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LEGAL AND TAX COUNSELING WORLDWIDE

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Indian Budget 2013

Impact on Joint Ventures

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Further to our hotline on Budget 2013 (India Budget Insights 2013-14) circulated on February 28, 2013, this JV Update discusses some of the essential changes introduced in Budget 2013 relevant to joint ventures involving foreign partners.

1. Marked Increase In Royalties And Fees For Technical Services!

Last year, the definition of royalty was amended to bring within the tax net a number of payments which would not commercially be considered royalty, such as payments towards the purchase of shrink wrap software, subscription to databases and clouds. This year, a further blow has been inflicted by way of an amendment to the rate of tax applicable to payments of royalty and fees for technical services ("**FTS**"). While previously a rate of 10% was applicable on a gross basis, going forward the rate is proposed to be 25% on a gross basis. The explanation that has been provided is that the 10% rate contained in Indian tax law is lower than the rates applicable to these payments under several of India's tax treaties and that non-residents situated in tax treaty jurisdictions will still be eligible to claim the beneficial rate. There is also a possibility that this move was intended to tap payments of royalty and FTS which have been used by foreign investors to repatriate profits even though the same is presently addressed under the transfer pricing provisions.

Analysis

Most significant issue with the rate change is that the 25% tax would be computed on a gross basis on all payments of royalty and FTS, and not merely on the net income amount. This could translate into the tax being potentially imposed even where there is a situation of loss in the hands of the foreign recipient. This is a retrograde move which is likely to be a significant blow to technology transfer, knowledge sharing and collaboration agreements across sectors, particularly as the foreign investor may never have sufficient tax obligations in its home country against which the substantial Indian taxes could be offset and foreign tax credits claimed.

This can have a significant impact in respect of joint ventures in India, where the Indian

party relies on technical know-how and expertise of the foreign joint venture partners.

2. Additional Tax On Buyback Of Shares

The Budget proposes to levy a tax of 20% on domestic unlisted companies, when such companies make distributions pursuant to a “buy back” under Section 77A of the Companies Act, 1956. This tax at the rate of 20% has been proposed to be imposed on consideration paid by a company over and above the amount received by the company at the time of issuing of shares. Buybacks hitherto were taxed as capital gains in the hands of the non-resident, and if the non-resident was a resident in a treaty jurisdiction like Mauritius, Cyprus and Singapore then the capital gains tax were exempt.

I. Analysis

i. Additional ‘distribution tax’

Akin to dividend distribution tax, this is an additional tax on distribution of monies by a company on buyback of shares. Though, once taxed at the company level, the proceeds received by a shareholder on account of buy-back will not be subject to further tax, however, introduction of this provision takes away certain benefits which could be availed by the shareholder discussed in detail below.

ii. No deduction

The Budget proposes that tax as imposed under these provisions shall be payable by the company irrespective of whether income tax is payable on its total income as computed under the ITA. The tax paid to the Central Government for the buy-back has been proposed to be treated as the final payment of tax and no further credit can be claimed by the company or any other person in respect of the amount of tax so paid. Further, no deduction is allowed to the company or to the shareholder in respect of the income which has been subject to this tax or the tax thereon. To that extent, the shareholders would now not be able to set-off the capital gains from buy-back of shares

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against capital losses which they could do earlier.

iii. Treaty benefits 'fruitless' / availing foreign tax credit a challenge

Introduction of this tax seems to be a calculated move by the Government to undo the current practice of resorting to buying back of shares instead of making dividend payments in the international context. The proposed provisions will have a significant adverse impact on offshore realty funds and foreign investors who have made investments from countries such as Mauritius, Singapore, Cyprus etc. where buy-back of shares would not have been taxable in India due to availability of tax treaty benefits. Further, being in the nature of additional income tax payable by the Indian company, foreign investors may not even be entitled to a foreign tax credit of such tax.

iv. Secondary purchase and indexation benefit disregarded

The scope of these provisions are far reaching as they do not just tax gains but tax the difference between the share subscription amount and the distribution. These provisions thereby implicitly tax gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back. Not only this, these provisions also disregard the cost incurred towards acquisition of shares which earlier did not form part of capital gains. Additionally, in the context of the domestic investor, even the benefit of indexation would effectively be denied to such investor and issues relating to proportional disallowance of expenditure under section 14A *(Expenditure incurred in relation to income not includible in total income)* may also arise. This would therefore result in the buy-back of shares being even less tax efficient than the distribution of dividends.

Up-streaming of cash to the foreign joint venture partners that was hitherto tax efficiently structured in nature of buy-backs by the Indian company of a shares (usually of a separate class) of the foreign joint venture partner, will now be significantly impacted.

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3. Gaar / Tax Residency

Budget 2013 has proposed a few amendments to the general anti-avoidance rules ("**GAAR**") introduced into India's tax statute last year. GAAR which was initially slated for implementation from April 1, 2013 has been widely criticized on account of ambiguities in its scope and application, lack of safeguards, and possibility of misuse by the tax authorities. GAAR empowers the Revenue with considerable discretion in taxing 'impermissible avoidance arrangements', disregarding entities, reallocating income and even denying tax treaty benefits to a non-resident investor.

With a view to address the dampening investor sentiment, the Government appointed the Shome Committee to consult with stakeholders and review GAAR as well as the retroactive amendment for taxing offshore share transfers. In its detailed report, the Shome Committee had recommended a substantial narrowing down of the GAAR provisions and other safeguards in the interest of fairness and certainty. Click here to read our insights and analysis of the Shome Committee's report.

Some of the key changes proposed to GAAR under Budget 2013 are as follows:

- To defer the implementation of GAAR for 2 years.

- GAAR shall apply only if the main purpose of an arrangement is to obtain a tax benefit. Currently, GAAR may apply even if obtaining the tax benefit is one of the main purposes of an arrangement. Presumably, the new GAAR provisions may not apply if an arrangement is backed by sufficient business purpose.

- Factors such as the holding period of the investment, availability of an exit route and whether taxes have been paid in connection with the arrangement may be relevant but not sufficient for determining commercial substance. Interestingly, these were the key factors considered by the Supreme Court of India when it decided that the USD 11.1 billion Vodafone-Hutch transaction was not a sham and could not be taxed in India.

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- GAAR cases shall be scrutinized by an Approving Panel chaired by a retired High Court Judge, a senior member of the tax office (of the rank of Chief Commissioner of Income Tax) and a reputed academician or scholar with expertise in taxation or international trade and business. The existing provisions relating to the Approving Panel only contemplate members from the tax department, which raises issues of independence, lack of objectivity and bias.

Further, this year's Budget also on to state that a tax residency certificate ("**TRC**") shall be necessary but not a sufficient condition to claim tax treaty benefits. While no criterion has been prescribed in the Finance Bill 2013-14 to determine what constitutes 'sufficient condition', statements have been made by the Finance Minister that only persons having 'beneficial ownership' of assets would be eligible to claim tax treaty benefits.

4. Added Deduction For High Value Investments

To attract new investment and to quicken the implementation of projects, Budget 2013 has introduced an investment allowance for new high value investments. A company investing 100 crore (USD 20 Million) or more in plant and machinery during the period 1.4.2013 to 31.3.2015 will be entitled to deduct an investment allowance of 15 percent of the investment. This will be in addition to the current rates of depreciation.

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Conclusion

Budget 2013 has failed to address some of the important relaxations which the industry was looking forward to. For instance, there has been no relaxation in the taxation of indirect transfer of shares which were at times used to give an exit to foreign investors at an offshore level. Also, there has been no clarity on the applicability of Indian minimum alternate tax ("**MAT**") to foreign companies. The current language of the MAT provisions is not clear on this issue and the matter has been litigated upon and discussed on a fairly constant basis. On a positive note, though the Finance Bill, 2013 itself did not initiate the introduction of a consolidated Goods & Sales Tax ("**GST**") regime, which was to replace the existing dual taxation regime, the Finance Minister has said[1] that the government will table the draft constitution amendment Bill and the draft GST Bill in Parliament in the coming months

1. http://www.livemint.com/Politics/tFIKWw49KnErGdIIXVejIL/Budget-2013-Chidambaram-hopes-for-implementation-of-GST-and.html

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