

“OVERVIEW ON INTERNATIONAL TAXATION”

*Seminar on International
Mergers, Acquisitions &
Valuations -*

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FLOW OF PRESENTATION

- ▲ SECTION I - PAYMENTS TO NON-RESIDENTS

- ▲ SECTION II – HOLDING STRUCTURES – USE OF FAVORABLE TAX TREATIES

PAYMENTS TO NON-RESIDENTS

PAYMENTS TO NON-RESIDENTS

- ▲ Guiding Section (Section 195)
- ▲ DTAA vs. Domestic Law
- ▲ Nature of Payments
- ▲ Permanent Establishment
- ▲ Royalty/ FTS
- ▲ Other Issues
- ▲ Consequences of Non Compliance

GUIDING SECTION (SEC 195)

Any person responsible for paying to a *non resident including a foreign company* any sum (other than interest on securities and dividends) which is *chargeable to tax in India* is required to deduct tax at source on such income at the time of payment.

GUIDING SECTION (SEC 195)

- INTERPRETATION

Transmission Corporation of AP (TCAP)

- ▲ TCAP made payments to Swiss companies towards cost of equipment, erection, installation and commissioning under separate contracts
- ▲ The tax authorities held above payments subject to withholding tax, which was subsequently confirmed by the High Court of AP
- ▲ On appeal, the apex court held that
 - ▶ Withholding tax is applicable to all sums payable to non-residents
 - ▶ However, tax is deductible only on the appropriate portion of income subject to tax in India

PAYMENTS TO NON RESIDENTS

- DTAA VS DOMESTIC LAW

- ▲ Provisions of Double Taxation Avoidance Agreement (DTAA) overrule domestic tax laws of contracting states.

- ▲ Difference may arise on account of
 - ▶ Tax Rates
 - ▶ Scope of Taxability

DTAA VS DOMESTIC LAW

- CASE STUDY

- ▲ The payee is entitled to avail benefit as per provisions of relevant DTAA i.e. lower rate or exclusion of service from scope of definition. A typical case is withholding tax on services. Since no surcharge is applicable on DTAA rates, these are generally beneficial.

Legislation	Basic (%)	Surcharge (%)	Cess (%)	Total (%)	Remarks
Domestic Law	10	0.25	0.301	10.56	<i>note 1</i>
DTAA	10	Nil	Nil	10	<i>note 2</i>

note 1 - Surcharge of 2.5% is applicable when payment exceed INR 10,000,000

note 2 - Surcharge and Cess not applicable on rates prescribed under DTAA

DTAA Vs DOMESTIC LAW – CASE STUDY

Background

Extracts of ‘management service’ contract between an Indian Company (ABC) and its Asia Pacific Headquarter (XYZ) in Singapore

“XYZ will provide the following service to ABC

- ▶ *Strategic planning in the field of finance and logistics, particularly in the area of global supply chain management*
- ▶ *Internal control policy and administrative matters*
- ▶ *Decision making on investment and human resource assignment*
- ▶ *Regional marketing and operational activities*
- ▶ *Organizing business planning conferences*
- ▶ *Coordinate communications*
- ▶ *Liaison regarding management and/ or administrative policies*
- ▶ *Any other ancillary services”*

DTAA Vs DOMESTIC LAW – *CASE STUDY*

Issues Under Consideration

1. Whether Management fee is taxable in hands of XYZ, Singapore in India under
 - ▶ Domestic Law
 - ▶ Provisions of DTAA
2. Withholding Tax Liability

DTAA Vs DOMESTIC LAW – CASE STUDY Analysis

[Definition of Technical Services]

<u>Domestic Law</u>	<u>DTAA</u>
<p><i>“fees for technical services means any consideration for the rendering of any managerial, technical or consultancy services but does not include</i>”</p>	<p><i>“The term “fees for technical services” as used in this Article means payments of any kind to any person in consideration for services of a managerial, technical or consultancy nature if such services:</i></p> <p><i>(a).....</i></p> <p><i>(b) make available technical knowledge, experience, skill, know-how or processes, which enables the person acquiring the services to apply the technology contained therein; or</i></p> <p><i>(c).....”</i></p>

DTAA Vs DOMESTIC LAW – CASE STUDY Analysis

[Definition of Technical Services]

<u>Domestic Law</u>	<u>DTAA</u>
any consultancy of technical nature is covered	only those services which make available technical knowledge or process available to other person are covered

In the instant case, all services were of an advisory nature or directory nature. Accordingly, XYZ argued that benefit is available under DTAA provision since it did not make available any know how or process to ABC, India. Hence no taxability in hands of XYZ

PAYMENTS TO NON RESIDENTS

- GENERAL

- ▲ For purposes of withholding tax, income falls under three main categories
 - ▶ Technical / Managerial Services i.e. incomes which accrue or deemed to accrue or arise in India
 - ▶ Business Income i.e. incomes earned through a fixed base of business in India
 - ▶ Other incomes i.e. interest, dividend etc

- ▲ Rate of withholding tax under domestic law
 - ▶ Technical Managerial Services/ Royalty – **10% on gross fee**
 - ▶ Business Income – **40% on business profits**
 - ▶ Interest etc – **30%**

PERMANENT ESTABLISHMENT

- ▲ Permanent Establishment (PE) is a “ Business Connection” of a non-resident in the source country to which profits can be attributable on a reasonable basis
- ▲ A PE is generally represented by a fixed place of business viz. branch, office, factory, warehouse etc but also includes a notional base.

PERMANENT ESTABLISHMENT - *INCLUSIONS*

- ▲ Place of Management
- ▲ Branch
- ▲ Office(Not including Liaison office)
- ▲ Factory
- ▲ Warehouse
- ▲ Mine, Oil or Gas well
- ▲ Store or other sales outlet
- ▲ Dependent Agent

PERMANENT ESTABLISHMENT - *EXCLUSIONS*

- ▶ Independent Agent

- ▶ Any activity of preparatory or auxiliary character

- ▶ Use of facilities solely for the purpose of storage or display of goods belonging to the enterprise

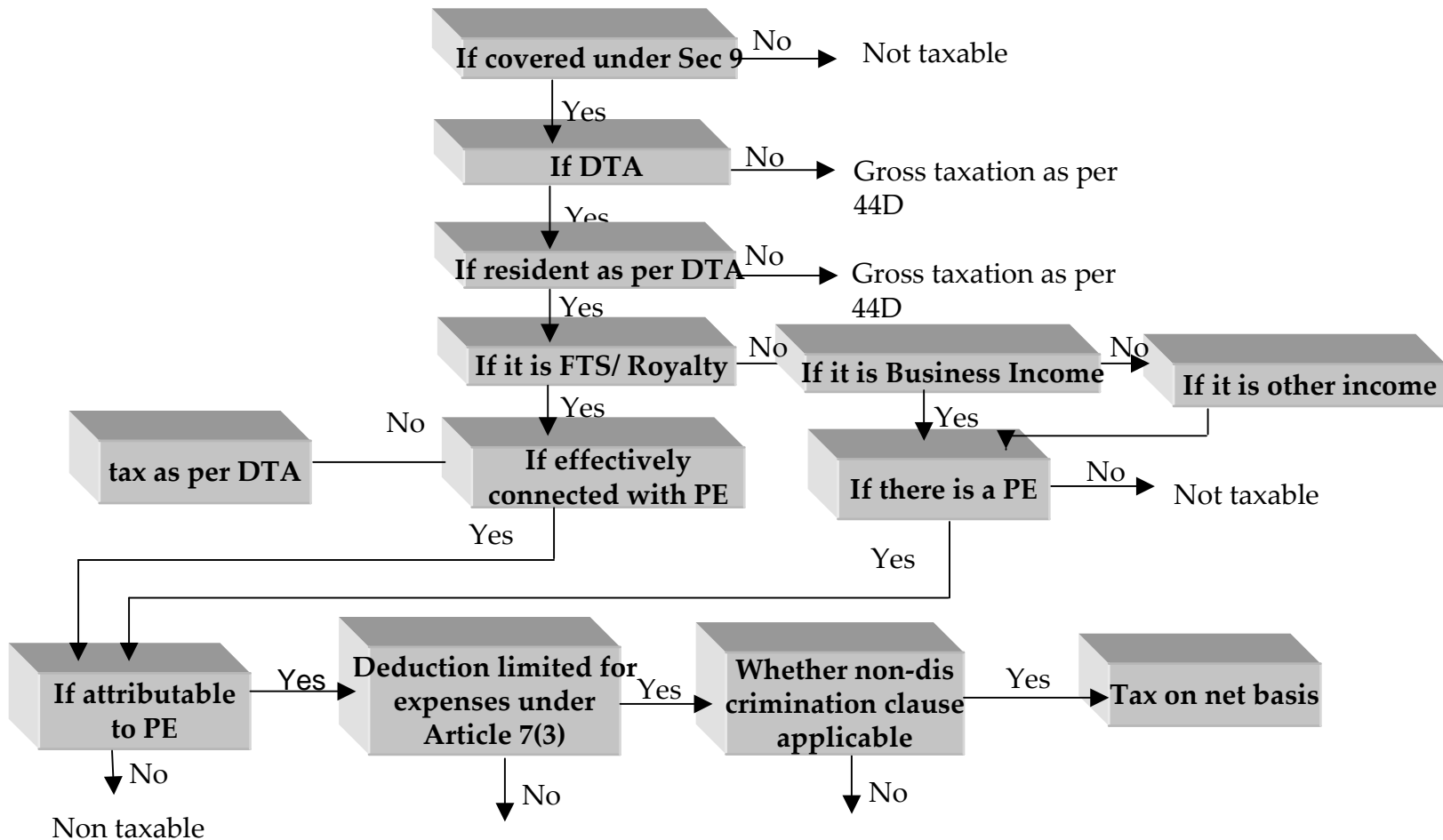
- ▶ Maintenance of stock of goods
 - solely for the purpose of storage or display
 - Solely for the purpose of processing

WITHHOLDING TAX RATES UNDER DTAA

-ILLUSTRATIVE

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

ROYALTY / FTS



SERVICE PE – CASE STUDY

Morgan Stanley Ruling

- ▲ MS Co, USA provides financial advisory services to its clients located across globe
- ▲ MSAS, India, a wholly owned subsidiary of MS Co, USA provided support back office services to MS CO, USA on an arm's length basis
- ▲ In order to maintain quality, MS Co, USA sent its personnel on short-term 'stewardship' to MSAS, India. The cost of stewards was paid by MSAS, India to MS CO, USA
- ▲ AAR held that MS Co, USA has a PE in India through employees sent on stewardship with MSAS, India

SERVICE PE – CASE STUDY

Morgan Stanley Ruling

- ▲ In a landmark judgment, the apex court has held that MSAS, India would amount to a service PE of MS Co, USA on account of services performed by the deputed staff but not on account of stewardship activities. Hence service PE will emerge.
- ▲ But since the transactions was at arms length price, nothing further was added to compute the income of PE.

PAYMENTS TO NON RESIDENTS

– PERMANENT ESTABLISHMENT

- ▲ Under a PE situation, withholding tax is applied at 42.23 percent i.e. the maximum tax rate applicable to foreign companies
- ▲ In case the margins are lower, either the payee or payer can make an application to the tax authorities for determining appropriate rate of tax

Estimated Project Receipts	INR 100,000,000
Estimated Net Profit	INR 20,000,000
Net Profit/ Receipts Ratio	20%
Tax @ 42.23% on Net Profit of 20%	8.45%
Withholding Tax on receipts at Normal Rates	42.23%

- ▲ The non-resident should provide adequate basis of arriving at the estimated net profit

PAYMENTS TO NON RESIDENTS

– *OTHER ISSUES*

- ▲ Credit of taxes paid in India is generally available as a set off against final tax liability in home country.
- ▲ The scope and the manner of providing such credit is contained in Article 25 of the DTAA
- ▲ Credit is available only to the extent of tax liability on that income in home country.
- ▲ For instance, tax withheld on technical fee of INR 1,000,000 in India is INR 100,000 (10%). If this fee is taxable in Singapore at 20%, credit will be available in Singapore only to the extent of INR 100,000.

PAYMENTS TO NON RESIDENTS

- OTHER ISSUES

- ▲ Payments between project office and head office are subject to withholding tax
- ▲ Payment by one 'non-resident' to other 'non-resident' outside India is subject to withholding tax
- ▲ M/s ABC, a UK resident, renders engineering services to a project office of M/s Gemini Engineering, UK in India. Even though both parties are non-residents and the payment to M/s ABC will be made in UK, these are subject to withholding tax

PAYMENTS TO NON RESIDENTS

- OTHER ISSUES

Payments made under a 'Net of Tax' are grossed up to arrive at gross fee and withholding tax thereon. For instance

Technical Fee (net of tax)	INR 90,000
Rate of Withholding Tax	10%
Grossed Up Fee Amount $\frac{\text{INR } 90,000}{90\%} \times 100\%$	INR 100,000
Withholding Tax on Gross Fee i.e. 10% of INR 100,000	INR 10,000

PAYMENTS TO NON RESIDENTS

- *OTHER ISSUES*

Dividend Distribution Tax Paid by Subsidiary in India – Whether Available as Tax Credit in Home Country?

- ▲ Dividend Distribution Tax (DDT) is tax levied on distribution of profits by Indian companies. In India, no credit is available in respect of DDT.
- ▲ However, such credit may be available in the home country of the non-resident recipient of dividend subject to the provisions of the DTAA

PAYMENTS TO NON RESIDENTS

- OTHER ISSUES

In case of India Singapore DTAA, article 25 is relevant. It states that

“Subject to the provisions of the Laws of Singapore.....Indian tax paid.....in respect in respect of income from sources within India shall be allowed as a credit against Singapore tax payable.....Where such income is a dividend paid by a company which is a resident of India to a resident of Singapore which owns not less than 25% of the share capital of the company paying the dividends, the credit shall take into account Indian tax paid in respect of its profit by the company paying the dividends”

In summary, the DTAA does provide a mechanism for claim of credit of Indian tax paid on dividend. However, the claim is dependent upon domestic tax provisions of the home country

PAYMENTS TO NON RESIDENTS

- OTHER ISSUES

Authority for Advance Ruling – 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

OVERSEAS HOLDING STRUCTURES – USE OF FAVOURABLE TAX TREATIES

OVERSEAS HOLDING STRUCTURES

- ▲ Need for Overseas Structuring
- ▲ Ideal Holding Company Jurisdiction
- ▲ Routing of Foreign Investments to India
- ▲ Some Case Studies

NEED FOR OVERSEAS HOLDING STRUCTURES

- ▲ Retention of profits in offshore jurisdiction
- ▲ Greater flexibility for inter company transfer of funds and for setting up operations in other overseas jurisdictions
- ▲ Future restructuring easy

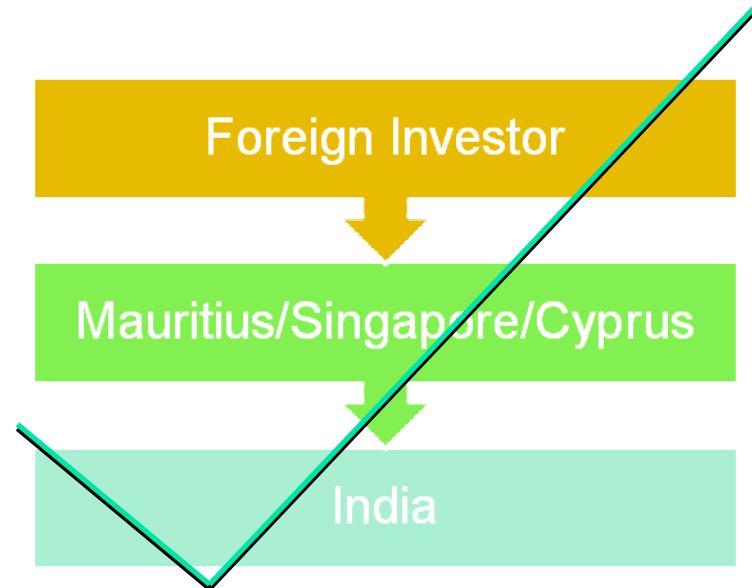
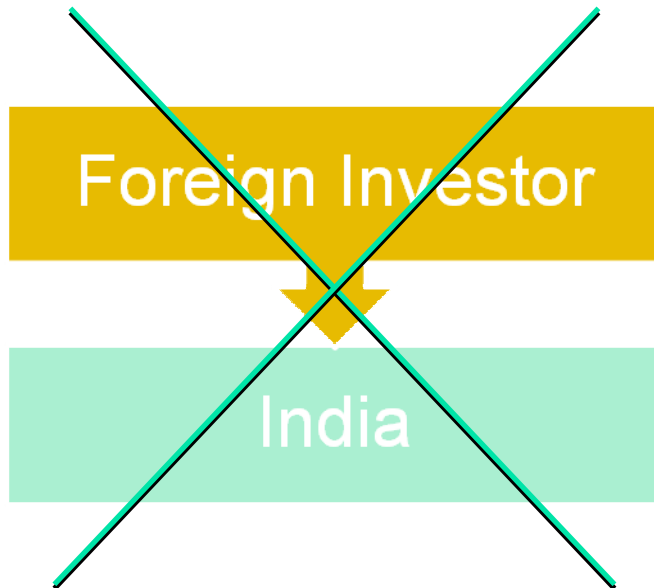
IDEAL HOLDING COMPANY JURISDICTION

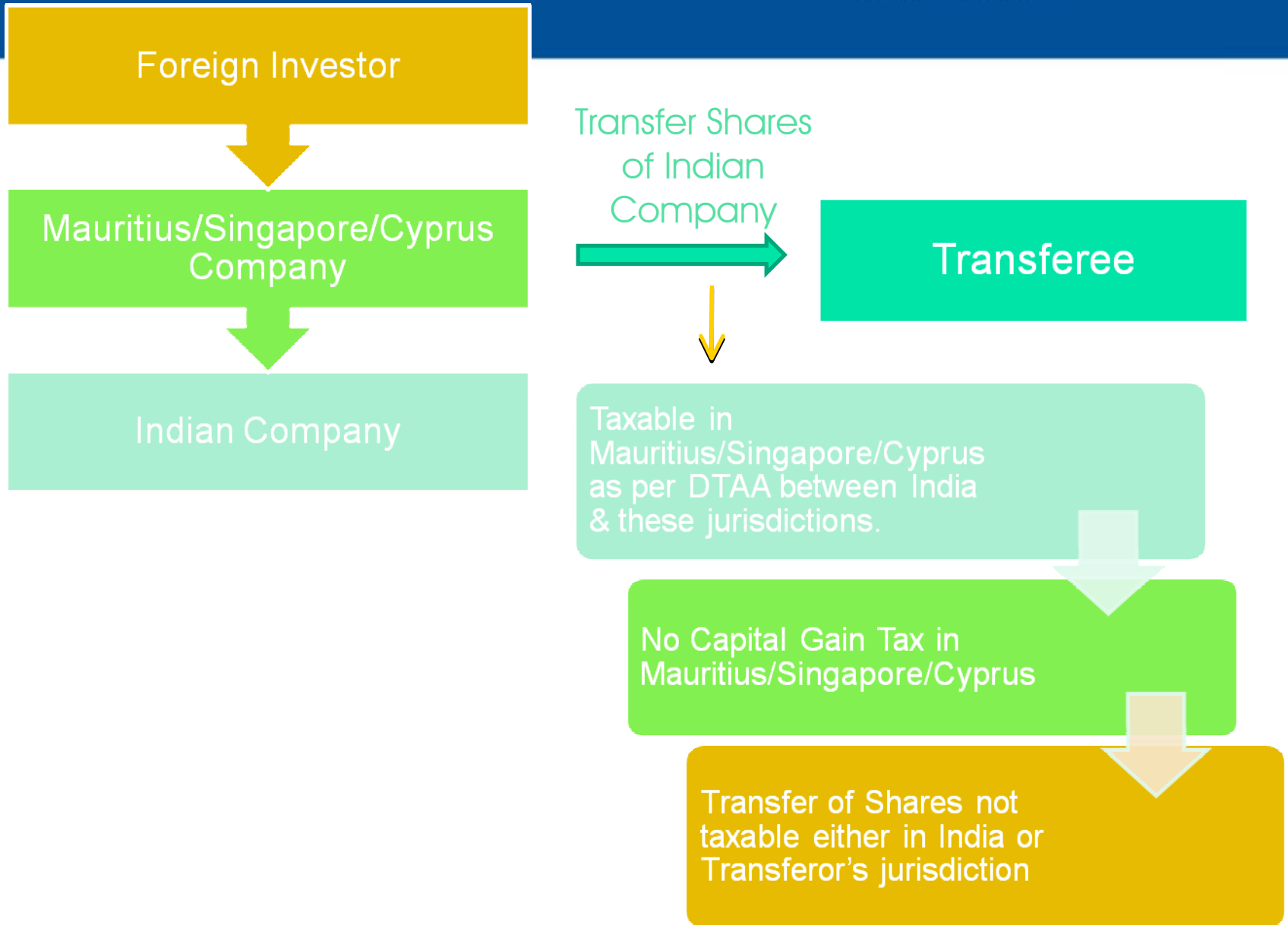
- ▲ Has a wide Tax Treaty network, thereby minimising withholding taxes on dividend income
- ▲ Has tax relief on foreign dividend income
- ▲ Does not charge capital gains tax on the disposal of subsidiaries
- ▲ Does not impose withholding taxes on distributions from the holding company to its parent or shareholders.

IDEAL HOLDING COMPANY JURISDICTION

- ▲ Does not impose capital gains tax on profits arising from the sale of shares in the holding company by non-resident shareholders
- ▲ Does not impose capital duties on share capital
- ▲ Does not have a minimum paid up share capital requirement.

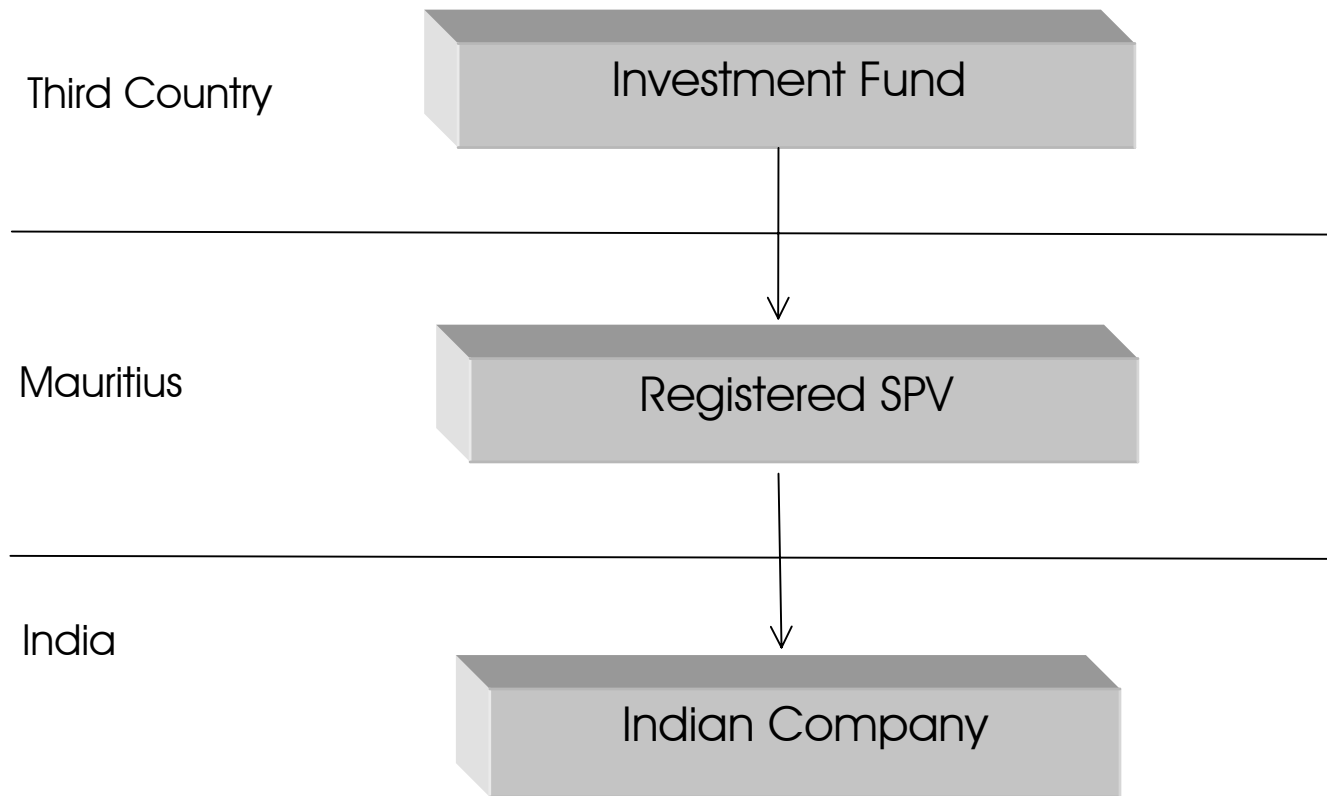
ROUTING OF FOREIGN INVESTMENTS IN INDIA





**AZADI BACHAO ANDOLAN
(MAURITIUS)**

TRANSACTION



AZAADI BACHAO ANDOLAN

- ▲ Circular No. 789 of 2000 issued by the CBDT clarified that the certificate of residence issued by the Mauritian Authorities shall be treated as an evidence of residence as well as of beneficial ownership (as will establish that control & management lies in Mauritius)
- ▲ Consequently capital gains from sale of shares in India became non-taxable in India
- ▲ The Delhi High court quashed the above circular on the ground that the it was ultra-vires the Income Tax Act as it curtails powers of the AO to examine control & management in the foreign tax jurisdiction. It further held that this amounts to treaty shopping, which is illegal and therefore is forbidden.

ISSUES INVOLVED

A Special Leave Petition was filed in the Supreme Court against the above order of the High Court on the following Grounds

- ▲ Whether the circular issued by the CBDT was ultra vires the Income Tax Act
- ▲ Since income from sale of shares is exempt in Mauritius whether such entities are eligible for benefits under the DTAA
- ▲ Treaty shopping – Whether it is illegal

DECISION

1. Circular No. 789 is valid in Law

- ▲ The circular in question in no way curtails the jurisdiction of the AO and therefore is not ultra-vires the Income Tax Act.

DECISION

2. Liability to Pay tax Vs Payment of Tax

- ▲ The court held that merely because exemption has been granted in respect of taxability of a particular source of Income, it cannot be said that the entity is not *liable* to tax therein.
- ▲ The Court held that the law cannot be interpreted to mean that avoidance of double taxation can only arise when tax is actually paid in one country.

DECISION

3. Treaty Shopping

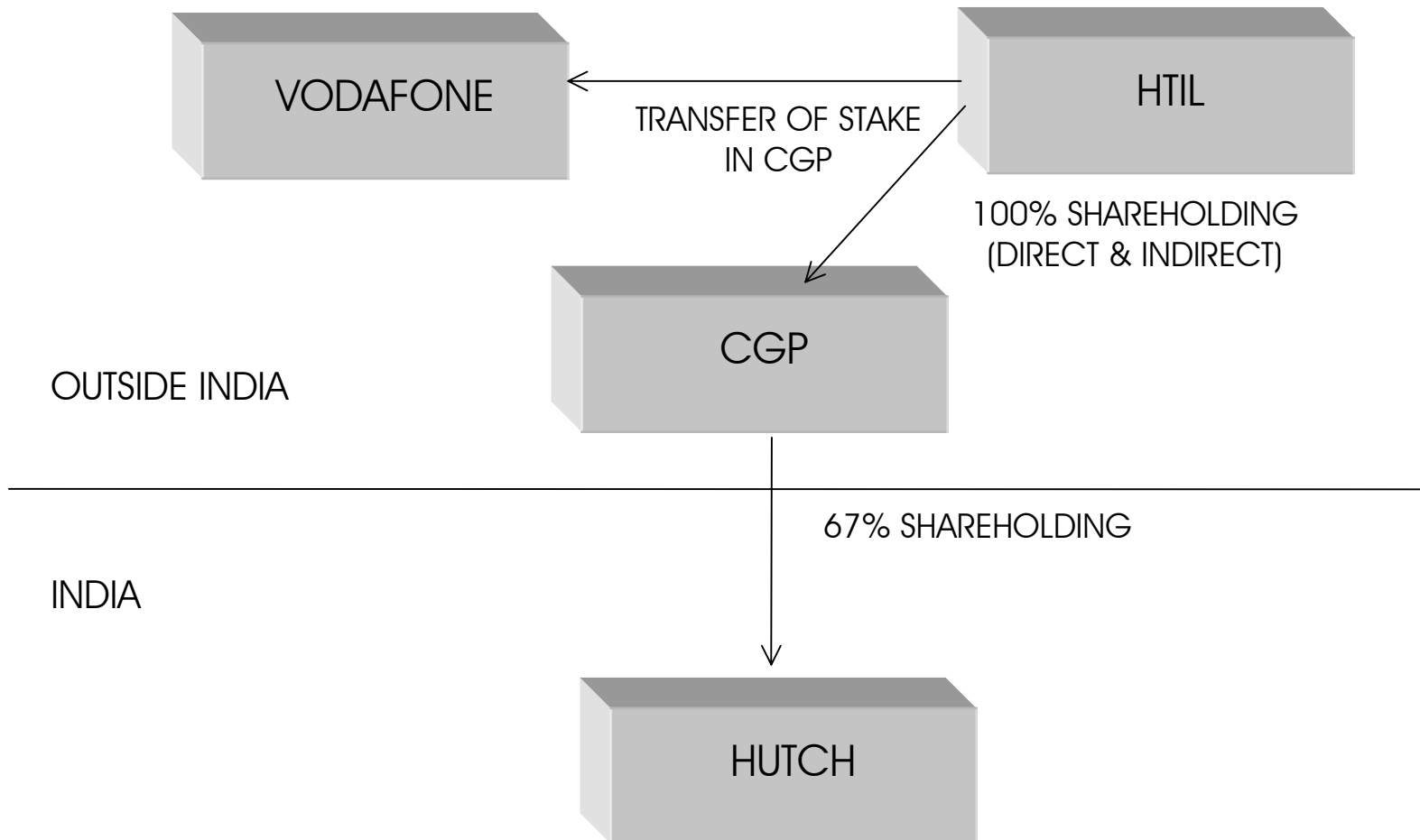
- ▲ In the absence of any contrary provisions, there is nothing to prevent nationals of third States to claim the benefits of the treaty.
- ▲ The transaction which is otherwise valid in law cannot be treated as void because of some underlying motive supposedly resulting in economic determinant to the nation.

VODAFONE INTERNATIONAL (CAYMAN)

BACKGROUND

- ▲ B.V. Vodafone International Holdings (Vodafone) bought 100% shares of CGP Investments (Holdings) Ltd. (CGP) from Hutchinson group, Hongkong (HTIL)
- ▲ CGP held 67% stake in Hutch Essar (India) Ltd. (Hutch).
- ▲ While making payment to HTIL, Vodafone did not deducted tax at source.

TRANSACTION



ISSUES INVOLVED

- ▲ Contentions of Revenue Authorities
 - Such transfer of shares represents transfer of business assets in India and therefore was liable to tax in India
 - ▶ Vodafone should have deducted tax at source while making payment
 - ▶ A show cause notice was served on Vodafone asking as to why it should not be treated as assessee in default for failure to deduct tax on source.

ISSUES INVOLVED

- ▲ Writ petition was filed by Vodafone on the following grounds
 - That the transaction was not taxable in India
 - Show-cause notice is without jurisdiction and Vodafone shall not be treated as assessee in default.

DECISION

The High Court held that “shares in themselves which may be an asset but in some cases like the present one, shares may be merely a mode or a vehicle to transfer some other asset(s). In the instant case, the subject matter of transfer as contracted between the parties is not actually the shares of a Cayman Island company, but the assets situated in India”

DECISION

Hence, the transaction is Prima Facie Taxable in India

- ▲ Transfer of shares is merely a mode of transfer of assets in India
- ▲ Vodafone by signing the agreement, acquired nexus to a source of income in India.
- ▲ Vodafone has also acquired interest in the license granted by the Department of Telecommunication in India.
- ▲ Income accrued to HTIL as a result of divestment of its Indian interest which could be liable for capital gains.

THANK YOU