

International Tax Developments in India – The Continuing Saga

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A Note Regarding Content

From time to time in the course of our practice we have encountered and informed clients about developments in matters of international taxation in various non-U.S. jurisdictions. This White Paper reports on certain recent tax law developments in India of potential importance to U.S. businesses and other multinational enterprises. Please note that, while McDermott Will & Emery has offices in the United Kingdom, Germany, Italy and Belgium as well as in the United States, and has a strategic alliance with MWE China Law Offices in Shanghai, it is not licensed to practice law in India or, with the exception of those mentioned above, any other international jurisdictions. This White Paper is solely informational in nature and does not constitute legal or tax advice.

In August 2009, the Indian tax authorities introduced a proposed Direct Taxes Code (Proposed DTC) that is scheduled to come into force on April 1, 2011, if enacted. The Proposed DTC appears to buttress the aggressive stance the Indian tax authorities have been taking with respect to the taxation of international transactions with an arguable Indian nexus, and the last quarter of 2009 was particularly replete with court decisions and administrative rulings, including the withdrawal of certain long-standing administrative guidance, that potentially affect nonresidents doing business and providing services in India.¹

The first half of 2010 has seen taxpayers making up some of the ground yielded in 2009, with the latest development being the revised discussion paper (Discussion Paper) on certain aspects of the Proposed DTC that was released by the Indian government on June 15, 2010². The Discussion Paper stems from comments received on the Proposed DTC. Certain aspects of the original proposals and the Discussion Paper that could be of particular interest from an international tax perspective are described below.

Indian Tax Residency

Currently, under the Indian Income Tax Act of 1961 (ITA), a company is considered resident in India for tax purposes if it is incorporated in India or the control and management of its affairs is considered to be situated *wholly* in India. While the Proposed DTC provides that a company incorporated in India will always be treated as resident in India, it also provides that a company incorporated outside India would be treated as resident in India if, at any time in the financial year, the control and management of its affairs was situated “*wholly or partly*” in India.

Consequently, a foreign company whose control and management is partly in India could be treated as a resident of India and, thus, liable to taxation in India on its worldwide income. This provision encountered some criticism on the basis that it was too broad and could impact foreign direct investment into India. The use of the word “partly” in the proposed statutory language was

¹ For a more complete description of some of these developments, please see McDermott Will & Emery’s *White Paper*, “At Cross Purposes: Recent International Tax Developments in India,” by Kumar Paul and John Engel of McDermott’s New York U.S. & International Tax Practice Group (February 8, 2010).

² Significantly, among these taxpayer “victories” is the case of E*Trade, whose wholly owned subsidiary based in Mauritius (E*Trade Mauritius) sold its holding in an Indian company to HSBC Violet Investments, also based in Mauritius. Under the India-Mauritius tax treaty, any gain arising from the transaction would be taxable only in Mauritius. However, the Indian tax authorities took the position that the transaction was taxable in India, on the basis that E*Trade Mauritius was a façade or a shell company and, therefore, could not avail itself of treaty benefits. E*Trade sought and, on March 22, 2010, obtained a ruling in its favor from the Indian Authority for Advance Rulings (AAR) (an independent body tasked with issuing rulings that bind the applicant taxpayer and the Indian tax authorities on matters concerning a taxpayer’s liability for Indian taxes). The AAR ruling followed the position established by a 2003 decision of the India Supreme Court and circulars issued by the Indian tax authorities to the effect that the production of a valid Mauritian tax residency certificate should be sufficient to claim the benefits of the India-Mauritius tax treaty. A similar ruling was released by the AAR (despite the Indian tax authorities objections) on February 25, 2010, involving a German company’s ownership of an Indian investment through a wholly owned Dutch holding company and the application of a similar exemption in the India-Netherlands tax treaty. In addition, several recent court decisions have pushed back on the decision reached by the Karnataka High Court which held in *CIT v. Samsung Electronics Co. Ltd.*, ITA No. 2808 to 2810 of 2005, that withholding on commercial payments to non-residents was necessary in all cases in the absence of a certificate from the assessor’s office. These recent cases have held that withholding on payments to non-residents is only necessary in the event the payments are taxable in India, and that the payor may make the initial determination of whether such payments are taxable.

considered to introduce a very low threshold for regarding a foreign company as resident in India. Concerns were expressed that potential existed, for example, for a foreign multinational company to be deemed to be resident in India if a single meeting of its board of directors was held in India or for a foreign company owned by Indian residents to be considered resident in India on the basis that the control of the company resided in India.

The Discussion Paper proposes that a company incorporated outside India will be treated as resident in India if its “place of effective management” is situated in India. Effective management is described by the DTC to mean:

- The place where the board of directors of the company or its executive directors, as the case may be, make their decisions
- In a case where the board of directors routinely approves the commercial and strategic decisions made by the executive directors or officers of the company, the place where such executive directors or officers of the company perform their functions

CFC Rules

Going beyond the changes contained in the Proposed DTC, the Discussion Paper also proposes the introduction of an anti-deferral regime (in the section dealing with tax residency). The Discussion Paper states in relevant part as follows:

- As an anti-avoidance measure, in line with internationally accepted practices, it is also proposed to introduce Controlled Foreign Corporation provisions so as to provide that passive income earned by a foreign company which is controlled directly or indirectly by a resident in India, and where such income is not distributed to shareholders resulting in deferral of taxes, shall be deemed to have been distributed. Consequently, it would be taxable in India in the hands of resident shareholders as a dividend received from the foreign company.

While this proposal is obviously aimed at Indian owners of foreign corporations, it would also impact a multinational that owns or acquires an Indian target with non-Indian subsidiaries. It is not clear at this stage what the parameters of the proposed rule would be and whether exceptions similar to those available under the Subpart F rules of the U.S. Internal Revenue Code would be included.

Treaty Override

Under the ITA (subject to certain specific exceptions), in case of a conflict between the provisions of Indian domestic law and those of an applicable international bilateral tax treaty, the provisions that are more beneficial to the taxpayer will apply. The Proposed DTC on the other hand provides that neither a tax treaty nor domestic law shall have a preferential status and that in the case of a conflict between the provisions of a treaty and the provisions of domestic law, the one that is later in point of time would prevail.

There were concerns that this proposed “treaty override” could result in uncertainty and render many, if not all, of the bilateral tax treaties entered into by India obsolete with respect to certain provisions. The Discussion Paper seeks to address this concern by reinstating the approach that applies under current law subject to certain exceptions. In particular, domestic law will override inconsistent provisions of tax treaties where the General Anti-Avoidance Rule (described below) is invoked, or when the Controlled Foreign Corporation provisions (described above) apply.

Introduction of the General Anti-Avoidance Rule

The Proposed DTC also introduces a general anti-avoidance rule (GAAR), which can override the provisions of any tax treaty and will be invoked if certain conditions are met.³

In reaction to the proposed introduction of the GAAR, concerns were expressed that the sweeping nature of the proposed provision would result in the GAAR being routinely invoked by exam teams, particularly in cases where no specific tax law provision covered what the exam team perceived to be an abusive transaction or arrangement. Concerns were also expressed that there was an insufficient distinction between arrangements that were aimed at tax mitigation rather than tax avoidance. The Discussion Paper seeks to address these concerns by proposing:

- That guidelines be issued providing for the circumstances under which the GAAR may be invoked
- The establishment of certain thresholds that must be breached before the GAAR may be invoked
- That taxpayers be provided access to a specialized panel to mediate and adjudicate alleged breaches of the GAAR

The Indian government's stated position is that the GAAR is only intended to apply to arrangements that are abusive or lack commercial substance.

Characterization of Income of Foreign Institutional Investors

Another potentially important development is the proposal in the Discussion Paper that income arising from the purchase and sale of securities by foreign institutional investors (FIIs) be deemed capital gains and not ordinary or business income.⁴

It appears that while the majority of FIIs report income from the disposition of such investments as capital gains (which are generally subject to tax in India unless exempt under domestic law or by an applicable tax treaty such as under the treaties India has with Cyprus, Mauritius and Singapore), some FIIs characterize such income as "business income." The characterization as business income is generally influenced by the volume and frequency of trading and an FIIs business income from Indian sources (particularly when covered by an applicable tax treaty) is generally only taxable in India if attributable to a permanent establishment of the FII in India. Consequently, the Discussion Paper notes that FIIs that characterize the income arising from the purchase and sale of securities as business profits claim a total exemption from taxation in the absence of a permanent establishment in India. The Discussion Paper states that the proposal to treat all such income as capital gain is aimed at simplifying the system of taxation, introducing certainty and eliminating litigation. The proposal potentially treats FIIs differently

³ The GAAR may be invoked if each of the following three conditions are met:

- The taxpayer has entered into an "arrangement" (this is somewhat analogous to the position taken in recent economic substance cases under U.S. income tax law, under which individual steps in any transaction aimed at securing a tax benefit can be treated as an arrangement and can include any interposition of an entity or transaction where the substance of such entity or transaction differs from the form given to it).
- The main purpose of the arrangement is to obtain a tax benefit.
- The arrangement includes one or more of the following attributes:
 - i) Has been entered into, or carried out, in a manner not normally employed for *bona fide* business purposes
 - ii) Has created rights and obligations which would not normally be created between persons dealing at arm's length
 - iii) Has resulted, directly or indirectly, in the misuse or abuse of the provisions of the DTC
 - iv) Lacks commercial substance, in whole or in part

⁴ The Indian securities laws permit FIIs to invest in certain specified securities issued by Indian companies.

than domestic investors engaged in the business of buying and selling securities. It also may result in instances of double taxation.⁵

Conclusions

The release of the Discussion Paper could be viewed as an indication that the Indian government is not completely insensitive to the “push-pull” nature of oversight and regulation that is a necessary component of balancing national and international interests in an economy endeavoring to attract foreign investment. The Discussion Paper reiterates in more than one place that the proposals are meant to bring the provisions of the Proposed DTC within the framework of internationally accepted norms and practices of fiscal administration and tax policy. However, at the same time the Discussion Paper does not seek to curb the proposed extraterritorial reach of the Proposed DTC, for example, as to the taxation of offshore transactions that lead to an indirect transfer of capital assets in India. The release of the Discussion Paper is no doubt only the most recent development in an ongoing saga.

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⁵ In general, for U.S. federal income tax purposes, when a U.S. person sells the stock of a foreign corporation, the gain (if any) is considered to have a U.S. source as it is sourced by reference to the residence of the seller. The India - United States tax treaty does not prohibit India from imposing capital gains tax on a U.S. person’s sale of stock in an Indian target company but it does not provide a “resourcing” rule with respect to such gain (*i.e.*, a rule that would characterize gain on disposition of shares in an Indian company as Indian source gain in the event such gain is taxable in India), and as a result, a U.S. person incurring an Indian tax on a share disposition in an Indian company may be precluded from obtaining a foreign tax credit for such Indian tax.

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