

# LET'S TAX JOHN - I

Let's hear a story. Even better, let's hear a story around Indian taxes! This is about my friend John who is working with Creaking Computers Ltd in UK. He hears the good news. He has been deputed to India for 3 years to kick start operations of their wholly owned subsidiary. Joining date November 1, 2005. John is excited. This will be his first visit to Asia and he has heard of the challenging market. Besides India, he will be overseeing operations for Nepal, Pakistan and Sri-Lanka where he expects to devote about 30 days each year. The pay packet looks good. Besides salary, a bungalow type furnished accommodation with security guards, both children schooling at the British school, annual paid holiday of 20 days for the family, 2 cars - what frills! And the best part - he is entitled to a 'Hardship Allowance' for his posting to a third world country.

He gets down to planning a recce visit on September 1st. He intends to spend a month in India meeting consultants, lawyers, etc in order to identify set-up procedures and handle office space issues. This would assist in firming up a project budget. Then he will move to India on October 24th. His family could join a week later. How about a holiday from Dec 23rd - Jan 2nd to Bali. This is looking good. He will visit Nepal for 5 days may-be in February.

As John fills up his diary he remembers his teleconference with Peter, a veteran on India. Peter in his usual manner had categorized the Indian tax system as leaky. What had he actually said? Oh yes, "plan around it, my dear boy, around it". John thinks, "Let me check on the Indian tax regulations governing my personal taxation while I am there". He starts looking for an Indian tax practitioner and fixes an appointment for September 20th at your office.

So, what do you tell John? More importantly, how do you tell John! The next few paragraphs navigate through the issues which John needs to be made aware to ensure his enjoyable stay. A pearl of wisdom. In your deliberations with John, remain factual and objective. Let not his personal wants and interpretation guide your professional instincts.

## Of the Block

Reality check time. John needs to understand that the Indian tax laws are no more the 'leaky' version. Much, if not all, has been repaired. What Peter experienced is history. Clear legislation and judicial rulings guide expatriate taxation in India. Having thus prepared him, off we go into the tax maze.

## Resident in India? But I am a UK citizen!

Indian tax laws, and not citizenship, will classify John as Resident or Non Resident ('NR'). Resident is sub-classified as Resident & Ordinary Resident ('ROR') and Not Ordinary Resident ('NOR'). The rules applied are similar to those governing Indian citizen and laid out in Section 6 of the Indian Tax Act, 1961 ('The Act'). A quick overview of the taxability linked to residential status.

Resident Status	Taxability
ROR	Taxable in India for worldwide income
NOR and NR	Taxable in India for India sourced income

The year in question is Financial Year 2005-2006. For John's benefit, do mention that the Indian tax system terms the financial year in which the income is generated as the Previous Year. The income is then reported for verification in the subsequent year referred in our legislation as the Assessment Year.

## NR, NOR or ROR?

This is his first visit to India. He joins Creaking Computers Ltd-India from Nov 1st (151 days upto March 31, 2006) plus recce visit (another 30 days) plus early arrival into India (another 7 days). Total 188 days. Are we forgetting something? Oh yes, his holiday to Bali and visit to Nepal i.e. out for 15 days. In effect, in Financial Year 2005-06, he is in India for 173 days. Domestic laws, through Section 6 of the Act, classify him as a Non Resident in respect of FY 2005-06. So, he pays taxes for his India sourced income i.e. his remuneration from November 1, 2005 through March 31, 2006. Hold on! Don't pass the verdict. Like I said, this not your usual story; it has ups and downs.

Time to visit the India-UK Double Tax Avoidance Agreement ('DTAA'). Para 2 of Article 16 of the DTAA will guide us that if John spends less than 184 days in India, he will not be taxable in India provided his salary is paid by a non-Indian entity and not charged to a fixed business in India. Do tell John that the DTAA overrides domestic laws. Given this new twist, the final verdict would now go like this. John will not be taxed in India for FY 2005-06 if

- (i) his actual stay in India remains less than 184 days; and
- (ii) Creaking Computers Ltd-UK pays his salary; and
- (iii) Creaking Computers Ltd-UK does not later recover John's salary from Creaking Computers Ltd-India
- (iv) John has paid taxes in UK for the period November 1, 2005 through March 31, 2006.

Oh, John does smile!

#### What Lies Ahead....

However, John needs to look ahead. He is looking at a horizon of 3 years stay in India. Keeping in view his annual vacation and official visits to adjoining countries, the scenario looks like this

Financial Year	Days spent in India	Residential Status
2006-07	365 less 20 (holiday) less 30(other countries visited) equals <b>305</b>	NOR
2007-08	2006-07 365 less 20 (holiday) less 30(other countries visited) equals <b>305</b>	NOR
2008-09	214 less 10 (holiday) less 15(other countries visited) equals 189*	NOR
* assuming departure Nov 1, 2007 and proportionate holiday and visits to other countries		

So, John pays no taxes in India for FY 2005-06. In FY 2006-07 and 2007-08, John's status appears that of a NOR, by virtue of which the remuneration he earns in India is taxable therein. But, FY 2008-09 is the watershed. He appears to be moving towards a Resident & Ordinary Resident ('ROR') status. Point out to John the change in Indian tax legislation governing NOR status. As compared to the earlier definition, by virtue of which the NOR status remained for 9 years from point of arrival, it is now a limited classification restricted to 2-3 years. Unless he is over zealous and wishes to know the actual legislation, let's spare him that; though we must ourselves be fully aware of the provisions. Never know what John may spring at us.

If he is classified as ROR in FY 2008-09 that would result in taxability of his worldwide income, including the salary for the full year. John, on the eve of his departure, would need to bring into the Indian tax net his worldwide interest, rental income, etc. Alongside he would need to seek exemption in UK from double taxing these. When he returns to UK he would have to reverse the situation in the following year. Definitely not fun! Can we help him? We

can show him the light i.e. if he was willing to spend less than 182 days in India in FY 2008-09. Say, he visits other countries and takes a longer vacation. That would enable us to evoke Article 16 of the DTAA. With planning, as indicated above, he may not have to pay taxes in India. This, however, needs to be closely studied before we generalise John's case as a flag bearer for all.

With all this good advise John is prepared to face the Indian tax regime. He knows when he is taxable. Now, the big one - how much does he have to pay? That, my professional brethren, is the next chapter.

## LET'S TAX JOHN - II

We left our story once we had educated John, the newly baptized Indophile, on his tax residential status in India. John was happy with our professional approach. We not only guided him on the immediate year, but took him through his tax resident status over the entire period of deputation, with specific guidance to plan in the last year of his Indian stay.

Now, John wants to understand the taxable components of his remuneration. To recapitulate, his employer Creaking Computers Ltd entitled him to salary, furnished accommodation with security, 2 cars, education paid for his 2 children, annual paid holiday for family and a hardship allowance. Besides, John wants you to guide him as to any peculiar feature of the regulations which you consider worthwhile for him to know. So, let's start educating John.

### I Knew That!

Let's build this up. Start with basics. "John, you are taxable in India on your basic salary and the hardship allowance". John may quiz you on taxability of the hardship allowance, but appears pre-settled to that. Now for the not so good parts of the story.

### Dilemma of Taxable Perks

John had liked the idea of the posh bungalow and all the domestic help which came along. The education bill paid and the annual holiday obviously sounded good. Let's call them perquisites. So, do you want to be the bearer of bad news?

As in case of any domestic resident, the furnished accommodation will be treated as a taxable perquisite in the hands of John and is valued at lower of 20 percent of John's annual salary or the actual rental. To that, we will add furniture hire cost or a 20 percent of purchase value, as be the case.

All security and domestic help will be treated as a taxable perquisite at actual cost. **Dilemma of Fringe Benefit Tax**

John's employer provides specific benefits namely children schooling, car and family holiday. These, amongst others, are classified as taxable fringe benefits. They are assigned a value which is based on predefined slabs. Thereafter, Creaking Computers Ltd is required to quarterly pay taxes on the total value of Fringe Benefits. As an overview, the taxable values are determined as

Value Assigned as a percent of Actual spending			
5	20	50	100
<ul style="list-style-type: none"> <li>• Hospitality (Hotel business)</li> <li>• Repair, running &amp; maintenance</li> </ul>	<ul style="list-style-type: none"> <li>• Entertainment</li> <li>• Hospitality</li> <li>• Maintenance of Guest House</li> <li>• Employee Welfare</li> <li>• Telephone (including</li> </ul>	<ul style="list-style-type: none"> <li>• Festival Celebration</li> <li>• Gifts</li> <li>• Club Facility</li> <li>• Health</li> </ul>	<ul style="list-style-type: none"> <li>• Free or concessional tickets for Private Journey</li> <li>• Contribution</li> </ul>

<p>of Motor Cars (Carriage of goods or passengers by motor cars)</p> <ul style="list-style-type: none"> <li>• Conveyance, tour &amp; travel including foreign travel (Construction / Pharmaceutical / Computer Software)</li> <li>• Use of Hotel, boarding &amp; lodging (Pharmaceutical / Computer Software)</li> </ul>	<p>mobile)</p> <ul style="list-style-type: none"> <li>• Repair, running &amp; maintenance of Motor Cars &amp; Air Crafts (including depreciation &amp; fuel)</li> <li>• Conveyance, tour &amp; travel including foreign travel</li> <li>• Hotel, boarding &amp; lodging</li> </ul>	<p>Club, Sports, etc</p> <ul style="list-style-type: none"> <li>• Scholarship to Children</li> </ul>	<p>to Superannuation Fund</p> <ul style="list-style-type: none"> <li>• Any other Reimbursement (<i>not specifically covered otherwise</i>)</li> </ul>
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Though John is not over concerned about Fringe Benefit tax, since tax burden is on Creaking Computers Ltd, perquisites is a different matter. John explodes, "Is there any way to save taxes on these perks?" We could have left it with a shrug of the shoulders. But we are the good guys.

### Tax Equalization

Tell John about *tax equalization*. Uh! Tax what? Tax *equalization* is the concept by virtue of which Creaking Computers Ltd can compensate John on tax he faces on account of addition of perks to his income in UK, he normally may not have to pay taxes on all these. Taking it further, Creaking Computers Ltd can even compensate him for the tax on his salary, if the tax rate in India is higher when compared to that in UK.

To take this forward

- i. (i) John will need to negotiate with his company to tax equalize i.e. Creaking Computers Ltd will pay taxes arising on accommodation.
- ii. (ii) To make his job easier, you could prepare a computation of his taxable income in India. Creaking Computers Ltd will provide a hypothetical computation of John's taxability in the UK on similar components. Assuming, UK taxes are lower, the differential can be paid as a 'special allowance' to John in order to compensate for the ills of the Indian tax regime.
- iii. (iii) Explain to John that the 'special allowance' will be added to his salary and will cause additional tax per provision 195A of section of the Act. In effect, he will lose some of the special allowance to taxes, unless Creaking Computers Ltd grosses up the 'tax-on-tax' component i.e. the 'special allowance' bill shoots up... However, John or rather Creaking Computers Ltd, can save "tax-on-tax". i.e. if Creaking Computers Ltd was to forego claiming the expense incurred in respect of the perquisite provided. More on this later.

## Getting Familiar with the Paperwork

If he has the capacity to absorb, a good time to slip in a few straight facts on registration and such. This will familiarize him with some of our local tax jargon.

- *Permanent Account Number ('PAN')* - Advise John on requirement to register with the Indian tax authorities by applying for a PAN. Seek specific information and passport photographs beforehand.
- *Visa* - Let John know that he needs an Employment visa and not the Business visa he obtained for his recce visit. It is usually difficult to convert visa status from within India.
- *Foreigner's Regional Registration Office ('FRRO')* - Within 14 days of starting his employment, John and his spouse will have to personally visit the FRRO for registration.
- *Company law* - In case he is to be full time working Director, his remuneration may need prior clearance from the company law board, if Creaking Computers Ltd is to set-up as a public company.
- *Exchange Control Norms* - Even if John is paid his salary in UK, Foreign Exchange Management Act ('FEMA') puts forth that 25 percent of the salary has to be remitted to India.
- *Branch Account* - On the basis of his employment letter and visa, John can approach any bank authorized to deal in foreign exchange to open his personal bank account. Under FEMA, these are classified as QA22 accounts.
- *Tax Withholding* - John's Indian company i.e. creaking computers India will have to monthly withhold taxes and deposit these into government treasury. In India this is referred to as Tax Deduction at Source ('TDS'). John will understand this as akin to Pay As You Earn ('PAYE') scheme of UK.
- *Annual Return of Income* - For each financial year, John will have to submit his Return of Income with the Indian tax authorities before a specified date, presently July 31st of the following year.
- *Assessment* - Indian tax authorities at random select returned income for verification. This is to confirm accuracy and proper compliance. In India this audit process is referred to as Assessment.

## LET'S TAX JOHN - III

We started out with John's coming to India. He navigated the issue of 'Residential Status' in the first chapter. In the previous chapters, we had slinked out post explaining the taxability of perquisites viz. accommodation, paid holiday etc. We had educated John of tax equalization. While you were out, John had a quick word with his Indian Veteran friend. When you come back into the room, John is not looking his expected perturbed self. He has the halo of hidden knowledge. You better listen to him.

### Bright Idea # 1

John has an idea. Actually a few. Here are some samples.

- (a) What if I take a portion of my salary from Creaking Computers Ltd in the UK as a retainer against a written contract which binds me to re-join Creaking Computers Ltd, UK post my deputation in India? Since it does not relate to work in India, and is neither an India sourced income, so as to speak, it should not be taxable in India.
- (b) Alternatively, or in addition, Creaking Computers Ltd UK can advance me a large loan at the outset of my deputation in lieu of a portion of salary. Normally, and likely, this is set-off as a bonus at end of the deputation. As this is not apparently linked to my Indian deputation, this is not taxable in India.

Now, he wants your answers. Fellow professional brethren bear in mind Section 277A of the Act. If John wishes to pursue any of these schemes, referred sometimes as Retainer Scheme and Loan Bonus Scheme, let his better judgment guide him. As a professional, show him the

pitfalls.

### **When the Glove Comes Off**

Earlier the law was unclear and judicial rulings guided matters relating to the abovementioned type planning avenues. However, take John no further than section 17(3)(iii) of the Income Tax Act which closed this loophole.

Besides, it is well worth a visit to interest, penalty and prosecution clauses laid out in the Act, namely

- *Section 201(1A), 234A, B and C*: Mandatory interest is levied for delay or deferment in paying taxes per specified dates.
- *Section 271(1)(c)*: Penalty is imposed on detection of any concealed income.
- *Section 276C*: Attempts for willful evasion of taxes can lead to prosecution. Given the well developed but somewhat slow legal system in India, this situation is highly avoidable.

It is in John's interest to best not take this direction, as similar approach in the past by many Multi National Corporate executives has been deftly handled by the Indian tax authorities. Raids and surveys brought out these issues and only self-admittance saved many from future penalties and prosecution.

At this junction, John may need a few pointers to appreciate the likely approach of the Indian revenue e.g.

- **Non Indian Bank Accounts**: During annual verification process i.e. assessment (explained in the previous chapter), the Indian tax officer may request John for his non-Indian Bank accounts to verify credits received from Creaking Computers Ltd and affiliated companies.
- **Pay Slips** - Similarly, the tax officer may request for pay-slips of Creaking Computers Ltd, UK prior to John's deputation to India. Through this, he could verify the level of salary pre-deputation.

Of course, both the above, if requested, can be refuted questioning the Indian tax officer's jurisdiction on this. However, this can bring undue attention to the matter.

### **Navigating Pot Holes**

It is worthwhile to bring into focus a few grey areas.

- Social Security* - It is likely that Creaking Computers Ltd, UK will continue to pay in UK towards John's social security contribution akin to Indian Provident Fund. This is common practice in developed countries and, for example, in Germany involves employer contribution to a few funds viz pension, solidarity fund etc. Will this be a taxable perk in John's hand? Judicial rulings on similar matters have directed that this will not be taxable if the employee does not acquire a vested right. If John has an appetite for detail, cite the Supreme Court rulings as: *CIT vs. LW Russel (53ITR91)*. Facts need to be understood prior to dishing out general advice.
- Working in other regions surrounding India - As John will work in Nepal, Pakistan and Sri-Lanka, is the salary attributable to work done there taxable in India? This is a delicate issue. Experience has shown that John would need to substantiate that the actual visit and work carried out there was not related to India and he was bound through his employment contract to service these countries. Furthermore, the non-taxability issue will remain alive only as long as John holds tax residence status of NOR/ NR. John should be prepared for some level of questioning on this during his *assessments*.

- iii. Income Tax Clearance Certificate ('ITCC') Prior to his permanent departure from India, John will need to obtain an ITCC from the Indian Tax officer as laid out in Section 230 of the Act. This may be requested by the immigration officer.
- iv. Tax-on-Tax: Though mentioned earlier, it is worthwhile to re-visit the situation where Creaking Computers Ltd is willing to compensate John for the tax liability arising on perquisites considered as taxable in India. This was through the tax equalization scheme. This will cause tax grossing up i.e. tax-on-tax. This higher incidence of tax can be offset if Creaking Computers Ltd is willing to embrace section 10(10CC) of the Act. In effect, this would mean that in exchange for a single point tax on perquisite value as reimbursed to John, Creaking Computers Ltd will forego claiming expense incurred in respect of the tax on perquisites provided. Useful for sure, in case of start-up ventures likely to accumulate initial losses.

## Bright Idea # 2

It is likely that John may seek to clarify on a practical aspect of his salary receivable. He may wish to directly receive the salary from Creaking Computers Ltd-UK or, even if paid by Creaking Computers Ltd India, remit this out of India. This may be spurred by his desire to hedge against currency fluctuation or to meet his obligations outside India. A quick look on these.

- *Salary from Creaking Computers Ltd-UK* - John can well receive his salary outside India. Indian tax laws are merely concerned with him paying his tax dues here. Circular 685 of the Act will impress upon Creaking Computers Ltd-UK to ensure monthly tax withholding i.e. TDS (explained in the previous chapter). Besides, John will need to remit into India at least 25 percent of his salary under Indian exchange control norms.
- *Salary from Creaking Computers Ltd-India* - As per current exchange control regulations. John can receive his salary from Creaking Computers Ltd-India and repatriate 75 percent of this.

In either situation, John will need to simply meet some procedural requirements i.e. the famous Indian paperwork!

With all that information, it is not only John but we as well may need a breather.

This 3 part story was an attempt to overview the regulatory environment from the perspective of an expatriate deputed to India. Addressing John's concerns and matching these to Indian regulations has been the guiding principle. Experience has shown that while advising, avoid painting a rosy picture when confronted by an agitated John. Give a clear, objective analysis and let him decide what is best for him. As a professional, that is what our job is all about. Cheers!