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India 2012 budget holds unpleasant surprises for nonresidents

Eagerly awaited by resident and nonresident taxpayers alike, India's budget for 2012 (Finance Bill 2012) announced on 16 March 2012 contains a number of significant – and far-reaching – direct tax measures that will have negative implications for nonresidents. One of the measures would provide that indirect share transfers outside India would be subject to tax in India, effectively overruling the Indian Supreme Court's decision in favor of the taxpayer in the landmark *Vodafone* case. The budget also includes a proposal to introduce a general anti-avoidance rule (GAAR), more rigorous requirements to obtain benefits under India's tax treaties, the application of withholding tax to nonresidents regardless of their presence in India and a broadening of the definition of "royalty." On a more positive note, an advance pricing agreement (APA) program would be introduced. However, considered in their entirety, most of the proposals would make it more difficult for nonresidents to do business in India.

In addition to the above measures, India's Finance Minister announced the following measures that could affect both residents and nonresidents:

- There will be no change in the base corporate tax rate for domestic and foreign companies, the surcharge or cess, or the dividend distribution tax;
- The 15% concessional rate of tax on dividends received by an Indian company from its foreign subsidiary would continue to apply for financial year 2012-2013;
- Interest paid by specified companies (infrastructure companies, such as companies engaged in the construction of roads, toll roads or bridges, power companies, etc., and companies in the business of the operation of aircraft or the manufacture or production of fertilizer) to a nonresident would be subject to a concessional withholding tax rate of 5%;
- The tax holiday for power companies would be extended through 2013;
- The Securities Transaction Tax on the actual delivery or transfer of shares would be reduced from 0.125% to 0.1%;
- The expeditious enactment of the Direct Taxes Code (DTC, originally slated to become effective as from 1 April 2012);
- The government is committed to the introduction of the goods and sales tax (GST); and
- The government has proposed to tax all services, except those on a "negative" list.

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Unless otherwise noted, all proposals, if enacted, would apply from 1 April 2012.

Taxing offshore transfers

The taxation of transfers of shares outside India has been a controversial issue. The controversy began with the attempt by the tax authorities to tax the Hutchison-Vodafone transaction in 2007, which involved the transfer of shares by Hutchison to Vodafone of an overseas holding company that indirectly held the shares in an Indian company. The tax authorities initiated proceedings against Vodafone, the overseas acquiring entity, for not withholding approximately USD 2.2 billion in tax on the payment of the sales consideration to Hutchinson, the overseas entity that sold the shares. Vodafone took the position that it was not required to withhold tax because the transfer by Hutchison was of a capital asset situated outside India. The Indian tax authorities, however, were of the view that the transfer was of rights and interests held by Hutchison in the Indian entity and indirectly involved the transfer of assets situated in India.

After a protracted and contentious dispute between the tax authorities and the mobile phone carrier, the Supreme Court ruled in January 2012 that the Indian tax authorities could not tax the capital gains derived by Hutchison on the sale of the shares because the transaction was structured as a deal between two foreign entities. On 20 March 2012, the Supreme Court rejected the government's petition to review the decision. In the wake of the decision in *Vodafone*, it has been expected that the Indian government would introduce rules that would allow India to tax cross-border transactions in which the underlying assets are located in India, although the retroactive nature of the rules was unexpected.

Under existing law, a foreign company is liable to tax in India on income accruing in or deemed to accrue in India or income received in India. In the context of a transfer of shares, income is deemed to accrue in India if it accrues through or from the transfer of a capital asset situated in India. Under the budget proposal, India would be permitted to tax capital gains arising in the hands of a nonresident from the transfer of shares in a company incorporated outside India that, in turn, has "substantial" assets or interests in India. More specifically, the "situs" of shares in a company incorporated outside India would be deemed to be in India if the shares derive their value, whether directly or indirectly, "substantially" from assets located in India. The budget amendments also clarify that, with effect from 1962, gains from indirect transfers always were includible in deemed income, thus reversing the Supreme Court's decision in the *Vodafone* case (whether the Indian tax authorities can now tax Vodafone is unclear since the Supreme Court has already ruled in the case).

The budget proposal would confer an economic nexus to India on such a transaction based on the principle that a source country has taxing rights with respect to gains derived from an offshore transaction if the value of the transaction is attributable to underlying assets in the source country.

Also troubling is the lack of a definition of the term "substantial," which leaves the meaning of the phrase "substantial assets" open to a subjective interpretation. The proposed DTC also includes a provision that would bring certain overseas transfers of shares or interests in a foreign company within the Indian tax net. However, that provision quantifies the threshold for such inclusion by stating that tax would be payable in India only on an indirect transfer in which the assets of an Indian company represent more than 50% of the total global assets of the company whose shares are being transferred.

General anti-avoidance rule

In the absence of a formal codified GAAR (although a GAAR was originally included in the DTC), the issue of tax avoidance in India has been addressed through special regulations and judicial doctrine. Budget 2012 proposes to introduce a GAAR into Indian law to tackle aggressive tax planning and the use of opaque low-tax jurisdictions for residence and the sourcing of capital. The proposal would codify the substance-over-form doctrine in which the real intention of the parties, the purpose of the arrangement and the effect of the transactions concerned would be taken into account to determine the tax consequences of those transactions, regardless of the legal structure used by the taxpayer. The GAAR would give the tax authorities broad discretion to characterize a transaction as aimed at avoiding taxation, to ignore an arrangement carried out exclusively for the purpose of avoiding tax and to treat it for tax purposes as if the structure did not exist, e.g. by denying a deduction, denying tax treaty benefits, etc.

Under the proposed GAAR, an arrangement would be declared an "impermissible avoidance arrangement" if its main purpose, or one of its main purposes, is to obtain a tax benefit and it satisfies at least one of the following tests:

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- The arrangement creates rights and obligations that are not normally created between parties dealing at arm's length;
- It results in the misuse or abuse of provisions in the tax law;
- It lacks commercial substance or is deemed to lack commercial substance; or
- It is carried out in a manner that normally is not employed for bona fide reasons.

An arrangement would be deemed to lack commercial substance if the substance or effect of the arrangement as a whole is inconsistent with, or differs significantly from, the form of its individual steps or parts, or it involves:

- "Round trip" financing transactions;
- Arrangements that include the presence of an accommodating party in a transaction;
- Arrangements that include elements that have the effect of offsetting or cancelling each other;
- Transactions conducted through one or more persons disguising the value, location, source, ownership or control of funds that are the subject of the transactions; or
- Transactions or structures involving the location of an asset or transaction or the place of residence of any party for the sole purpose of obtaining tax benefits.

Circumstances such as the length of time an arrangement has been in existence, taxes arising from the arrangement and the exit route would not be taken into account in determining commercial substance for purposes of the GAAR.

Under the proposed GAAR, the taxpayer would have the burden of proving that a tax benefit was not the main purpose of an arrangement. This proposal reverses what many would consider the prevailing view that taxpayers enter into transactions for business purposes and anti-avoidance provisions can be triggered only once the tax authorities can demonstrate that this is not the case.

The GAAR would bestow considerable administrative discretion on the tax authorities in applying the provision, thus potentially creating uncertainty as to where accepted tax planning ends and abusive tax avoidance begins. The proposal does offer, however, at least some procedural protection: GAAR cannot be invoked merely as a matter of course in an audit. The procedure for invoking GAAR involves the prior approval of the Commissioner and a panel drawn from the administration at the option of the taxpayer. The Panel must give its determination within a time limit of six months.

The key to the GAAR's success will depend on its implementation and administration. The sweeping discretion granted to the authorities will need to be carefully considered when they are formulating, implementing and administering the provisions of the GAAR.

Advance pricing agreements

An APA program, initially included as part of the DTC, would be introduced. Under the proposal, the Central Board of Direct Taxes, with the approval of the central government, would be empowered to enter into an APA with any person to determine the arm's length price or the method to be used to determine the arm's length price of an international transaction. The arm's length price could be determined using the prescribed methods or any other method, with necessary adjustments or variations.

An APA would apply only to international transactions and would be valid for either a period of five consecutive years or the period specified in the agreement. An APA would be legally binding on both the taxpayer and the income tax authorities in respect of the international transactions in relation to which the APA is entered into. It would not be binding, however, if there was a change in law that had a bearing on the APA.

The Central Board of Direct Taxes would be responsible for specifying the procedures, etc., for a taxpayer to obtain an APA. The procedural aspects relating to the filing of returns, assessments and re-assessments consequent to the conclusion of an APA also would be modified.

Claiming tax treaty benefits

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The budget would introduce specific requirements for obtaining benefits under India's tax treaties. Nonresident beneficiaries of income would be required to submit a tax residence certificate (containing specified information), although the certificate would not be conclusive proof of eligibility. It is not clear, however, what other proof would be required.

Withholding tax obligations

The budget contains a far-reaching proposal to broaden and clarify the scope of the withholding tax rules. Under the measure, all persons, whether resident or nonresident, that have a business connection in India would be required to withhold tax at source if the payment would be chargeable to tax in India. This obligation would apply regardless of whether a nonresident payer has a residence, place of business, business connection or any other presence in India. The broad scope of this provision, which would apply retroactively as from 1962, clearly could have negative implications for nonresidents.

Definition of "royalty"

In an effort to resolve the long-standing debate on the meaning of "royalty," particularly with respect to the characterization of software payments, the budget proposes to retroactively define "royalty" to include payments made for the use of, or the right to use, computer software (including the granting of a license), regardless of the medium through which the right is transferred. Royalty would include consideration for any right, property or information regardless of whether the payer retains possession or control of the right/property/information and regardless of the location of the right/property/information.

Additionally, the term "process" as used in the definition of royalty would be clarified to include transmission by satellite, cable, optic fiber or any other similar technology, irrespective of whether such process is a secret process.

The amendment would broaden the domestic law definition of royalty to include a payment for copyrighted articles, which is a departure from the OECD's accepted view, and the retroactive nature of the change – it would be effective as from 1 June 1976 – would mean that many Indian companies would have to pay tax with respect to past purchases of computer software. However, in a tax treaty context, nonresidents would still be able to claim tax treaty protection and rely on the Commentary to the OECD model treaty to distinguish between payments made for a copyright and payments made for a copyrighted article, with only payments for a copyright being considered a royalty.

While it is always beneficial for a taxing jurisdiction to clarify the law, providing a retroactive effect is clearly unfair. Hopefully, Parliament will keep this in mind and withdraw the element of retroactivity when it enacts Finance Bill 2012.

Comments

As the above discussion of the budget proposals indicates, nonresident investors will need to rethink their tax strategies in India. The budget proposals will now be discussed by Parliament.

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Costa Rica:
Pre-approved tax reforms submitted to Constitutional Supreme Court

Costa Rica's National Congress pre-approved income tax and VAT reform proposals on 14 March 2012. Major reform proposals include the following:

- A move from a pure territorial system of taxation to a limited territorial system, so that passive income such as dividends, interest and royalties derived from abroad would be treated as Costa Rica-source income, and therefore taxable (such income currently is treated as nontaxable offshore income);

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- The introduction of withholding tax on dividend distributions made by free trade zone companies that begin operations as from 2015 (currently exempt); and
- An increase in the standard VAT rate from 13% to 14%.

These measures now must be reviewed and approved by the Constitutional Supreme Court of Justice and then returned to the National Congress for final legislative approval. It is unlikely that the changes will enter into effect before December 2012.

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Russia:
Exemption on sale of quoted shares of high-tech (innovation) companies clarified

The Russian government issued guidance on 22 February 2012 (Resolution No. 156, effective as from 13 March 2012) that clarifies the classification of publicly listed shares of Russian companies as high-tech (innovation) economic sector shares.

Under general rules, capital gains derived by companies are taxed as ordinary income at the 20% corporate income tax rate. However, an exemption applies for gains derived from the sale of unquoted shares and participations in Russian companies and quoted shares in Russian high-tech (innovation) companies that are acquired after 1 January 2011 and held for more than five years.

The resolution clarifies the following major conditions for obtaining the high-tech classification, and thus claiming the exemption:

- Shares traded on a stock exchange will be recognized as high-tech (innovation) sector shares if :
  1. They are listed as shares of innovation companies; and
  2. The capitalization of the Russian entity that issues the shares does not exceed RUB 10 billion within the first week of trading such shares.
- The entity issuing the shares submits an application to the stock exchange to treat the shares issued as high-tech (innovation) shares. The stock exchange will review the application within 10 days and will either confirm or deny the qualification of the shares as high-tech (innovation) shares. If a positive decision is reached, the exchange will include the details of the issuer and the shares on the official website of the exchange and provide relevant information about the shares to interested parties.

The primary goal of the exemption and subsequent clarification on the sale of such quoted shares is to encourage foreign investment in Russia's high-tech (innovation) sector.

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Sweden:
Government proposes further restriction on deduction of interest on intragroup debt

The Swedish government presented a proposal on 22 March 2012 that would impose further restrictions on the deduction of interest on intragroup debt. The proposed measure would bring all intragroup debt within the scope of the deduction restriction as from 1 January 2013. However, an exception would appear to apply in some cases where the corresponding interest income is taxed at a rate of at least 10%.

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The proposal can be summarized as follows:

- The scope of the interest deduction restriction rule would be broadened to include all intragroup debt regardless of the purpose of the loan. Under current rules, the restriction applies only to interest expense on intragroup loans related to an intragroup acquisition of shares.
- A deduction is allowed under current rules provided the corresponding interest income is taxed at a rate of at least 10% in the hands of the beneficial owner. According to the proposal, even if the 10% threshold is met, the tax authorities would be empowered to disallow a deduction if from a group perspective the loan structure is mainly tax driven.
- Under current legislation, a deduction is allowed even if the 10% threshold is not met if the intragroup acquisition and the debt are based on sound business reasons. The proposal suggests that this exception would not be applicable if the beneficial owner of the interest income is tax resident in a non-treaty country outside the EEA.

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United Kingdom:
High Court rejects challenges to low value consignment relief changes

The U.K. High Court ruled against Jersey and Guernsey in their judicial review case against the U.K., in which the Islands were seeking to block the proposed changes to the U.K.'s low value consignment relief (LVCR) that are due to take effect on 1 April 2012.

Under the LVCR, mail order goods imported into the U.K. from the Channel Islands are exempt from VAT provided the value of the shipment is under GBP 15. According to the explanatory note that accompanied the draft legislation to effect the change (which was published in December 2011), most LVCR trade is from the Channel Islands. The U.K. government, therefore, concluded that the supply of mail order goods to U.K. customers from the Channel Islands was affecting the conditions of competition on the U.K. market. The Chancellor announced on 9 November 2011 that LVCR would be withdrawn completely for all goods imported on or after 1 April from the Channel Islands.

As from 1 April, mail order goods imported into the U.K. from the Channel Islands will no longer be eligible for the relief, so VAT will be due on them regardless of their value, while mail order goods sent to the U.K. from other non-EU countries will not be subject to VAT provided the value of the shipment is below GBP 15.

The court decided that the EU law principle of fiscal neutrality does not apply to transactions involving non-EU countries so there is no reason why imports from Jersey and Guernsey should be dealt with in the same way as shipments from other non-EU countries. The court also held that the EU law principle of proportionality does not apply outside the EU.

Leave to appeal the decision has been granted, although it is unclear whether Jersey and Guernsey will appeal, and if so, whether the appeal will be fast tracked by the Court of Appeal so that any appeal can be decided before the U.K. law changes on 1 April.

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In brief

Australia – On 14 March 2012, the Deputy Prime Minister announced that the government would amend the tax law to reduce the corporate tax rate from 30% to 29% as from the 2013-14 income year.

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Russia – The Prime Minister has instructed several Russian ministries to prepare proposals by the end of March to amend current legislation to impose profits tax on foreign organizations that are controlled from Russia, in particular, offshore subsidiaries of Russian businesses (i.e. controlled foreign companies or CFCs). While there is no publicly available document or draft that outlines even the basics of the potential CFC rules, the proposals must take into account applicable international practices and, if adopted, could enter into effect as from 2013. It is possible that a CFC regime would include a requirement for Russian companies to report all affiliated foreign entities and that the failure to do so could result in the imposition of fines. The introduction of a CFC regime likely will face a number of impediments, notably obtaining information on the bank accounts of offshore companies. The Ministry of Finance, however, has stated its intent to conclude tax information exchange agreements and is currently reviewing the format for such agreements and other nuances, including ratification requirements.

U.S. Virgin Islands – The gross receipts tax increased from 4.5% to 5% as from 1 March 2012.

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United Kingdom
2012 budget measures affecting foreign multinationals
The 2012 budget has been released and includes a further 1% cut in the previously announced corporation tax rate reductions. The Chancellor also confirmed introduction of the new CFC and patent box regimes, as well as the intent to proceed with a narrowly targeted general anti-avoidance rule. [Issued: 21 March 2012]
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