

# **OVERVIEW OF INDIA'S TAX REGULATION SYSTEM**

**May 3, 2006**



**Ajay Sethi – Partner**

- ❑ Tax System in India
- ❑ Double Taxation Avoidance Agreements ('DTAA')
  - Taxability of Business Income
  - Capital Gains
  - Taxability of Royalty & Fee for Technical Services ('FTS')
- ❑ Expatriate Tax Matters
- ❑ Advance Ruling Mechanism
- ❑ Transfer Pricing

# TAX SYSTEM IN INDIA

# TAX SYSTEM IN INDIA – STRUCTURAL OVERVIEW

- ❑ Federal Taxes
  - ▶ Income Tax
  - ▶ Customs Duty
  - ▶ Excise Duty
  - ▶ Service Tax
  - ▶ Wealth Tax
  
- ❑ State Level Taxes
  - ▶ Sales Tax, VAT, Lease and Works Contract Tax
  - ▶ Profession Tax
  
- ❑ District / Municipality Level Taxes
  - ▶ Entry Tax / Octroi

- ❑ Tax Levied on Basis of Residential Status
- ❑ Indian Incorporated Companies Taxed on Worldwide Income
- ❑ Rates of Tax (%) – Maximum Marginal Rates

Assessee	Resident	Non Resident
Corporate	33.66	41.82
Individual	33.66	33.66

- ☛ Tax of 10% on Royalties and Fee for Technical Services

# TAX SYSTEM IN INDIA - CORPORATE INCOME TAX

- Relief from Double Taxation through Tax Treaties
- Tax Holiday for New Units in Backward Areas
- Deemed Profit Provisions Available to Foreign Companies (Specific Industries)  
– To Avoid Maintenance of Detailed Expense Records
- Tax Holiday for a 10 years up to AY 2010-11 for 100% Export Oriented Units ('EOU')
- 5 years Holiday in a Block of first 10 years for units in Special Economic Zone ('SEZ')
- Advance Rulings on Transactions Possible

# TAX SYSTEM IN INDIA - OTHER SIGNIFICANT TAXES

## ❑ **Excise Duty**

- ▶ On manufacture of goods. Peak rate at 16%
- ▶ Basic duty + additional excise duty + special excise duty
- ▶ Credit allowed of duty paid to limit the cascading effect of duty

## ❑ **Customs Duty**

- ▶ On the import of goods into India. Peak rate at 12.50%
- ▶ Basic duty + Additional custom duty
- ▶ Duty drawback on goods re-exported. Significant concessions

❑ **Sales Tax** - On sale of movable goods. Rates vary for different states. Substituted by Value Added Tax ('VAT') effective April 2005

❑ **Service Tax** - Levied at 12% on identified taxable services

❑ **Research & Development Cess**- On import of technology into India at 5% on payments

- ❑ Submission : Return of Income
- ❑ Verification Process : *Assessments*
- ❑ Evaded / Under Declared Income
  - ▶ Interest & Penalty
  - ▶ Prosecution

# **DOUBLE TAXATION AVOIDANCE AGREEMENT**

# DTAA – INDIA / SINGAPORE

- ❑ Objectives
  - Avoidance of double tax or granting relief
  - Other economic objectives
- ❑ Rule of Residency
  - Applicability of treaty - resident of one of the contracting states
  - Resident of one contracting state - application of DTAA
  - Based on fiscal residency
  - Limited companies - country of incorporation
  - 'Tie breaker' test - resident of both contracting states
- ❑ Option to Tax Payer
  - Section 90 of Indian Income Tax Act - treaty or domestic law, whichever is beneficial

# TAXABILITY OF BUSINESS INCOME – GENERAL GUIDELINES

- ❑ General Principles of Taxability (Article 7 of DTAA)
  - ▶ Source State
  - ▶ Residence State
  
- ❑ Permanent Establishment ('PE')
  
- ❑ Attribution of Profits, Directly or Indirectly to the PE
  
- ❑ Computation of Profits (specifically treatment of HO expenses - para 3 of Art 7 & Sec 44C of the Indian Income Tax Act)
  
- ❑ Questions Relevant for Source State;
  - ▶ whether the enterprise has a PE in their State,
  - ▶ if yes, amount of profits on which the PE should pay tax i.e. tax only so much profits as are directly or indirectly attributable to the PE

# BUSINESS INCOME – PERMANENT ESTABLISHMENT

- ❑ Definition (Article 5)
  - ▶ fixed place of business through which business is carried on, wholly or partly
  
- ❑ Implication of PE
  - ▶ right of Contracting State to tax business income
  
- ❑ Possible forms of PE
  - ▶ a fixed place of business
  - ▶ carrying on business through dependent agent

# BUSINESS INCOME – PERMANENT ESTABLISHMENT

## ❑ Fixed Place of Business

- ▶ Fixed period of building site, construction, etc is normally 12 months under OECD model & 6 months under UN model
- ▶ Planning & supervisory activities also covered
- ▶ Usually, period applies to individual projects
- ▶ Activities carried out through a PE of a sub-contractor also covered to determine the total period

## □ Dependent Agent –

### *Carrying on Business Through Dependent Agent*

- ▶ Has authority to conclude contracts in 'Source State' on behalf of the enterprise
- ▶ Repeated use (habitual exercise) of this authority and not merely isolated cases
- ▶ Works almost exclusively for the enterprise

## Morgan Stanley and Co. International Limited

Authority for Advance Ruling Held

- ❑ PE means a fixed place of Business in India through which Business is carried out.
- ❑ No PE relationship when dealing through Broker, General Commission Agent or any other agent of an independent status as activities of an Agency are not carried out wholly and exclusively for one company.
- ❑ Even if Broker deposes one or more of its employees wholly for the Company, it would not constitute PE in India and hence taxability of Business Income under Article 7 does not arise.

# BUSINESS INCOME – PERMANENT ESTABLISHMENT – *CURRENT ISSUES*

- ❑ Association of Persons ('AOPs') - Ramifications
- ❑ Taxability of Foreign Companies Engaged in the Business of Executing Turnkey Projects
- ❑ Issues Related to E-Commerce Transactions
- ❑ Liaison Offices

## BUSINESS INCOME – AOP's

- ❑ Definition
- ❑ Residency
- ❑ Scope of taxability
- ❑ Issues
  - ▶ Offshore income
  - ▶ Members from different states
  - ▶ Credit of taxes in **resident state**

# BUSINESS INCOME - EXECUTION OF TURNKEY PROJECTS -- TAXABILITY OF FOREIGN CONTRACTORS

- ❑ Work carried out partly outside India and partly in India
- ❑ Transfer of ownership (within India or outside India?)
- ❑ CBDT internal instruction
- ❑ Taxability to be:
  - ▶ 10% of the gross receipts from the contract as the net income of the contractor
  - ▶ further only 1% of the gross receipts would be attributable to the activity of sale itself

*(CBDT internal instruction)*

# BUSINESS INCOME - PE ISSUES RELATED TO E-COMMERCE

- ❑ Website - *Combination of Software & Electronic Data*
- ❑ Server - *Equipment Having a Physical Location*  
*(fixed place of business)*
- ❑ Website Hosting Arrangement
- ❑ Operation of Computer Equipment at a Location Where No Personnel are Present
- ❑ Internet Service Providers (ISPs)

# BUSINESS INCOME

## PRESUMPTIVE TAXATION UNDER DOMESTIC LAW

Section	Business Income Covered	Extent of Deemed Income
44B/172	<b>Shipping</b> Business Income on Account of Indian Ports or Receipts in India	7.5% of Receipts
44BB	Business of Providing Services or Facilities in Connection With Equipment Hire for Using in Prospecting or Extraction of <b>Mineral Oils</b>	10% of Receipts
44BBA	Operation of <b>Aircraft</b> on Account of Carriage from India or Receipts in India	5% of Receipts
44BBB	Civil Construction, Erection, Testing, Commissioning or Equipment in Connection With Approved <b>Power</b> Projects	10% of Receipts

- ❑ India - Singapore Comprehensive Economic Cooperation Agreement ('CECA') creates new opportunities for Singapore investors
- ❑ Sale of shares held in an Indian company not to attract tax
- ❑ Benefit for genuine investor and not shell/ conduit company
- ❑ Only other similar agreement between India and Mauritius

# ROYALTY AND FTS - DEFINITION

## Article 12 - Royalty (*UN Model*)

Payment of any kind received as

- ❑ consideration for the use of or right to use of any copyright
  - of literary/artistic/ scientific work
  - industrial/commercial/scientific equipment
  
- ❑ Information concerning
  - industrial/commercial/scientific equipment/experience

## ROYALTY AND FTS - DEFINITION

### Article 12 - FTS (*UN Model*)

- ❑ Payment of any kind to any person in consideration for services of the following nature
  - ▶ managerial
  - ▶ technical
  - ▶ consultancy
  - ▶ provision of services of technical or other personnel

Normally excludes payments made for independent personal services which are dealt with separately in most treaties

- ❑ Domestic Law [Sec 9(1)(vii)]
  - ▶ explanation 2 exempts the following from the definition of FTS:
  - ▶ consideration for any construction, assembly, mining or like project undertaken by the recipient

# ROYALTY AND FTS – GENERAL PRINCIPLES

- ❑ Residence State
- ❑ Source State at a Concessional Rate if the Recipient is the Beneficial Owner of Royalties & FTS *(generally on a gross basis)*
- ❑ Concessional Rate of Tax Not Available in Cases Where PE Exists *(taxable as business income)*

# WITHHOLDING TAX RATES (AGREEMENTS AFTER MAY 1999)

Income Head	IT Act	Singapore	UK	Mauritius	Netherlands
<b>FTS</b>	10/20/30	10	10/15/20	Nil	10/20
<b>Royalty</b>	10/20/30	10	10/15/20	15	10/20
<b>Interest</b>	20	10/15	10/15	20	10
<b>Dividends</b>	Nil	10/15	15	5/15	10
<b>Capital Gains</b>	20/40	Nil	20/40	Nil	20/40
<b>Business Profits as PE</b>	10/20/40	20/40	20/40	20/40	20/40

## ROYALTY AND FTS - *CURRENT ISSUES*

- ❑ Payments for use of data lines for transmission of high speed data/calls. Payments made typically by back room processing centres/ call centres like GE, Amex etc. to enterprises which own data lines like AT & T etc.

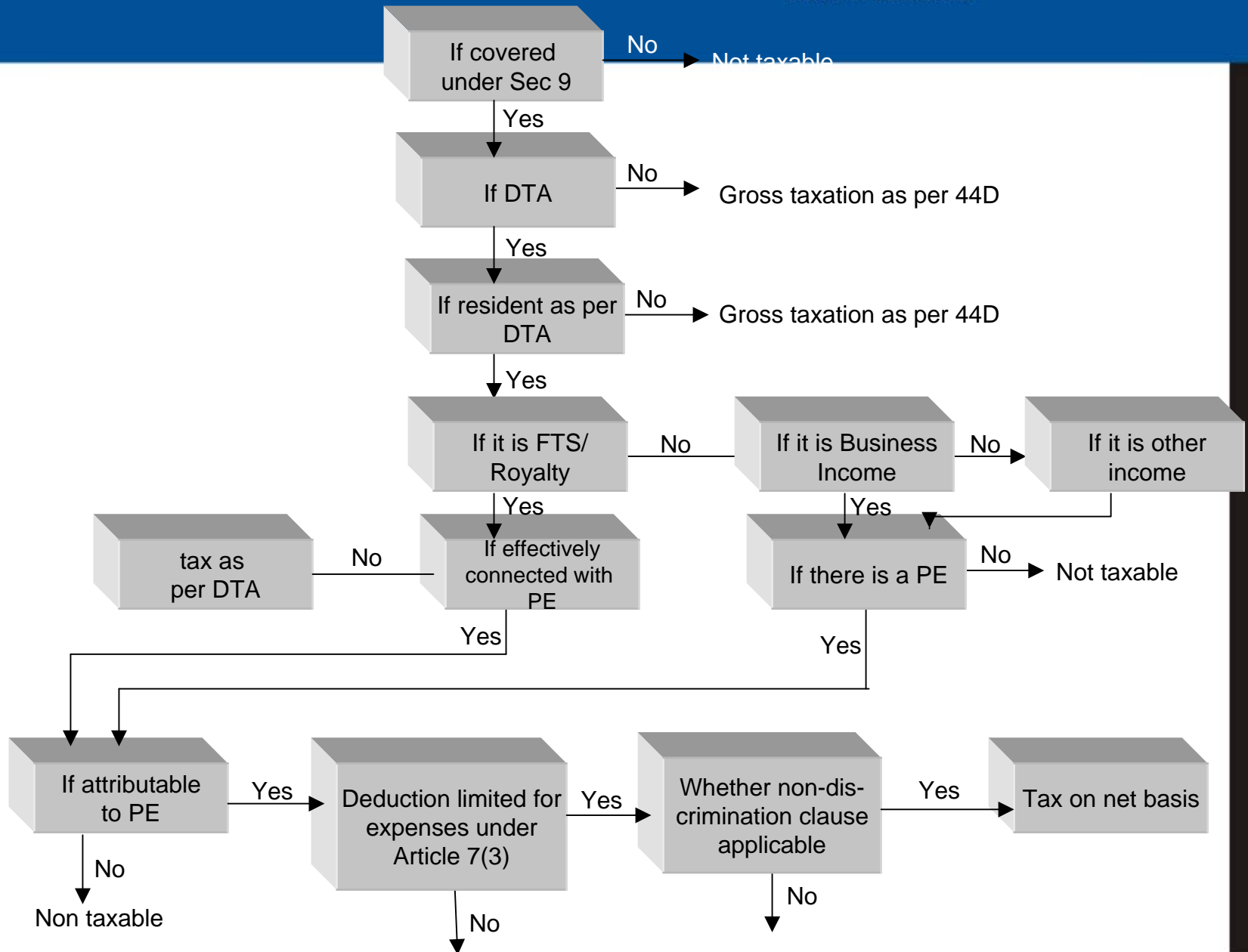
***Question: Whether Such Payments Constitute Royalty or FTS?***

## ROYALTY AND FTS - *CURRENT ISSUES*

- Payments made for transactions entered into for electronically downloading digital products such as software, images, sound or text from computer/internet

***Question: Whether Such Payments Constitute 'Royalties'?***

# ROYALTY & FTS - FLOWCHART



# EXPATRIATE TAXATION

# EXPATRIATE TAXATION IN INDIA

## KEY ISSUES

- Tax Payer's Residency
- Taxable Income
- Exchange Control Norms
- Planning Avenues

- ❑ Resident (ROR) or Non-Resident (NR) ?
  - ▶ **Primary Conditions** – Stay of 182 days in one year **or** 60 in one year and 365 in last four years in India. Indian origin is also relevant
  - ▶ **Secondary Conditions** – Non resident in nine out of 10 preceeding years or stayed less than 730 days in India in last 7 years
  
- ❑ Not Ordinarily Resident (NOR)

# EXPATRIATE TAXATION IN INDIA

## – TAXABLE INCOME

- ❑ Basic Salary
  
- ❑ Perquisites/Fringe Benefits
  - ▶ Accommodation
  - ▶ Car, Water, Electricity
  - ▶ Social Security Benefits
  
- ❑ Allowances
  - ▶ Hardship
  - ▶ Children Education
  - ▶ Leave Travel
  
- ❑ "Tax on Tax"

- ❑ Mr Lim, a Singapore national on Deputation in India
- ❑ Stay in India during FY 2004-05, 2005-06 and 2006-07

Financial Year	Stay in India	Residential Status
< 2003-04	0	NR
2004-05*	150	NR
2005-06	225	NOR
2006-07	225	NOR
<b>Total</b>	<b>600</b>	

\* tax paid in UK

- ❑ Accordingly, Mr Lim pays no tax for FY 2004-05 and only India sourced income tax in respect of FY 2005-06 and 2006-07

- ❑ Stay in India during FY 2007-08 for 129 days or more could convert residential status from NOR to ROR and hence would need to report global income to the Indian authorities
- ❑ However, his contract expires only in end of October 2007. How to avoid global taxation in India?? – Arranges long business trips and vacations aggregating to 100 days.
- ❑ Reports income upto October 2007 in India and obtains Income Tax Clearance Certificate ('ITCC') before leaving India.

# ADVANCE RULING MECHANISM

# AUTHORITY FOR ADVANCE RULING (AAR) - MECHANISM

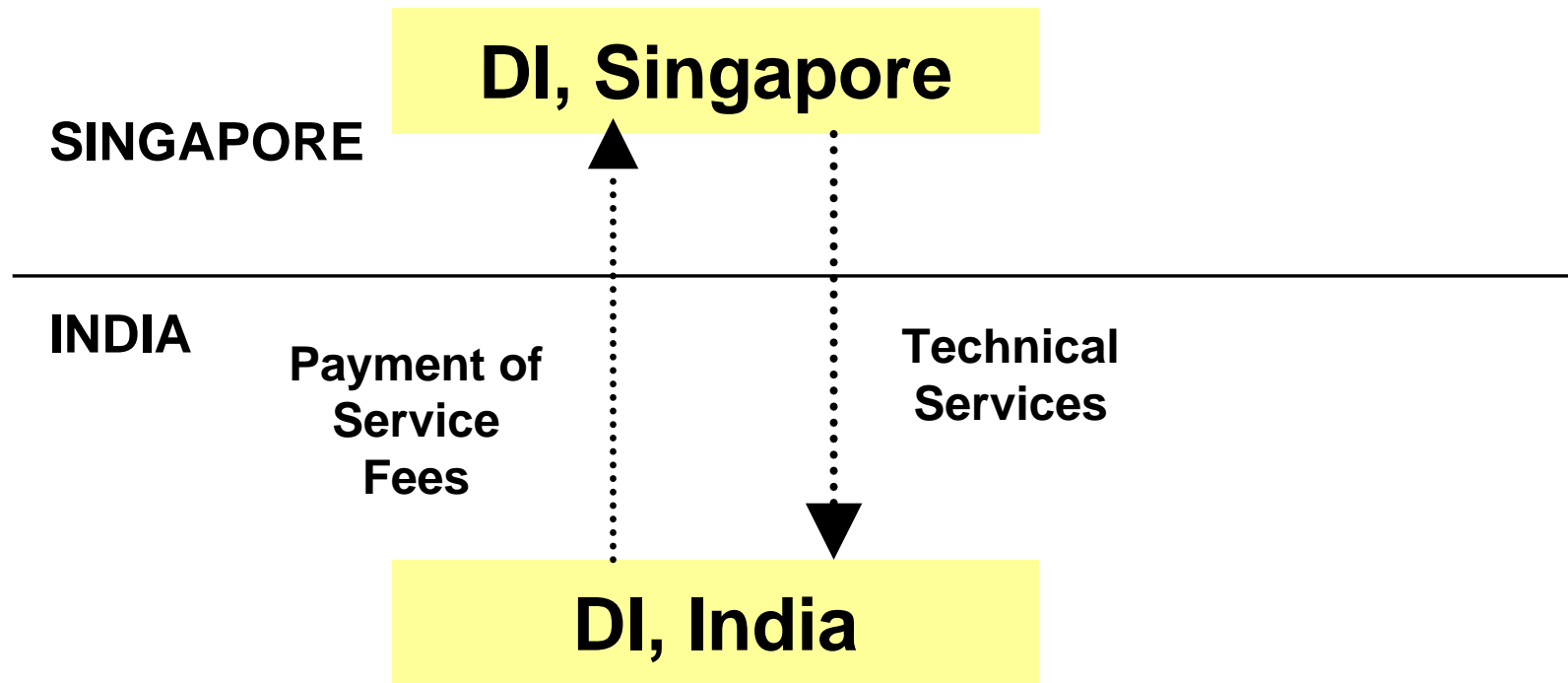
- ❑ Authority to determine tax liability of non-residents on existing or proposed transactions. Specified residents viz. those dealing with non-residents eligible to obtain ruling.
  
- ❑ AAR is lead by a retired Judge of the Supreme Court of India and supported by one member each from the Indian Revenue Service (IRS) and the Indian Legal Service (ILS)
  
- ❑ Assists non residents to plan income tax affairs well in advance by obtaining a **binding ruling** for their tax matters pending before any tax authorities.

## AAR - MECHANISM

- ❑ Once application admitted by AAR, the matters gets decided within six months
- ❑ Ruling of the AAR is binding in respect of the transaction(s) in relation to which ruling has been sought on the following persons
  - on the income tax authorities in respect of the applicant
  - ▶ on the applicant who had sought it
- ❑ Ruling of the AAR is not binding on any other person for any transaction

# SAMPLE ADVANCE RULING

DANFOSS INDUSTRIES PRIVATE LIMITED,  
IN RE 138 TAXMAN 280



### **Question Before AAR**

- ❑ Whether the tax was to be withheld by the Indian company on the service fee it pays to DI, Singapore?

### **AAR Held**

- ❑ The service fees paid to DI, Singapore includes a profit element; and
- ❑ The service fee cannot be construed as a reimbursement; and
- ❑ The Indian company to withhold tax.

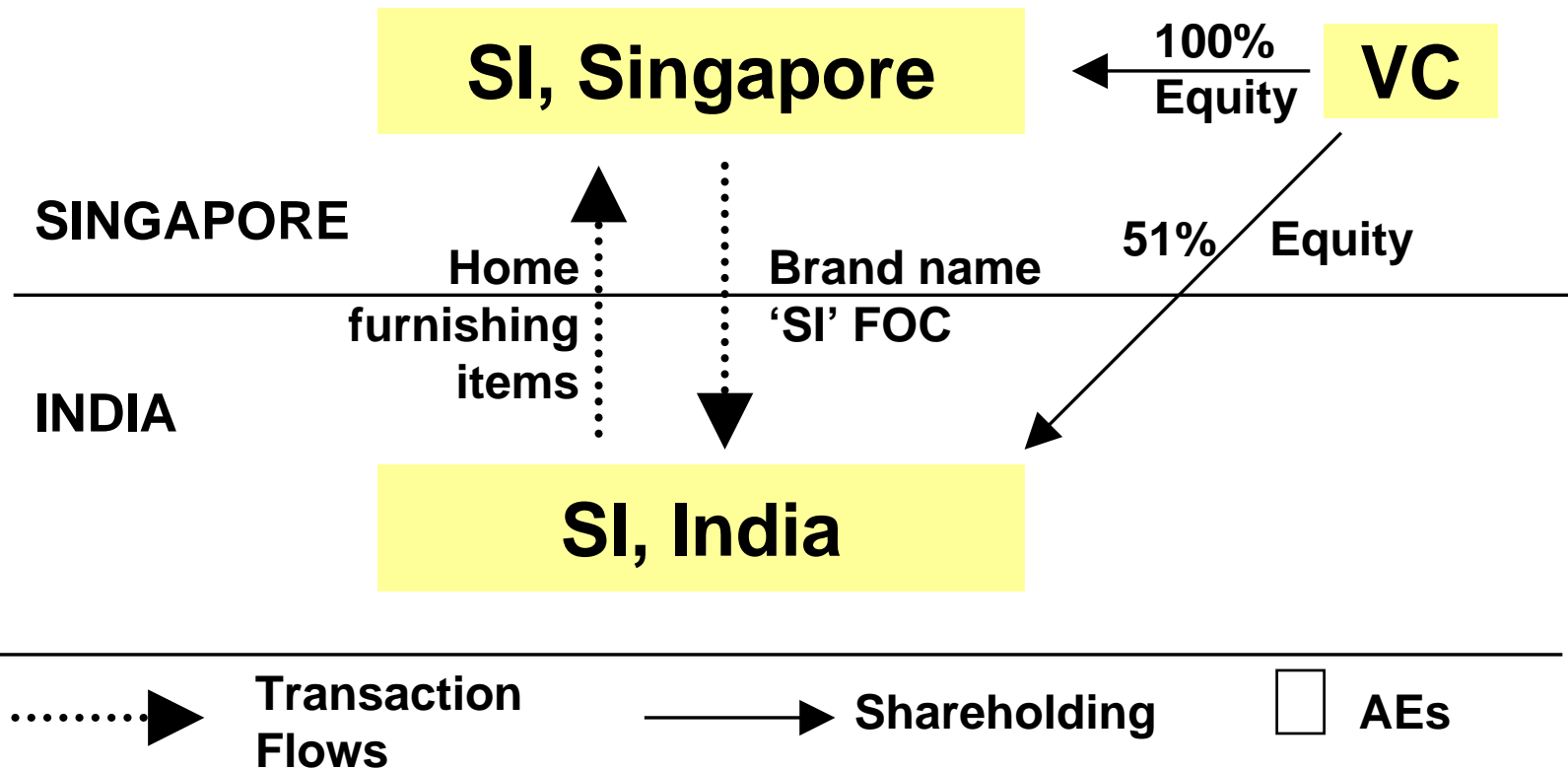
# TRANSFER PRICING

# TRANSFER PRICING - ARM'S LENGTH PRICE (ALP)

- ❑ Any income arising from an international transaction between associated parties, will be computed having regard to ALP
- ❑ ALP means, a price which is applied in a transaction between independent parties with no influence over other's business

# TRANSFER PRICING - CASE STUDY

## - EXPORT OF GOODS



### Main Observations

- ❑ No major players dealing in similar products
- ❑ Data of similar products found not comparable
- ❑ Though many small players dealing in similar products, financial data not in public domain
- ❑ Finally, internal comparable data was used as the major raw materials used were same
  - ▶ costing of different end products was comparable
  - ▶ However, mark-ups of Unrelated AE more as compared to those of AE

- ❑ Documentation – Though prescribed, leaves room for subjective interpretation
- ❑ Threshold at INR 50 million (\$\$ 2 million) for Mandatory Verification is Very Low
- ❑ Knowledge Base of Transfer Pricing Officers at Infancy Stages Thereby Resulting in Higher Litigation
- ❑ Weak Information Databases. Only Few Available
- ❑ Stringent Penalty Provisions

**THANK YOU**