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Mauritius Global Business Update – GB11

THE INDIA DIRECT TAX CODE BILL (“DTC”)

This Update has been prepared for international investors and businesses who are seeking or already using Mauritius as a cost and tax efficient jurisdiction for the structuring of their international business activities with an Indian angle. It summarizes some of the key proposals in the DTC from an international tax perspective and is not exhaustive in nature. This Update should be considered as a general guide only and it contains information, which, to the best of our knowledge and belief, is correct at the time of writing. You are however, strongly recommended to seek specific advice before acting on any information contained therein.

Introduction

Almost a century ago, the British House of Lords enunciated a landmark tax principle in the case of Duke of Westminster, namely, that a taxpayer is entitled to arrange his affairs so as to reduce his liability to tax. This principle was also re-affirmed by the Indian Supreme Court in the celebrated Azadi Bachao Andolan Indian case in October 2003. This latter case upheld the India Mauritius tax treaty making this treaty one of the very few tax treaties in the world that has the sanction of the highest court in any land. The two bench judges in this case remarked that treaty shopping may be a necessary evil for developing countries.

India has since about 2 years now embarked on a mission to completely overhaul its tax laws and this has given rise to the proposed DTC to replace the four decade old Indian Income Tax Act, 1961. The original version of the DTC was published in August 2009 for public comments and contained many controversial provisions which corporate houses and other stakeholders felt could seriously harm the economic growth of India. Representations were made to the Indian Government by industry specialists and Foreign Institutional Investors (FIIs) which resulted in the revised discussion paper issued on 15 June 2010. The DTC was placed by the Government of India before the Indian Parliament on 30 August 2010 and is envisaged to come into force on 1 April 2012.

We would like to place emphasis on the fact that the DTC implications extends to all jurisdictions which invest/do business resulting in inflows into and outflows from India.



Main features of the DTC which are of relevance to our discussion

Application and operation

The DTC contains certain General Anti Avoidance Rules (GAAR) which empowers extensively the Indian tax authorities to declare certain arrangements as impermissible avoidance arrangements and hence taxable in India.

The GAAR provisions would thus apply where a taxpayer has entered into an arrangement, the main purpose of which is to obtain a tax benefit and such arrangement is entered or carried on in a manner not normally employed for bona-fide business purposes or is not at arm's length or abuses the provisions of the DTC or lacks economic substance.

It is proposed that detailed guidelines, including minimum threshold limits for GAAR applicability, would be introduced to guide the GAAR intended applicability.

Residence criterion

The DTC introduces the concept of place of effective management (POEM) as a test of residential status of companies. A foreign company is considered to be a resident in India if its POEM at any time in the year is in India.

To mitigate POEM risks, appropriate documentation should therefore be maintained to demonstrate that POEM is not in India.

POEM is

1. the place where the board of directors of the company or its executive directors, as the case may be, make their decisions; or
2. in a case where the board of directors routinely approve 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.

India nexus in relation to transfer of shares of a foreign company

The DTC proposes to tax transfer of shares of a foreign company, on the basis that there is a transfer of a capital asset situate in India. The DTC clearly seeks to avoid what Indian revenue authorities may deem to be unjustifiable tax revenue losses to India in circumstances akin to those prevalent in the now notorious Vodafone case.



Accordingly, income shall be deemed to accrue in India, if it accrues, whether directly or indirectly, through or from the transfer, of a capital asset situated in India.

Income from transfer of share or interest in a foreign company by a non-resident outside India will be deemed to accrue in India if the fair market value of the assets owned (directly or indirectly) by that company exceeds 50 percent of the fair market value of the total assets owned by that company

Further, it is provided that proportionate gains would be taxable in India where any income is deemed to accrue to a non-resident by way of transfer of share or interest in a foreign company

Controlled Foreign Corporations (CFC) provisions

General

CFC Rules would have an impact on overseas holding companies set-up by Indian companies and individuals. Profits of CFC attributable to the India resident tax payer would be attributable to the Indian shareholder in line with his shareholding in the CFC and would hence have immediate Indian tax implication, even if the resident tax payer does not receive any income from the CFC at any time. In this sense, it dissolves the corporate veil between a corporation and its shareholders.

If a foreign subsidiary of an Indian company qualifies as a tax resident of India as well as a CFC, it could result in tax implications for the foreign company itself as well as its Indian shareholder. Appropriate clarification on this aspect in the DTC is definitely required to mitigate undue hardships for tax payers.

The overriding rationale for CFC provisions is to prevent the accumulation of income earned by an overseas corporate body in a foreign jurisdiction.

CFC means a foreign company:

1. that is a resident of a territory with lower rate of taxation (i.e. where taxes paid are less than 50 percent of taxes on such profits as computed under the DTC)
2. whose shares are not listed on any stock exchange recognised by such territory
3. which is controlled individually or collectively by persons resident in India (through capital, voting power, income, assets, dominant influence, decisive influence, etc.)
4. that is not engaged in active trade or business (i.e. it is not engaged in commercial, industrial, financial undertakings through employees/personnel or less than 50 percent of its income is of the nature of dividend, interest, income from house property, capital gains, royalty, sale of



goods/services to related parties, income from management, holding or investment in securities/shareholdings, any other income under the head income from residuary sources, etc.)

5. has specified income exceeding INR 2.5 million

The income attributable to such a CFC will be based on the net profit as per the profit and loss account of CFC for the accounting period as per IFRS, GAAP or Accounting Standards notified under the Companies Act, 1956 and will be determined based on a specified attribution formula.

The amount received from a CFC as dividend in a subsequent year will be reduced from the total income to the extent it has been taxed as CFC income in any preceding previous year

As in the case of GAAR, the CFC rules will override provisions in tax treaties notwithstanding that such provision in the treaties may be more beneficial.

Specific

1. CFC provisions will impact many outbound investments by Indian residents who use intermediate jurisdictions as a platform for investments
2. Active trade or business test excludes the sale of goods/supply of services to inter alia an associated enterprise. This could impact intra group supply/service arrangements between related parties
3. For measuring 'lower rate of taxation', the resident tax payer will need to compute the tax on profits of each CFC based on the provisions of the DTC. This could entail a cumbersome exercise for the resident tax payer and may involve several complexities
4. The CFC provisions are silent on the manner in which losses of the CFCs inter-se are to be dealt with
5. There is lack of clarity on the availability of credit/deduction in the hands of the resident tax payer for foreign taxes paid by the CFC
6. Possible double taxation can arise on account of the interplay between transfer pricing and CFC provisions
7. The DTC does not provide a mechanism to exempt subsequent gains realised by resident shareholders on the sale of shares of the CFC, to the extent such CFC has undistributed income that has been previously taxed under the CFC provisions.



GAAR

General

GAAR empowers the tax authorities to disregard or recharacterise transactions which are considered to be “impermissible avoidance transactions”. An “impermissible avoidance transaction” is defined as a transaction whose main purpose is to obtain a tax benefit and which:

1. creates rights or obligations which are not at arm’s length.
2. results, directly or indirectly, in the misuse or abuse of the provisions of the DTC
3. lacks commercial substance, in whole or part
4. is entered into in a manner which would not normally be employed for bona fide purposes.

It is specifically provided that an arrangement is presumed to have been entered into for the main purpose of obtaining a tax benefit unless the taxpayer proves otherwise and that GAAR would override tax treaties entered into by India.

Specific

1. GAAR confers vast and discretionary powers to the tax authorities to disregard any business transactions like a tax neutral merger or holding company structures, especially those which involve countries with which India has entered into favourable tax treaties. Potential impact: This would lead to significant uncertainty with respect to conducting business in India.
2. The DTC does not contain any ‘grandfathering’ provisions. Potential impact: Structures that are currently in place could potentially be challenged under the new legislation causing significant hardship to existing investors.
3. The application of GAAR to a specific structure by the tax authorities could change from year to year. Potential impact: resulting in significant fiscal uncertainty.
4. Transactions / structures that have been specifically upheld by Courts could also potentially be targeted under the GAAR. Potential impact: significant uncertainty
5. The GAAR could lead to cumbersome, time consuming and costly litigation each time a transaction or structure is sought to be tested under the GAAR by the tax authorities. Potential impact: significant uncertainty
6. GAAR is an indirect tax treaty override mechanism. Potential impact: concerns about the sanctity of benefits conferred under treaties and affect India’s credibility as a reliable treaty partner.



Capital Gains Exemption for On Market Transactions

Transactions in listed securities made on the market will generally remain exempt from capital gains tax in India so long as the transactions are made on a recognized stock exchange, the securities are held for at least one year and the seller has paid a nominal securities transaction tax.

Equity shares or equity-oriented mutual funds which have been held for less than one year and where STT has been paid on the transfer, there will be a deduction equal to 50 percent of the capital gains.

Current status of the DTC

The DTC has been referred to the Standing Committee on Finance of the Lok Sabha (Lower House of Indian Parliament) for further debate and consideration of submissions by various stakeholders.

The Mauritius Global Business private sector has already submitted a discussion paper to the Standing Committee on Finance of the Lok Sabha and now awaits to depone in front of the committee. This is being done through the Global Institutional Investors Forum (“GIIF”).

GIIF is a non-profitable, charitable purpose trust which represents and promotes the views and interests of international investors operating from Mauritius. GIIF works with institutional investors, the Government and local institutions.

MITIGATION OF THE RISKS OF INDIAN TAXATION UNDER THE DTC

The DTC and the proceedings of certain current landmark cases such as the Vodafone case are clear warnings to foreign investors in India of the need to be extremely careful in structuring any business and/or investments in India. It is essential that steps to mitigate the effect of the potential new legal landscape in India be implemented.

As a general matter, investors should (i) avoid the creation of a permanent establishment in India, which would subject the organization to taxation there, (ii) build substance in any treaty jurisdiction utilized for Indian investments, and (iii) undergo internal reviews to ensure strict compliance with the applicable tax rules.



Avoiding a Permanent Establishment (PE)

With regard to the review of activities in India to avoid the creation of a PE in India, investments should be negotiated and contracts should be signed outside India by non-Indian residents. Indian residents should only be employed by a separate Indian advisory company subject to tax in India. The advisory company may advise on transactions but should not be involved in negotiating transactions. PE considerations may vary from one tax treaty to the next.

Building Substance in a Treaty Jurisdiction

This is absolutely crucial. GWMS always provides recommendations to its clients on how to enhance substance in Mauritius. Building substance does however have a cost.

To illustrate, one of the limitation of benefits clause of the India-Singapore tax treaty stipulates that benefits under the treaty will only be available where the Sing company's total annual expenditure (12 months) on operations in Singapore is equal to or more than S\$ 200,000 in the immediately preceding period of 24 months from the date the gains arise i.e. the date of alienation. Such a company would be deemed to have operational substance.

Unfortunately expenses/costs which are relatively a minimal fraction of the potential benefits that clients using Mauritius may obtain are often given more prominence than the much more considerable benefits. This results in not building substance or having minimal or negligible substance in Mauritius at all putting the Mauritius operations at a direct risk of default under the existing tax treaty provisions, Mauritius laws, our recommendations, current Indian laws and most definitely under the forthcoming DTC.

What do Indian tax authorities look for generally?

During a tax audit, the Indian tax authorities will review all activities, documents, minutes of meetings (including those of investment committees where applicable), deal approval memos, emails, other correspondence and written materials to determine whether any investment or business activities may have taken place in India. In addition, they will also review websites, press announcements, business cards and marketing materials.

GWMS recommendations

GWMS endeavours to reasonably ensure that the Mauritius tax residence status of GBL1 entities under our administration is enforced at all times, thereby mitigating threats of denial of treaty benefits to our clients. To this end, GWMS strongly recommends that planning points suggested by us be implemented. This is especially crucial in the context of the forthcoming DTC.



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