revenues have turned their attention to what they perceive as a growing trend for multinational companies to push their activities into low- or no-tax jurisdictions. This perception led to the G20 asking the OECD to create an action plan that culminated in July 2013 with the publication of the OECD Action Plan on Base Erosion and Profit Sharing (the Report). The Report acknowledges the increase in cross-border trade, facilitated by factors such as the removal of trade barriers and the use of technology, which make it ever easier for businesses to locate production far from the jurisdictions in which their customers are located. The Report identifies the fact that the trend is influenced by tax considerations, the more aggressive aspects of which are clearly going to come under increasing scrutiny. The Report identifies the need to tighten rules on transfer pricing, to end or neutralise tax arbitrage arrangements, and to prevent companies artificially avoiding establishing permanent establishments, and also identifies areas for action, such as increasing disclosure requirements. In all, the Report identifies 15 areas that are likely to dramatically change the tax landscape for companies and businesses operating in the global economy.

Despite this backdrop of uncertainty and the threat of increasingly complex rules with penalties for those companies that move jobs and economic activity elsewhere in a manner deemed unacceptable, companies will continue to trade in the global economy and across borders. This requires, more than ever before, not only detailed evaluation and comparison of the tax benefits and incentives available in competing jurisdictions, but also consideration of the tax consequences of moving capital and income flows across international borders. Consideration of such cross-border tax opportunities, issues and conflicts between tax systems requires business tax advisers to be increasingly aware of tax laws beyond the geographical boundaries of the country in which they practise.

The aim of this book is to provide a starting point for readers, and to assist businesses and advisers, each chapter providing topical and current insights from leading experts on

the tax issues and opportunities in their respective jurisdictions (and, in one chapter, within the European Union). While specific tax advice is always essential, it is also necessary to have a broad understanding of the nature of the potential issues and advantages that lie ahead; this book provides a guide to these.

I should like to thank the contributors to this book for their time and efforts, and above all for their expertise. I would also like to thank the publisher and the team for their support and patience. I hope that you find the work useful, and any comments or suggestions for improvement that can be incorporated into any future editions will be gratefully received.

The views expressed in this book are those of the authors and not of their firms, the editor or the publishers. Every endeavour has been made to ensure that what you read is the latest intelligence.

Tim Sanders
Skadden, Arps, Slate, Meagher & Flom LLP
London
January 2014

Chapter 14

INDIA

TP Janani, Megha Ramani and Rajesh Simhan[1]

I INTRODUCTION

The Indian economy has been one of the fastest growing economies of the past decade. Over the past few years, India has been gradually relaxing capital controls and other restrictions under the exchange control regulations and has also revamped various key financial sector regulations to encourage inward investment. More often than not, corresponding changes have been made to tax legislation but gaps have remained, giving rise to uncertainty in the investment regime.

Regulatory clearance mechanisms and administrative enforcement processes have become more efficient and transparent although a lot more needs to be done. The tax authorities have increasingly taken an aggressive view on tax aspects relating to cross-border transactions, especially where treaty benefits have been claimed. Tax and other litigation is a long process (and preferably avoided) but sound judicial decisions provide comfort that genuine transactions will be respected and the rule of law will be upheld. These bottlenecks aside, India's huge market, with a good network of tax treaties and bilateral investment protection treaties, make it an attractive investment destination.

Exchange control regulations in India are governed primarily by the Foreign Exchange Management Act 1999 (FEMA). Currently, FEMA permits the following main inward investment routes or regimes:

a foreign direct investment (FDI);
b foreign venture capital investors (FVCIs);
c foreign institutional investors (FIIs);
d qualified foreign investors (QFIs); and
e non-resident Indian (NRIs) investors (including persons of Indian origin (PIOs)).

1 TP Janani and Megha Ramani are associates and Rajesh Simhan is a partner at Nishith Desai Associates.

Steps have been taken to rationalise and consolidate these investment routes, further discussed in Section X, *infra*.

The Companies Act 1956 (CA 1956) was so far the primary companies legislation. The Companies Act 2013 (CA 2013), a shorter and modernised version of CA 1956 Act, was finally enacted in August 2013; for some time, however, both Acts will continue to apply as only certain sections of CA 2013 Act have been notified to take immediate effect as law. Most operative details of CA 2013 Act have been left to subordinate legislation, which is awaited. Income tax is governed by the Income Tax Act 1956 (ITA). A revamped version of the ITA, the Direct Taxes Code (DTC) is also pending parliamentary approval.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

Businesses are generally set up in the form of a company with limited liability, which may be either a private limited[2] or public limited company. Some of the key differences between the two are as follows:

Criterion	*Private company*	*Public company*
Minimum paid-up share capital	100,000 rupees	500,000 rupees
Minimum subscribers to the memorandum of association	2	7
Minimum number of directors	2*	3
Maximum number of members	200†	Unlimited
Quorum for general meeting	Minimum 2	Minimum 5
Right to transfer shares	Restricted	Unrestricted
Invitation to the public for subscription	Prohibited	Permitted

* A one person company must have one director.
† CA 2013 has raised this limit from 50 members, which was prescribed under CA 1956. This does not apply to one person companies.

Alternatively, companies may be set up with unlimited liability or with liability limited by guarantee. In the latter case, members' liability is limited by memorandum of association to such amount as members respectively undertake to pay, if necessary, on liquidation of the company.

Tax treatment

Tax liability of all entity types is calculated in relation to the financial year, which runs from 1 April to 31 March. Taxation of different forms of business entities vary (both as to scope of taxable income and tax rates) depending on tax residence. In a particular

2 CA 2013 has introduced the concept of a one person company (not yet notified as law) which falls under the category of private limited company.

financial year, a company is treated as resident in India if it is either incorporated in India or wholly controlled and managed in India during that financial year.

Resident entities are taxed on their worldwide income; non-residents are taxed on their Indian-sourced income (i.e., income accruing or arising, or deemed to accrue or arise in India, or income received or deemed received in India).

Resident companies are taxed on their income (net of permissible deductions) at 30 per cent[3]. Dividends distributed by an Indian company are subject to a 15 per cent dividend distribution tax (DDT) in addition to the income tax on profits. Tax liability is on the company and dividends are not further taxed in the hands of the recipient shareholder. Foreign shareholders may not be able to claim relief under a tax treaty either by way of reduced tax rate on dividends or by way of foreign tax credit in their country of residence.

A non-resident company is taxed at 40 per cent on its Indian-sourced income, which includes income earned through branches, project offices or liaison offices in India and from operations carried out through an agent in India. A non-resident may opt to be taxed under the ITA or the applicable tax treaty, whichever is more beneficial. Under most comprehensive tax treaties entered into by India, business income of a non-resident is not subject to tax in India unless the non-resident has a permanent establishment (PE) in India or unless its income falls within specific categories such as dividends, interest or royalties listed in the respective tax treaty.

Non-corporate

General partnerships are permitted but there is a restriction on maximum number of partners and registration is not compulsory. Foreign investors are not allowed to invest in partnerships set up in India. For the purposes of the ITA, a partnership is considered resident in India if even a part of its control and management is situated in India. Partnerships are taxed at 30 per cent only at the level of the partnership, with the distributed profits being tax exempt in the hands of partners.

Limited liability partnerships (LLPs) have been recently permitted but foreign investment is allowed only under restricted circumstances and with prior government approval. LLPs with FDI are neither eligible to make downstream investments nor permitted to avail themselves of offshore debt under FEMA's external commercial borrowings regime. FIIs and FVCIs are not permitted to invest in LLPs. Further, capital contribution to LLPs by a foreign investor is allowed only by way of cash considerations.

3 All rates mentioned in this article are exclusive of surcharge and cess. In the case of resident companies, surcharge at 5 per cent or 10 per cent is applicable on their income tax liability if their total taxable income in a financial year is in excess of 10 million rupees but up to 100 million rupees or in excess of 100 million rupees, respectively. In the case of non-resident companies, a surcharge of 2 per cent or 5 per cent is applicable in similar circumstances. In the case of resident partnerships (including LLPs), a surcharge at 10 per cent is applicable on their income tax liability if their total taxable income in a financial year is in excess of 10 million rupees. Cess (education cess and higher education cess) at 3 per cent (cumulatively) is payable by all entities on the total of their income tax liability and surcharge.

LLPs are considered resident in India if even a part of their control and management is situated in India. Resident LLPs are taxed at 30 per cent on their income (net of permissible deductions). Unlike dividends, distribution of share of profits of partners of LLPs is not taxable either in the hands of partners or the partnerships. Conversion of a general partnership or a company into an LLP is a tax-neutral event subject to the satisfaction of specific conditions prescribed for this purpose.

Apart from establishing subsidiaries, which are corporate entities, the only other non-corporate entity into which foreign investors can invest into is a venture capital fund (VCF) established as a trust. In such a trust, only FVCIs registered with the Indian securities exchange regulator, Securities and Exchange Board of India (SEBI), are permitted to invest. Recently, the SEBI (Alternative Investment Funds) Regulations 2012 (the AIF Regulations) were notified, which succeeded and repealed the erstwhile SEBI (VCF) Regulations 1996 (VCF Regulations). VCFs registered with SEBI prior to the AIF regulations can continue to operate as VCFs (unless transitioned to the new regime under the AIF Regulations) and foreign investors are permitted to invest in such VCFs. The exchange control regulations do not, however, contemplate or provide for investment in funds registered under the new AIF Regulations without obtaining prior regulatory approval.

Legally, a trust is an obligation attached to property. The properties of the trust legally vest in the trustee that manages the trust, but the trustee holds such property in a fiduciary capacity for the benefit of beneficiaries, so designated for the purposes of the trust. In the case of venture capital funds, the investors are the beneficiaries to the trust. Such venture capital funds are fiscally transparent for tax purposes.

Indian law does not provide for limited partnerships, where only the liability of the general partner is unlimited.

III DIRECT TAXATION OF BUSINESSES

Resident entities are taxable on worldwide income while non-residents are only taxable on Indian-sourced income. Taxable income under the ITA is calculated as the sum of income calculated under mutually exclusive heads of income.[4]

i Tax on profits

Taxable profits must be calculated in accordance with prescribed accounting standards but with adjustments required to comply with restrictions prescribed with respect to depreciation, losses and expenditure. To the extent these may be calculated differently for accounting purposes, adjustments are made when calculating tax profits. Therefore, taxable profits may differ to a significant extent from accounting profits.

An important restriction with respect to expenses is the prohibition on deductibility of expenses on which tax withholding obligations are not complied with. Depreciation on assets is deductible at rates prescribed under the ITA for different individual assets

4 Salaries, income from house property, profit and gains from business or profession, capital gains and the catch-all heading of 'income from other sources'.

as well as for blocks of assets. Depreciation is permissible not only for tangible capital assets but also for intangible assets. Further, in order to incentivise certain activities such as research and development or sectors like infrastructure, certain capital allowances are permitted. Profits earned by certain enterprises such as those set up in special economic zones (SEZs) are exempt in varying proportions over certain number of years.

Expenses attributable to income qualifying as exempt income cannot be deducted while calculating taxable income where a business earns both taxable income and exempt income; however, determining expenses attributable to taxable income is a highly disputed issue. Further, to discourage excessive rebates and deductions being claimed by companies, where the tax liability determined based on the regular method for calculation of taxable profits is lower than the minimum alternate tax (MAT) prescribed under ITA, such MAT becomes payable. MAT is determined as 18.5 per cent of the 'book profits' as defined under the ITA. Certain expenses, amounts amortised and allowances are added back to the taxable profits to determine such 'book profits'. However, MAT credit (excess of MAT over regular tax liability) can be carried forward up to 10 years for adjustment against taxable profits to the extent they are in excess of MAT.

As per accounting standards, companies are required to maintain accounts on an accrual basis; however, under the ITA, it is permissible to maintain accounts either on the basis of receipt or accrual, at the discretion of the business entity subject to maintaining consistency (i.e., the same method) over the years.

Capital and income

The general principle is that all income or net receipts of a revenue nature are subject to tax unless specifically exempted and capital profits (i.e., capital gains) are exempt unless specifically subject to tax. The ITA defines 'income' to include 'capital gains'.

Income is taxed at the rates prescribed under the ITA (discussed above) that are imposed by the Finance Acts annually. Capital gains are taxed only to the extent they constitute gains arising from the transfer of a capital asset. Gains from transfer of capital assets other than shares and listed securities of a company and certain other specified securities, if held for a period up to 36 months, are classified as short-term capital gains and if held for a period longer than 36 months, as long-term capital gains. In the case of shares and listed securities and certain other specified securities, the threshold would be 12 months instead of 36 months.

Recent amendments have been introduced to tax capital receipts that do not involve any element of profit or gain. They include taxation of notional gains from (1) the purchase of shares by a company (other than a company held by the government or a listed company) for a value less than the fair market value of the shares, to the extent of the difference; and (2) issue of shares at a premium by a company (other than a company held by the government or a listed company), to the extent the fair market value of the shares do not justify such premium.

Losses

Losses attributable to a particular source of income in a financial year can be offset against losses attributable to other sources of income within the same head of income in the same financial year, except in the case of long-term capital loss. Long-term capital loss from a particular source in a particular year can be set off only against long-term

capital gains (and not against short-term capital gains) earned in that year from other sources. If any loss could not be completely set off under the same head, except in case of capital loss, they have to be first offset against gains under the heading capital gains and to the extent such loss is in excess of the gains, it can thereafter be set off against income under any other head; however, the reverse is not possible as capital gains cannot be set off against income from any other heading. If any loss cannot be so set off in the same year, they can be carried forward for up to eight years. In the event of unabsorbed depreciation, it can be set off against income from any category other than salary and there is no time limit for carrying forward.

There are no provisions in the ITA for carry back of losses.

Previous years' unabsorbed business losses, if any, are first set off against the current year's profits and then unabsorbed depreciation is set off. Carried-forward business losses may be set off only against business income in the successive years.

In the event of change of ownership due to merger or demerger, the accumulated business losses of the transferor entity may be set off against any business income of the transferee entity subject to restrictions applicable with respect to continuity of business and ownership. There are additional restrictions in case of a merger where only certain kinds of entities or undertakings are able to offset such losses. Similarly, the unabsorbed depreciation of the transferor entity may be set off against any income of the transferee entity.

Rates

See Section II.i, *supra*.

Administration

Each resident company and every non-resident company earning income in India or claiming benefit under a tax treaty is required to file its tax returns with respect to every financial year before 31 October of the next financial year or before 30 November for companies required to submit transfer pricing reports. As part of their returns, resident companies are also required to disclose assets (including financial interests in any entity) located outside India or signing authority in any account located outside India. Further, persons withholding taxes on payments made to non-residents are also required to submit certain prescribed statements. Corporate tax liability must be discharged by way of advance tax (i.e., on the basis of 'pay as you earn' or PAYE). This is payable in four instalments by 15 June, 15 September, 15 December and 15 March.

It is compulsory for businesses with a turnover of 10 million rupees or more to have their accounts audited.

In cases where there is uncertainty as to the taxability of a transaction involving a non-resident, the non-resident or the resident entity counterparty may approach the Authority for Advance Rulings (AAR) for a ruling, subject to restrictions as to pendency of regular litigation on the matter and valuation. The AAR is an independent quasi-judicial body outside the tax department and its rulings are binding on the tax authorities with respect to the particular transaction on which the ruling has been rendered. In the case of transactions between associated enterprises involving the determination of arm's-length price, the AAR does not provide advance rulings as it does not deal with matters

pertaining to valuation. Instead, advance pricing arrangements could be resorted to, as discussed in Section IX.iii, *infra*.

When the taxpayer is dissatisfied with the order of the assessing officer (who is the first authority responsible for determining the tax liability of a taxpayer), it can challenge the order before the Commissioner (Appeals), who is an officer within the tax department itself. Thereafter, it may challenge the order before the Income Tax Appellate Tribunal (ITAT) and, thereafter, the respective High Court and then the Supreme Court. In a number of cases, orders by tax authorities challenged in tax tribunals and high courts have been reversed, but, while appealing a decision of a lower authority, the taxpayer is often required to deposit a significant portion of the disputed tax liability to be able to proceed with the appeal process. Separately, constitutional remedies can be sought at different stages of litigation by approaching the High Court or the Supreme Court, which have the discretion to admit or reject such applications.

In transfer pricing matters, an alternative mechanism when the matter is pending before the assessing office (AO) is to approach the Dispute Resolution Panel (DRP) after the AO issues a draft order to the taxpayer (which is issued prior to the final order being passed). The taxpayer, if it has objections to the adjustments in the draft order, has the option to either opt for the standard litigation process by filing objections with the AO or file objections with the DRP, which then issues directions to the AO confirming, reducing or enhancing the adjustments. The directions issued by the DRP are binding on the AOs; however, the taxpayer is permitted to appeal against the orders of the DRP and such an appeal can be directly filed with the ITAT instead of having to approach the Commissioner (Appeals).

Tax grouping

India does not provide for consolidated tax grouping.

ii Other relevant taxes

Direct taxes other than income tax[5] on taxable profits include tax payable on employees' salary, which must be deducted at source by the employer.

Indirect taxes are imposed on the sale of goods and services. While the liability to pay the tax is on the seller, the seller may pass on the burden to the purchaser.

Central sales tax (CST) at 2 per cent is levied on inter-state trade while value added tax (VAT) is levied by the state governments on the sale of goods. Payments are made at every stage of sale and, to avoid the cascading effect of taxation, credits are claimable on VAT already paid on the purchase of inputs. While states have the

5 Another important direct tax is wealth tax, which is imposed on the net wealth of all entities. But it is not relevant for business entities, as building and land attached thereto are not subject to wealth tax so long as they are rented out or occupied by the taxpayer for business purposes or held as stock-in trade. Further, assets such as shares and securities are not included within the ambit of the tax. The only important asset that could get covered is vacant land. Wealth tax is charged at 1 per cent of the net wealth (assets minus liabilities) above the taxable threshold of 3 million rupees.

discretion to determine VAT rates, most states currently impose VAT at two basic rates of 5 per cent and 14.5 per cent.

Excise duty is levied on the production or manufacture of goods in India and rates vary depending on the goods involved. The general rate of excise duty is 12.36 per cent. Credit can be claimed for excise duty and service tax paid to the seller on purchase of inputs against excise duty and service tax payable on sale of output.

Customs duty (ranging from 12.5 per cent to 100 per cent) is imposed on import of goods and specified exports. It consists of a basic customs duty, a countervailing duty instead of excise duty and additional customs duty in lieu of state and local taxes.

Service tax at 12.36 per cent is imposed on services other than those specified in the negative list. Taxability of a service depends on the place of its provision, as determined under rules prescribed. Service tax is usually paid by the service provider but passed on to the consumer. Under the reverse charge mechanism applicable to specified services, the service recipient is responsible to pay this tax.

India is proposing the implementation of a comprehensive goods and services tax subsuming most indirect taxes on the sale of goods and services, but the proposal is pending parliamentary approval.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

See Section II.i, *supra*. for corporate residence and, as discussed in that section, an offshore company wholly controlled and managed in India would be classified as an Indian tax resident, taxable on its worldwide income. Control and management is considered to be located in the jurisdiction where decisions are taken with respect to the affairs of policy and such other vital matters concerning the general and corporate affairs of the company, which generally is the situs of the meeting of the board of directors of the company.

If a company incorporated outside India is considered to be a resident in India under the ITA, and if a tax treaty entered into by India applies to the company, the company will only be treated as a resident of one of the two countries based on the tie-breaker rule in the treaty.[6] According to judicial decisions, it is the place from which the day-to-day affairs of the company are carried out *de facto* as against the place in which the ultimate control lies (the criteria that determines a company's residence under the ITA).

ii Branch or permanent establishment

Under the ITA, a non-resident is considered to have a fiscal presence (as distinguished from residence) in India for purposes of source-based taxation if it has a 'business connection' with India. Income of a non-resident attributable to its 'business connection' with India is taxable in India. The meaning of 'business connection' is broader compared with the concept of permanent establishment (PE) in treaty law; it has been defined in an inclusive manner to include agency relationships, and has been judicially interpreted[7] as

6 The 'place of effective management' of the company.

7 *CIT v. RD Aggarwal & Co* [1965] 56 ITR 20 (SC).

postulating an element of a real and intimate relationship and an element of continuity. Thus branch offices and PEs are encompassed within its scope.

In the case of non-residents to whom a tax treaty applies, however, the ITA is applicable only to the extent that it is more beneficial. Under the tax treaties entered into by India, a non-resident business entity is considered to have a fiscal presence for the purposes of source-based taxation only if it has a PE in India. Such a PE of a non-resident business entity may be constituted if the non-resident entity has a fixed base, office or branch, etc., in India. The fixed base need not be owned by the non-resident.

A dependent agent may also constitute a PE if the agent habitually contracts or negotiates on the behalf of the foreign entity, but an independent agent may not constitute a PE for the entity engaging such agency. Generally, the mere fact that a non-resident is a holding company of a company incorporated in India would not render the Indian subsidiary a PE of the non-resident holding company in India. Further, under many of the tax treaties entered into by India, personnel through whom services are provided may constitute a PE in India if the duration for which such services are provided in India exceeds such number of days (as prescribed in the respective treaty) in any one-year period.

Under most of India's tax treaties, a non-resident company with an Indian branch or other PE is subject to tax only to the extent of the income attributable to such Indian branch or PE. The income so attributable to the branch is determined as the amount of profits that the branch would have made if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. The Supreme Court has held that where payments by the non-resident to its Indian PE are at arm's length, no further attribution is required. Such income net of expenses incurred by such branch in generating such income may be taxed at the rate of 40 per cent. In addition, any actual expenses incurred by the head office on account of the Indian branch or 5 per cent of total adjusted profit of the branch, whichever is lower, are deductible.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

The ITA does not provide for a holding company regime. There is a limited participation exemption in certain circumstances. Dividends received by an Indian company from a foreign company, which is normally subject to tax at corporate tax rate of 30 per cent, is taxable at 15 per cent for financial years 2012–13 and 2013–14 if the Indian company holds a minimum of 26 per cent equity share capital of the foreign company; this reduced rate is expected to be extended to future years. Another such instance of limited participation exemption is DDT not being applicable to a holding company where DDT has been paid on such sum by its domestic subsidiary or where 15 per cent tax has been imposed on receipt of dividends from a foreign subsidiary. CA 2013 has expanded the definition of a holding company to mean a company that holds or controls more than 50 per cent of the total share capital of another company (as opposed to only equity share capital, as prescribed under CA 1956).

ii IP regimes

CA 2013 has introduced the concept of a dormant company, which may be used to hold intellectual property. India does not have a comprehensive IP regime but provides for specific tax benefits:

a costs incurred for the acquisition of patents and copyright is deductible in equal instalments over a period of 14 years or until a re-transfer, whichever is earlier;

b costs of acquisition of know-how is deductible in equal instalments over a period of six years;

c capital expenditure on scientific research or payments made to approved research associations and companies is deductible up to 100 per cent, 175 per cent and 125 per cent of such expenditure or payment; and

d income earned by approved research associations is exempt as long as it is utilised for scientific, statistical or social science research.

iii State aid

The petroleum and agriculture-related sectors are the prominent sectors in which state aid in the form of subsidies is granted.

iv General

While there has been growing uncertainty over the tax treatment of cross-border transactions, particularly in the recent few years, methods do exist to mitigate the risks arising from such uncertainty, including application for advance rulings.

Benefits for specific sectors have also made it attractive for doing business in India. The important benefits include a tax exemption for undertakings set up in SEZs starting from the year in which they begin manufacture or provision of services, subject to prescribed conditions. The tax benefits are described below:

a a tax holiday of 100 per cent for the first five years and 50 per cent for the following five years for offshore banking units;

b a tax holiday of 100 per cent for the first five years and 50 per cent for the following five years for banking units of international financial services centres; and

c for other undertakings, tax holiday of 100 per cent for the first 5 years and 50 per cent for the following five years; and a tax holiday of 50 per cent for another five consecutive years, if certain conditions are met.

However, from financial year 2011–2012, SEZ units, which were earlier exempted from MAT at the rate of 18.5 per cent (as described in Section III.i, *supra*), have been made subject to MAT.

The tax holiday applicable earlier in the case of export-oriented undertakings and undertakings located in free trade zones have also been recently withdrawn.

Further, business entities operating in certain sectors such as infrastructure, power, etc. are also entitled to varying degrees of tax breaks, subject to prescribed conditions.

There have also been positive measures taken with respect to bringing about certainty, including the amendments introduced to the general anti-avoidance rules (GAAR) coming into force from 2015 and the appointment of a committee to reform the tax administration system in India.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)

Any person (including non-residents) who is responsible for paying a sum chargeable to tax under the ITA to a non-resident must deduct income tax payable on such sum[8] at the time of the credit of such income to the account of the payee or at the time of payment.

If the non-resident does not furnish his or her permanent account number,[9] tax must be withheld at the rate applicable to that income or 20 per cent, whichever is higher.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Exemptions are available for specific items such as dividends subject to DDT, sale of shares of a listed company on the floor of the stock exchange (if held for more than a year), income with respect to units of a mutual fund, etc. In other cases, the withholding obligation should not arise or would be applicable at reduced rates if the outbound payment is not subject to tax in the first instance or is subject to reduced tax rates (e.g., due to beneficial provisions under a tax treaty).

iii Double taxation treaties

India is party to comprehensive double tax avoidance treaties[10] with more than 90 countries, of which at least 85 are in force, including those with the United Kingdom, the United States, Singapore, Germany, France, Japan, Netherlands, Cyprus and Luxembourg.

The tax treaty will apply to the taxpayer to the extent that it is more beneficial to the taxpayer than the ITA (provided treaty eligibility criteria are met). The rates and incidence of tax prescribed differ from treaty to treaty, but a high-level comparison of the ITA and India's tax treaties follows:

8 Tax must be withheld at prescribed rates (which may be a different from the tax payable on such sum).

9 The tax registration number.

10 As against limited double avoidance tax treaties, which provide relief only with respect to income from certain sources.

	ITA	Tax treaty
Local withholding on outbound payments		
Dividends from resident companies	Since the DDT is a tax on the paying company, treaties do not provide relief in this respect. Some treaties may provide for credit for underlying corporate taxes. However, despite such a provision, due to the basic corporate tax rate being 32% (inclusive of surcharge and cess), it may not be possible to avail credit on the additional 15% DDT (on the profits after the 32% tax), unless the tax rate in the other country is greater than 32%.	
Royalty/fees for technical ervices (FTS)	Wide definition of royalty that disregards factors such as control/use/location in India. Human intervention in the provision of technical services is required to subject it to Indian tax. 25% withholding.	Narrower definition of royalty and FTS. Rates range between 10–20%
Interest paid on foreign-currency denominated loans	20% withholding	Rate between 5–20%
Interest paid on foreign-currency convertible bonds	10% withholding	
Interest paid on foreign-currency borrowings for specific sectors	5% withholding	
Other sources of interest	40% withholding	
Business profits of a non-resident (income of a non-resident not falling under any of the above categories in the absence of a PE and including income falling under the above categories if there is a PE)	See Section IV.ii. A PE under treaty law is narrower in scope than a business connection under the ITA. Tax treaties restrict the taxation of business profits to those profits attributable to a PE (as against a business connection under the ITA). However, tax treaties do not provide any relief on the tax rate applicable to such business profits.	
Capital gains	See Section III.i. Some treaties offer relief with respect to capital gains earned from transfer of shares of a company which is dual resident in the treaty countries (and which does not primarily derive its value from immovable property), by stating that only the country of the shareholder's residence has the taxing right.‡	
‡ Examples include the tax treaties with Mauritius, Singapore, Cyprus and the Netherlands		

	ITA	Tax treaty
Withholding on inbound payments		
Foreign dividends	For financial years 2012–13 and 2013–14, subject to certain conditions, reduced 15% tax applies for Indian companies which receive dividends from foreign companies in which they hold a minimum of 26% equity share capital; this reduced rate is expected to be extended to future years as well; 30% tax applies for other dividend receipts.	Rate between 5–25%
Other kinds of income received from outside India by Indian residents.	See Section II.i. In the absence of a tax treaty, ITA provides for a foreign tax credit subject to certain conditions. In such cases, no underlying tax credit is available.	Vice versa as compared to position in case of local withholding on outward payments. In addition, in case of residents, the treaty provides for credit for foreign taxes on the corresponding income.

iv Taxation on receipt

See Section VI.iii, *supra*.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation

There is no restriction on debt-to-equity ratios, but under the GAAR, the Revenue has the power to re-characterise equity as debt and debt as equity.

ii Deduction of finance costs

Specific finance costs such as insurance premiums, interest on borrowings, bonuses or commissions are deductible. As a general rule, revenue expenditure wholly and exclusively incurred for the purposes of the business is deductible. Expenditure incurred by an Indian company wholly and exclusively for the purposes of merger or demerger of an undertaking is deductible in five equal instalments over five successive years, beginning with the financial year in which the amalgamation or the demerger took place.

Expenses payable to a non-resident on which the withholding obligation has not been satisfied are not deductible if the withholding tax is not deducted and paid. Further, if any income of a taxpayer is tax exempt, expenses attributable to such income cannot be deducted. This has an impact on acquisition financing since the income earned by the target can be regarded as exempt income (since the dividend distribution tax is an additional income tax in the hands of the target and exempt in hands of the shareholder) and hence can lead to a situation of non-deductibility.

iii Restrictions on payments

Under CA 1956, dividends can be paid or declared by any company for any financial year only out of the current year's profits or previous year's accumulated profits (arrived at after allowing for depreciation) or out of both. Further, a company cannot declare dividend on its equity shares if it fails to redeem its preference shares as prescribed. Also, before any dividend is declared or paid, the prescribed profit percentage (not exceeding 10 per cent) must be transferred to the reserves of the company. If profits are insufficient to pay dividends in a particular year, the company is permitted to pay it out of the previous year's reserves, subject to the prescribed rules.

Under CA 2013, the above profit-to-reserve transfer requirement has been made voluntary and the restriction on dividend declaration upon a failure to redeem preference shares has been removed.[11]

11 These provisions have not yet been notified as being in force.

iv Return of capital

Share buy-back is the most common method employed for capital reduction as it does not require the court's approval. CA 2013 provisions on buy-back have not yet been notified but are largely similar to those of CA 1956.

A company is permitted to buy-back its own shares up to the level of 10 per cent of its total paid-up capital and free reserves, subject to authorisation by the board of the company and other conditions. One key condition is that debts owed by the company must be less than twice the paid-up capital and reserves post-buy back. Buy-back is permitted of more than 10 per cent but up to 25 per cent of the total paid-up capital and reserves if it is approved by a three-quarter majority in the general meeting of shareholders. Listed companies must comply with additional restrictions.

Buy-back of shares is not tax neutral. Until recently, it was taxable as capital gains from which relief could be claimed by non-residents investing through treaty jurisdictions where the tax treaty takes away or reduces India's right to impose tax on capital gains from the transfer of an Indian company's shares. From this year, such gains have instead been made subject to a 20 per cent tax in the hands of the company buying back the shares as additional tax payable on the profits distributed by way of such buy-back.

Companies are also permitted to reduce capital through extinguishing or reducing liability on unpaid share capital or reducing or extinguishing paid-up share capital. However, these methods are unpopular as they require confirmation by the court under CA 1956 and by a quasi-judicial body under CA 2013. Further, such reduction of capital, to the extent the company possesses accumulated profits, is treated as distribution of dividends on which DDT is payable.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Commercially, there are different methods that could be adopted for acquisition of the business of an Indian company by a foreign company. They primarily include share acquisition, merger or demerger, and asset acquisition. Each method has its own advantages and disadvantages, both from a commercial and from a tax perspective. Direct acquisition of shares of an Indian company is preferable where the shares have been held by a non-resident situated in a favourable treaty jurisdiction on account of which it would not be liable to capital gains tax in India on the transfer of such shares. Where the shares of the Indian company are not so held, in the case of listed companies held for more than one year, however, they can be acquired on the stock exchange through the 'bulk deal' mode (as long-term capital gains from listed securities sold on the floor of the stock exchange are exempt from capital gains tax). The withholding obligations

with respect to the aforementioned alternative would not apply as the sum involved is not subject to tax liability in the first instance.

Further, asset acquisition in the form of acquisition of a business as a going concern[12] by a local subsidiary is also possible as the business as a whole is considered a capital asset and the transfer thereof is subject to long-term capital gains at 20 per cent (without any benefit of indexation for inflation) if such business has been in existence for longer than three years, irrespective of the period for which the individual assets of the company have been held. This being a domestic transaction, and there being no specific provision for withholding under the ITA, there is no withholding obligation applicable.

In terms of financing alternatives, while interest is generally preferred as it can be used as a method of repatriation of profits, there are exchange control restrictions with respect to debt financing not in the nature of securities compulsorily convertible into equity. Further, if any such expenditure has been incurred in relation to the earning of exempt income, the same cannot be deducted in calculating taxable profits.

ii Reorganisation

Domestic mergers or demergers are tax neutral subject to the certain conditions, the most important among them being the following:

a in the case of demergers, the transferee company issuing shares to the shareholders of the transferor company on a proportionate basis; and

b in the case of the both mergers and demergers, shareholders holding at least three-quarters in value of the shares in the transferor company becoming shareholders of the transferee company (other than by way of shares already held, if any, by such shareholders in the transferee company).

Therefore, an acquired business can be consolidated with an existing business in a tax neutral manner.

Under CA 1956, while a foreign company can merge or demerge into an Indian company, the reverse is not permitted. Such merger or demerger into an Indian company is tax neutral subject to satisfaction of the above conditions. However, under CA 2013, the reverse is also permitted, though the relevant provisions are yet to be notified. Further, no specific provisions that would make them tax neutral have been introduced to date.

Capital gains from the transfer of shares of an Indian company as a consequence of merger of two foreign companies is tax neutral if:

a at least 25 per cent of the shareholders of the transferor foreign company continue as shareholders of the transferee foreign company; and

b such transfer does not attract capital gains in the country in which the transferor company is incorporated.

12 The consideration payable should be for the business as a whole as against being the sum total of consideration attributable to individual assets, in which case the gains would be computed for each asset separately.

The transfer of shares of an Indian company as a consequence of demerger of a foreign company into another foreign company is tax neutral if:

a shareholders holding no less than three-quarters in value of the shares of the demerged foreign company continue as shareholders of the resulting foreign company; and

b such transfer does not attract tax on capital gains in the country, in which the demerged foreign company is incorporated.

iii Exit

Although not permitted under CA 1956, under CA 2013, an Indian company can relocate its *situs* by merging with a foreign company. These provisions of CA 2013 are yet to be notified. From a tax perspective, there are no penalties for a change in tax residence status arising from such relocation, although there can be tax consequence on the outbound merger.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

The GAAR, introduced by the Finance Act 2012 and modified by the Finance Act 2013, aim at checking tax avoidance by investors. An arrangement would be considered an 'impermissible avoidance arrangement' if its main object was to obtain a tax benefit. In such a case, the tax authorities have been given broad powers to subject to arrangement such tax treatment as they deem appropriate, including denial of benefits under applicable tax treaties. GAAR would only be invoked if a minimum tax benefit of 30 million rupees is obtained due to the arrangement; however, the implementation of GAAR has been postponed to apply to tax benefits obtained from the 1 April 2015, based on structures put in place on or after August 2010.

The ITA also provides that the transactions by residents with parties located in offshore jurisdictions notified as non-cooperative territories,[13] are subject to transfer pricing regulations. Deduction for the purposes of calculating taxable profits are not allowed with respect to payments made to financial institutions located in such a jurisdictions unless the taxpayer furnishes an authorisation allowing the income tax authorities to seek relevant information from the financial institution on its behalf. Deduction with respect to other transactions with a person in such jurisdiction is also not allowed unless the taxpayer furnishes prescribed information. Income earned by residents of such jurisdictions from Indian sources is subject to an enhanced withholding tax of 30 per cent irrespective of a lower withholding rate provided under Indian law or an applicable tax treaty. The government recently, notified Cyprus as a non-cooperative jurisdiction for this purpose. However, based on communications from the Cyprus Ministry of Finance, it is expected that the India–Cyprus tax treaty will be renegotiated to address India's concerns and that, after such amendment based on such renegotiation,

13 Such notification can be made under the ITA if such jurisdiction has not signed a tax information agreement with India or does not adequately exchange information with India.

the notification would be withdrawn with retrospective effect from the date of its coming into force. However, on 17 December 2013, Indian officials stated that the decision on withdrawing the notification would depend on whether Cyprus provides information on certain investments made from Cyprus to India within a two-month period.

ii Controlled foreign corporations

There are no rules for controlled foreign corporations in India, but such rules could be introduced by the DTC, which is the legislation proposed to replace the ITA. The exact scope of such provisions depend on the final form in which the DTC is enacted.

iii Transfer pricing

The ITA has transfer pricing provisions according to which any income arising from an international transaction (a transaction between two or more associated enterprises, either or both of whom are non-residents) is required to be computed having regard to the arms' length price. Modes of calculation of arm's-length price are given in the ITA. Recently, the term 'international transaction' has been defined with retrospective effect. Important among these transactions are the following, which were previously considered to be outside the scope of transfer pricing on account of the absence of an element of income or gain in such transaction:

a capital financing; or

b a transaction of business restructuring or reorganisation, irrespective of the fact that it has bearing on the profit, income, losses or assets of associated enterprises at the time of the transaction or at any future date.

Recently, provisions have also been introduced to enable taxpayers to make an application for entering into an advance pricing agreement (APA) with the authorities, determining the arm's-length price or specifying the manner in which it must be calculated, in relation to international transactions to be entered into by that person for a period of up to five years.

To reduce transfer pricing disputes arising with respect to determination of arm's-length price, the ITA provides for the framing of safe-harbour rules. Safe-harbour rules prescribe thresholds satisfaction of which binds the tax authorities to accept the transfer price declared by the assessee. According to the safe-harbour rules notified by the government, which are applicable for five financial years beginning from 2012–13, an assessee can opt for the safe-harbour regime for a period of its choice but not beyond financial year 2016–17.

iv Tax clearances and rulings

Please refer to Section III.i, *supra*, for a basic understanding of advance rulings.

These rulings are statutorily required to be rendered within a period of six months. While these rulings have been rendered within six months to two years, it may not be final, as either of the parties (taxpayer or the tax department) have the option of approaching the High Court or the Supreme Court against such ruling seeking constitutional remedies.

Though it is not mandatory, where there are significant risks from tax uncertainty, obtaining an advance ruling is highly preferable for investors proposing to do business in or with India on account of the high level of certainty offered with respect to the tax consequences of their transactions.

X YEAR IN REVIEW

Against a backdrop of high inflation and worsening current account deficit, there was a relaxation in the investment caps for FDI in certain sectors. Automatic investment without prior regulatory approval has been permitted in stock exchanges and single brand retail trading (up to 49 per cent) while in the telecoms sector, automatic investment up to 74 per cent will continue and excess up to 100 per cent will require regulatory approval. SEBI has issued draft regulations to rationalise the foreign investment regime. Key changes include (1) classifying investment up to 10 per cent of equity of an Indian company as portfolio investment and above 10 per cent as FDI, (2) merging FIIs and QFIs into a new class, 'foreign portfolio investor', and (3) adopting a risk-based know-your-client approach for foreign investors, divided into low, medium and high risk categories. India's central bank, the Reserve Bank of India, has permitted non-resident investors who are already in control[14] of a listed Indian company to acquire shares of a listed Indian company on the floor of a stock exchange through a registered broker under the FDI route. Previously, only FIIs, NRIs and QFIs were permitted to do so.

Subject to the satisfaction of prescribed conditions, Indian companies have been allowed to list themselves on overseas stock exchanges for a two-year period since 11 October 2013, and the earlier requirement of prior, simultaneous or subsequent listing on Indian stock exchanges has been removed. Capital raised in this way may be used for offshore purposes, but if not so used within 15 days, it should be repatriated to India for domestic purposes.

Heightened suspicions in the context of poor corporate governance standards has led to instances of global PE funds carrying out post-investment due diligence in their portfolio companies. Another manifestation of global investors asserting their rights is the institution of investment arbitration proceedings against India in the recent past. This led the government to set up a permanent body this year to review and renegotiate all 82 of its BITs to protect the country's interests.

CA 2013 introduced corporate social responsibility for companies meeting certain thresholds of net worth, turnover or net profits. They must spend 2 per cent annually of the company's average net profits of the preceding three financial years on social projects or explain why such spending has not taken place. It is debatable as to whether this obligation is voluntary or mandatory.

14 The term 'control' for this purpose include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

CA 2013 has also imposed restrictions on the number of subsidiaries an Indian company may have.[15] A company is not permitted to make investments through more than two layers of investment companies. The term 'investment companies' is defined to mean companies whose principal business is acquisition of shares, debentures or other securities; however, this provision does not prevent a company from acquiring any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of that country.

In 2012, India retrospectively made certain offshore share transfers subject to Indian tax where the foreign company's shares derive, directly or indirectly, substantial value from assets located in India. In this regard, the decision in *Sanofi Pasteur Holdings SA*,[16] is significant. The deciding state High Court has clarified that the retrospective amendment on indirect share transfers will not affect treaty interpretation.

The tax authorities have also initiated transfer pricing scrutiny on intra-group share subscriptions on the ground that shares were issued at less than market price. Notices have been sent to Shell, HSBC Securities and Standard Chartered in relation to their respective inbound transactions. Against this backdrop, a ruling by the Hyderabad Tribunal in an outbound transaction assumes great significance. In the matter of Vijai Enterprises, the Tribunal held that investments in share capital outside India were in the nature of capital investments and did not give rise to chargeable income. Consequently, they would not attract transfer pricing regulations.

XI OUTLOOK AND CONCLUSIONS

It is expected that CA 2013 will be implemented fully and that subordinate legislation on the finer operational details will be issued, although in instalments. The DTC is yet to be made into law, but when it is, it may introduce taxation of CFCs, branch profits tax and the residence criterion of 'place of effective management' into Indian law. Alternatively, the government may choose to bring in certain changes through the Finance Act, which will implement next year's budget.

15 This provision has not yet been notified into law.

16 *Sanofi Pasteur Holding SA v. The Department of Revenue* [TS-57-HC-2013 (AP)].

Appendix 1

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