GROWING (CAPITAL) PAINS IN INDIAN TAXATION AND OTHER FISCAL AILMENTS FOR FOREIGN INVESTORS

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1. Introduction

For many years, Indian direct tax legislation and UK tax legislation have more or less kept apace with each other in terms of format and process. Each country has a mother ship statute: the equivalent of the Income and Corporation Taxes Act 1988 in the UK is the Income Tax Act 1961 in India. Annual flying saucers are added to the fleet in the form of Finance Acts in each country[1].

The space fleet in both countries is going through renewal. The UK has opted for splitting out the base legislation into ITTOIAs, ITEPAs, ITAs and CTAs while not yet confining the mother ship to the scrap yard. In August last year, the Indian Government introduced a perhaps more radical overhaul when it launched the draft Direct Taxes Code ("DTC"). The Government emphasised at the time that simplification was a key objective, and managed to produce a bill which covers all Indian direct taxation including both corporate and individual, and restricting the length to 254 pages. The Income Tax Act 1961 will be repealed in its entirety.

Initially, this seemed like a very laudable exercise. Foreign tax practitioners engaged in Indian transactions were particularly pleased that the DTC with accompanying notes and summary was very portable in paperback. Unfortunately, whatever initial euphoria this produced came to an abrupt end on reading the content. In addition, the Government initially announced an uncertain but necessarily short period of consultation, with the intention of legislating in the 2009 Winter Session of Parliament. The DTC was intended to come into force with effect from 1st April 2011[2]. These timeframes did not alleviate the tension in the taxpaying community, both domestic and international.

The concerns thrown up by the DTC proposals relate to some wide-reaching provisions as well as specific ones. In the former category are proposals to introduce a treaty override provision which will mean that in cases of conflict between double tax treaties and Indian domestic tax legislation, the later provision will prevail[3]. There is further a new general anti-avoidance provision in the legislation. The domestic Indian tax community in particular has also become agitated by another provision to introduce a minimum alternate tax on companies based on the value of gross, not net, assets of a company.

All of these proposals are relevant to foreign investors with Indian investments, as well as those looking at new investments. However, there are other specific provisions which have created great uncertainty for these investors. In this article, I discuss the three most significant ones, which are:

- The extension of the Indian capital gains taxation basis to include transfers of overseas assets which result in indirect transfers of underlying Indian assets

- Changes to the test of corporate residence

- Changes to the source rules for interest

2. Capital Gains Extension

In India, there is no capital gains tax as such as capital gains is a separate head of income tax. For convenience, this is referred to as "CGT". The DTC proposes to deem as Indian income any gain which accrues, "whether directly or indirectly", through or from...the transfer, directly or indirectly, of a capital asset situated in India." The use of the word "indirectly" twice may smack of overkill, but it is the second reference which creates the extension of the current CGT charge.

Commentators have referred to this provision as the enactment of the Indian tax authorities' stance in the well-known *Vodafone* tax litigation. It is outside the scope of this article to discuss those proceedings, other than to say that they raise the issue of whether a sale, by a non-resident seller, of shares in an offshore holding company which (through other subsidiaries) owns shares in an Indian company can give rise to Indian CGT on the basis that the sale was in reality the sale of the underlying Indian company. It should be noted that this issue has as yet to be decided on the merits in that litigation. In the meantime, the DTC amendment appears to put the position beyond doubt i.e. that such a sale would trigger an indirect transfer of the Indian shares, if the sale occurs after the DTC has been enacted.

However, the amendment potentially goes some way beyond the *Vodafone* issue. Some examples illustrate the enormity of the proposal. Assume a multinational offshore group which conducts operations worldwide including through a local subsidiary in India. The board of the parent company decide to sell the particular business division which houses the subsidiary. This is a global divestment of subsidiaries and business assets. Suppose that the Indian subsidiary, together with other Asian subsidiaries, is held by a single offshore holding company and it is the shares in that holding company which are sold. Such a sale would apparently involve the indirect transfer of the underlying Indian subsidiary, thus triggering an Indian CGT charge.

This is a large commercial transaction under which the Indian subsidiary happens to be one item in the subject-matter of the sale. An Indian purchaser would have the liability to deduct withholding tax from the sale consideration[4].

Tax managers and advisers on both sides of such a transaction will need to be alert to the impact of the DTC. A well-advised purchaser would negotiate hard to ensure that it can withhold and that the seller gives it all the necessary information to work out how much to withhold, together with an indemnity for withholding too little.

In the above example, the indirect owner of the Indian subsidiary has a controlling interest, just as in the *Vodafone* facts. But the new provision arguably goes further and could catch offshore portfolio investors. Now suppose there is an open-ended investment fund located in the Channel Islands. The fund has a Mauritian subsidiary which has a portfolio of Indian stock. What happens if a foreign investor sells his holding in the top fund to another non-resident or redeems his holding? In both cases, he has given up his indirect interest in a pro rata share of the Indian stock portfolio. Is that a transfer of the pro rata interest which would be subject to Indian CGT[5]? The situation gets even more unreal from the exiting investor's viewpoint if he did not even know about the constitution of the Indian portfolio. A potential tax charge in such a situation cannot be the intended result, but in the absence of any limitation of the extended charge to controlling interests only, it cannot be ruled out.

The final example relates to international capital markets investors. The DTC retains the exemption from CGT for transfers of global depositary receipts ("GDRS") between non-resident parties offshore where the GDRs represent interests in Indian company shares. But that exemption relates to the GDRs. A transfer of a GDR would also involve the indirect transfer of the underlying shares. One would like to think that the specific exemption would preclude a charge in relation to the underlying shares arising under the more general charging provision. However, since the charge would be on a different asset to that covered by the exemption viz.

the shares as opposed to the GDRs, it is not clear that this would necessarily be the right result. It obviously should be.

Apart from substantive charging issues, there will be very serious difficulties of compliance for non-residents, particularly if they do not even know that a transfer involves an indirect transfer of Indian assets. It is hoped that the charge is not in fact introduced or, if it is, its scope is both limited and clear.

3. Corporate residence

Like the UK, India has two tests of corporate residence. The first is incorporation in India. That is not relevant here. The second currently provides that a company is resident in India in any fiscal year if the control and management of its affairs is situated wholly in India[6].

The DTC proposal changes the second test so that a company will be resident in India if "its place of control and management, at any time in the year, is situated wholly, or partly, in India"[7].

Again, the width of this wording and its extension from the current law is dramatic. The combination of doing something "at any time" and the word "partly" means that a single act in a day could make a company Indian tax resident if that act is one of control and management. It would not matter that the company is otherwise managed and controlled offshore.

If a company becomes so resident, it would be subject to tax in India on worldwide income, subject to the application of any tiebreaker clauses in treaties, and would further be subject to the dividend distribution tax when paying dividends.

The provision rules out a foreign investing company holding even a routine board meeting in India in isolation unless it is prepared to argue that routine business does not constitute control and management. Clearly, the risk would be unacceptable. But even more significantly in practice, the provision could make a foreign company resident if there is an Indian director who, for example, attends board meetings by telephone from India. This is a particularly worrying scenario because it is not uncommon for a key individual in an Indian business owned by non-residents to be appointed to the board of the ultimate offshore parent. It would be unthinkable that such an appointment could expose the parent to taxation on worldwide income in India.

Finally, a non-resident director of a foreign company could make the company Indian tax resident by attending board meetings while temporarily in India e.g. on a business trip or on holiday.

The width of the provision practically invites companies to become resident inadvertently. As currently drafted, it is unworkable both in terms of compliance by foreign companies and enforcement by the tax authorities.

4. Extending the Source of Interest

Finally, here is a puzzling scenario. A UK resident multinational top company ("UKCo") raises money in the capital markets by way of a bond issue. The funds are to be used for group operations in different countries. One is India, where there is an Indian trading subsidiary ("IndCo"). For simplicity, let's suppose it is held directly out of the UK. UKCo wants to provide additional funds to IndCo and decides to do so out of part of the bond issue proceeds. The funds are provided to IndCo by way of a subscription for shares.

The bonds issued by UKCo are listed and sold widely to investors in different countries. As is customary in the international markets, investors expect to receive interest payments free of any withholding taxes. To meet this requirement in the UK, UKCo has taken advice and made sure that the bonds qualify for the "Quoted Eurobond" exemption in Section 882 of the Income Tax Act 2007.

One would normally think that is the end of the matter so far as withholding tax on interest payments on the bonds is concerned and that the use of funds in this particular context would be irrelevant. The DTC, however, has other ideas. Section 5(2)(d) of the DTC deems interest income to accrue in India where it is:

> "interest accrued from any non-resident, if the interest is in respect of any debt incurred and the debt is used for the purposes of:

- a business carried on by the non-resident in India: or

- earning any income from any source in India".

The example under consideration does not fall within the first bullet point as UKCo itself is not carrying on an Indian business. But what about the second scenario? UKCo will get dividends from time to time from IndCo. Those dividends will clearly have an Indian source.

Prima facie, therefore, the facts fall within the second scenario as the earning of dividend income from IndCo will be one purpose for the use of debt proceeds to inject equity in India: no doubt there would be other purposes for this financing, but that appears to be irrelevant i.e. the purpose of earning any income from India does not have to be the sole purpose.

If this is correct, then the upshot is somewhat remarkable. UKCo will have to withhold Indian income tax on interest payments on the bonds to the extent that the interest is attributable to that part of the debt used for the benefit of IndCo. So, not only would the UK bond issuer have to withhold Indian tax, but it would have to ascertain how to do a partial withholding on the interest payments since the proceeds are only part-used in India. Once it did this, it would have to gross up for tax withheld under the terms of the bonds so that investors are kept whole.

Meanwhile, in India, IndCo would be fully taxed on its trade profits at 25% under the proposed DTC corporate rate and would have to account for dividend distribution tax when paying dividends to UKCo-an effective tax rate of over 40%, which would not be absorbed fully in foreign tax credits in the UK.

If the source doctrine in India applies in this way, foreign companies will no longer be able to raise funds in the international capital markets on competitive terms where all or part of the funds go to Indian subsidiaries.

The capital markets environment produces a particularly stark example of the width of the source extension. But it applies in other perfectly commercial scenarios too-such as syndicated lending. The provision applies to all forms of interest bearing debt.

There is a further practical problem for multinationals. It is quite common for such entities to raise funds first for general treasury purposes and to retain them until specific group needs arise. If one of those needs is in an Indian subsidiary, then one reaches the curious situation whereby the borrowing is not subject to withholding so long as it has not been applied towards the Indian subsidiary. Once it has, the offshore borrowing parent will have to withhold Indian tax on its interest payments. That again is quite an unfortunate result.

5. Conclusion

I have tried to show in this article how the DTC contains a number of major pitfalls for non-resident corporate groups with existing business interests in India as well as those contemplating investing in India. It is hoped that the final version of the Code will contain considerable pushback from where things are at the moment. If not, very real commercial considerations arise for financial directors and treasurers of multinationals as to whether the potential tax cost, burden of compliance and continued fiscal uncertainty makes investing in India worthwhile or not. It would be very counterproductive for tax to be a deterrent against foreign investors enjoying the benefits of Indian economic liberalisation and committing long-term to India.

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[1] The annual Budget is also delivered around the same time in the first quarter of the calendar year: the Indian Budget is usually a month before the end of the 31st March fiscal year.

[2] In his 2010 Budget Speech delivered on 26th February 2010, the Finance Minister reaffirmed the Government's intention to implement the DTC with effect from this date. There were no clues given as to what amendments might be made.

[3] In fact, there is some ambiguity as to whether the override only applies between the DTC and treaties or whether it will include future Finance Acts. It will be surprising if it will not, but this is far from clear.

[4] Whether a non-resident purchaser would have to withhold is the subject-matter of *Vodafone* and is as yet to be decided.

[5] Note that a "transfer" includes the extinguishment of any rights in an asset, its relinquishment or the buy-back of shares. It would include a redemption of shares.

[6] Section 6(3) of the Income Tax Act 1961. The concept of control and management is similar to central management and control under UK tax law, but not identical.

[7] Section 4(3) of the DTC. There are no safe harbours provided in construing "at any time" or "partly".