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Déjà vu as India's Direct Tax Proposals enter Round 3

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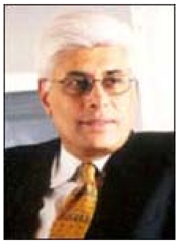

After a year of intense debate and deliberation, the Direct Taxes Code ("DTC") has finally been tabled before the Indian Parliament. Once enacted, it will replace the existing income tax and wealth tax law in India and would be effective from April 1, 2012.

In Round 1, the Government sent shivers across the global investing community by introducing a number of radical proposals as part of the first draft of the DTC released in August 2009.

However, compelled by widespread criticism, Round 2 saw the Government release a revised discussion paper in June 2010 which adopted a more pragmatic stance vis-à-vis several controversial proposals.

As the debate finally enters Round 3, one gets an uncanny sense of déjà vu considering that the latest version of the DTC largely resembles the existing tax regime in India- something like an Income Tax (Amended and Restated) Act of 1961 ! Further, many of the not-so-good aspects of the earlier DTC draft continue to remain unaddressed.

In this hotline, we provide insights into the impact of the DTC bill proposals on the international business community and focus on those aspects that are of special concern to cross-border investments and M&As.

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Status quo prevails over 'radical change'

In the DTC Bill, corporate tax rates continue to remain at 30%, while foreign companies would be subject to an additional branch profit tax of 15%, thereby raising their effective tax rate to 40.5%. This is an increase from the standard corporate tax rate of 25% proposed in the first DTC draft. The rate of minimum alternate tax ("MAT") has been set at 20% which is similar to the existing rate when coupled with surcharge and education cess. MAT would also continue to be levied on book profits rather than on gross assets as was initially proposed. Tax on dividend distributions also remains constant at the rate of 15%. The maximum marginal rate for individual taxation also continues to remain at 30% with slight variations in the tax slabs.

Investors can heave a sigh of relief as long term capital gains on the sale of shares (held for more than a year) on the stock exchange will continue to be tax exempt, but would attract securities transaction tax at the rates applicable today. Short term capital gains on the sale of such shares (held for less than a year) would be taxed at ordinary rates subject to a 50% exemption. Other capital gains income shall be taxed at ordinary rates applicable to the taxpayer.

Units in special economic zones ("SEZ") that commence operations before March 31, 2014 would continue to receive tax deductions in relation to export profits as they do today. The tax holiday available to SEZ developers for projects notified before March 12, 2012 would also be grandfathered.

The present tax regime applicable to venture capital funds ("VCF") will remain untouched. Accordingly, VCFs would continue to remain pass-through entities with respect to income from investments in venture capital undertakings engaged in specified sectors. Such income would be taxed at the level of the investors on a receipt basis.

Mutual funds would be allowed to retain their tax exempt status although a tax would be payable at the rate of 5% on distributions made to unit holders. Currently, distributions from equity oriented mutual funds are tax exempt.

The DTC Bill also gives effect to the Government's revised stance of doing away with tax treaty override. It preserves the current scheme which allows tax payers to take advantage of provisions of the treaty or domestic law to the extent beneficial to them.

Critical issues remain unaddressed

The Government seems to have lent a deaf ear to a number of concerns raised regarding the detrimental impact of certain DTC proposals on cross-border transactions.

As per the DTC Bill, mergers between foreign companies having underlying Indian subsidiaries may be taxed in India and the present tax free status of corporate mergers has been confined to those that are sanctioned under the Indian Companies Act, 1956. We believe that this is a drafting error that has not been rectified since the first DTC draft. However, if the Government has consciously decided to tax foreign mergers, the proposal may be considered extremely regressive and conflicts with the Constitutional mandate of equality as well as India's commitment to non-discriminatory tax treatment under the various tax treaties signed by it.

All income earned by foreign institutional investors ("FII") from sale of Indian portfolio investments would be treated as capital gains income and hence taxed in India in the absence of any treaty based capital gains tax exemption.

The proposal seems to have ignored relevant factors such as the scale of investments, frequency of trade and the fact that such investments may be held as stock-in-trade in the books of the FII. Under the present regime, it is possible that such income may be taxed in India only if the FII has a permanent establishment in India. This proposal would negatively impact FIIs such as pension funds investing from jurisdictions that do not have favourable tax treaties with India.

The DTC Bill has not introduced any additional safeguards to the application of the infamous general anti avoidance rules ("GAAR") which bestow sweeping powers to the income tax authorities to disregard transactions or entities and to re-characterize instruments or reallocate income between parties.

Although, the Central Board of Direct Taxes has been given the power to lay down conditions for the application of GAAR, there is little certainty that these powers will not be used to target legitimate tax planning structures.

Cross-border M&As will run into further rough weather with the DTC Bill extending the tax net to offshore share acquisitions where the target foreign company holds direct or indirect assets in India that are more than 50% of the fair market value of all assets held by the company at any time within 12 months preceding the transfer. The extraterritorial scope of this proposal transgresses Constitutional limitations as well as customary international law principles of comity of nations.

Also relevant in the cross-border context is the introduction of the place of effective management criterion for determining tax residence of a company. This criterion lays emphasis on the place where the board of directors of a company makes its decisions. While this is a standard followed across the world, it cannot be said that it is superior to the present objective threshold for residence which requires the management and control of the foreign company to be wholly situated in India.

Another proposal borrowed from more developed tax regimes is the controlled foreign corporation ("CFC") provisions which seek to tax resident companies in relation to undistributed profits of specific foreign corporations controlled by such resident companies. Elaborate formula has been provided for determining the profits that may taxed in the hands of the resident company. However, no provision seems to have been made for obtaining credit in respect of foreign taxes paid on such income.

Back to square one?

When the first draft of the DTC was introduced, the broad object was to improve the efficiency and equity of India's tax system. The DTC's approach was explained in terms of achieving the three-pronged goal of eliminating distortions in the tax structure, introducing moderate levels of taxation and expanding the tax base. On this basis, the Government undertook the mammoth task of rewriting the entire tax law by starting from a clean drafting slate. It is therefore quite ironical that after all the rounds of internal and public scrutiny, things seem to have gone back to square one.

As the DTC bill is being considered by Parliament, the important question to be asked is to what extent has it achieved any of its stated objectives. There haven't been any significant changes in terms of tax structure or rates. Certain key tax benefits will continue to be available to taxpayers. At the same time certain proposals such as those impacting cross-border investments and M&A are likely to give rise to immense litigation and uncertainty.

If this is the outcome, one wonders whether it makes sense to shelf the entire endeavour and continue with the present tax regime with a greater sense of certainty and stability. However, if change is considered inevitable, it is necessary that each DTC proposal is thoroughly analyzed on the basis of relevant economic theories, statistical data, revenue projections and legal principles.

It is not advisable to immediately shift to new regimes such as GAAR and CFC without undertaking a comprehensive cost benefit analysis after factoring in increased implementation and compliance challenges. It is hoped that a select committee of Parliament would be appointed to carefully review the Bill and consider these macro aspects while determining the fate of India's new direct tax regime.