tax notes international

Volume 53, Number 8 ■ February 23, 2009

A Tax Planning Primer for U.S.-Controlled Indian Business Operations

by William M. Sharp Sr., Andrea D. de Cortes, Nishith M. Desai, and Parul Jain

Reprinted from *Tax Notes Int'l*, February 23, 2009, p. 705

taxanalysts®

A Tax Planning Primer for U.S.-Controlled Indian Business Operations

by William M. Sharp Sr., Andrea D. de Cortes, Nishith M. Desai, and Parul Jain

William M. Sharp Sr. and Andrea D. de Cortes are with Sharp & Associates, PA in Tampa, Florida. Nishith M. Desai and Parul Jain are with Nishith Desai Associates in Mumbai.

This article is based on an outline the authors prepared for the November 14, 2008, Florida Bar Seminar entitled ''Legal Process Outsourcing (LPO) in India — What You Need to Know About Who, How, Why, and Why Not.''

I. Introduction

A. Overview

The purpose of this article is to provide the U.S. tax adviser with a technical yet practical primer for structuring U.S. outbound active business investments in India, including a review of recent tax reform developments. This article also provides an analysis of the more significant in-country Indian inbound tax and related issues as those issues tie into U.S. outbound tax planning issues. Finally, this article provides a practical planning summary for the U.S.-based business that has already invested in India and needs to consider restructuring.

B. Teaming Up With In-Country Professionals

Any proposed investment in India, whether an equity investment or a contractual arrangement such as a legal process outsourcing (LPO) transaction, must be analyzed in conjunction with a team of professional advisers, including a U.S.-based tax lawyer and CPA as well as well-qualified in-country Indian professional advisers. The professional infrastructure in India is well-developed, and generally speaking, the U.S. professional adviser can appropriately rely on the engagement of an in-country Indian professional team. Given the complex nature of the U.S. outbound rules as they apply to India (or any country), however, the U.S. professional team needs to stay on top of all relevant issues, both U.S and Indian, given their interconnectivity.

C. Overview of India

Despite the recent global economic slowdown, India represents dynamic opportunities for foreign direct investment (FDI) and contractual opportunities for the U.S.-based operation. Over the past several years, the U.S. economy has witnessed a major outbound shift of manufacturing, processing (including LPO), assembly, biotech and pharmaceutical development, high-tech development and processing, and several other migrations of activities formerly conducted on U.S. soil, including LPO and other outsourcing transactions. This article will not debate whether this migration of U.S.-based business from America to India is advantageous or disadvantageous to the long-term health and security of America. Instead, this article will focus on the technical and practical aspects of conducting business operations from a U.S. perspective in India.

India gained independence in 1947 after two centuries of British colonial rule; also in 1947, the sovereign state of Pakistan was created. As the second most populous country in the world, India has grown to the 12th-largest economy in the world, based on nominal U.S. dollars, but actually has grown to the third-largest economy when measured at purchasing power parity exchange rates. India is a country of contrasts, diversity, and conundrums, and is well-known for its dilapidated and highly inefficient public sector, which coexists with a substantial and growing diversified private sector.

As a democratic independent state since 1947, by and large democracy in India has worked quite well in a peaceful setting. (India has recovered quite well from the tragic ''26/11'' terrorist event.) While the Indian offshore industry has boomed in recent years, especially in manufacturing, pharmaceuticals, high technology, and general outsourcing of mid- and high-end labor (for example, LPO), India's public infrastructure has continued to deteriorate, with unremarkable progress in most public institutions, ranging from roadways, public works, and related areas. India is taking measures to attack its public infrastructure problems, and real GDP growth is expected to continue between 7 percent and 8 percent over the next five years.

India is highly important to the U.S. economy, and indeed the U.S. is the largest target market for Indian exports, consuming almost 20 percent of Indian exports. India's predominant exports include engineering goods, petroleum products, textiles and clothing, and gems and jewelry; however, these statistics do not take into account the substantial high-tech and related high-end services that India provides. India has emerged from a low-end sweatshop-style in-country manufacturing and processing operation to a mid- to high-end technology services and outsourcing jurisdiction. Many American MBA program graduates are moving to India instead of Silicon Valley or Wall Street to launch their careers.

By using the English language and the British common-law system, the development, operation, and disposition of businesses in India are comfortable from an American perspective, although it must be cautioned that India has its fair share of corruption at some political and even business levels, particularly at the labor union level. Appropriate care needs to be taken with potential issues in that regard, especially in view of the U.S. Foreign Corrupt Practices Act.

II. Indian Regulation of Foreign Investment

A. Introduction

Why is U.S. investment in India so important? India is the third-largest economy in Asia and is second only to China in terms of the continent's fastest growing economies. Most international business experts are of the view that India has outstripped all other Asian countries, including China, regarding high-end services and technology development, particularly in software technology, biosciences, pharmaceuticals, LPO, and other high-end sectors.

In recent years India has enjoyed a consumer boom, as import restrictions have been lessened and more international companies have developed the lucrative Indian market, especially regarding India's middle class, in excess of 300 million people. Also, over half of India's population is under age 25, and about one-fourth of the entire world's younger population resides in India.

India is extremely attractive to U.S. investment because of its low-cost labor pool, which is highly educated, with the literacy rate in India exceeding 90 percent. The U.S. investor in India is permitted to own 100 percent of the equity of an Indian business, at least in most sectors.[1] In addition to having a 100 percent equity ownership stake, foreign investors may register their capital investment without any prior processing or approval from the Reserve Bank of India (RBI), and repatriations of profits and capital are commonplace.

B. Forms of U.S. Investment in India

Since the early 1990s, the Indian government has substantially liberalized the rules for attracting foreign investment in India. As discussed further below, the three primary forms of foreign investment in India are foreign direct investment, foreign institutional investor (FII) investment, and foreign venture capital investment (FVCI). The latter two categories are typically financial or passive investors, as opposed to FDI, which would be the typical U.S. investor establishing an active business operation in India, whether as a wholly owned operation, a joint venture, or perhaps even a hybrid of both whereby the Indian partner and the U.S. company work on a contractual but not equity-sharing basis.

1. FDI: Through an Indian Company

Organization and operation of an Indian enterprise, usually in the form of an Indian company limited by shares, is comparable to organizing a U.S. corporation; however, the process is somewhat more bureaucratic than the U.S incorporation process, especially regarding postorganization reporting, filing, and compliance obligations. Some required corporate registrations must be filed under the Indian Companies Act, 1956, and some filings must be made with the RBI.

C. No CGT on Public Company Shares

Another favorable aspect of Indian tax law is that no capital gains tax applies to some qualified investments that are held for more than 12 months and are made on a recognized stock exchange based in India, so long as a securities transaction tax of 0.125 percent is paid on the transaction value. In contrast, foreign investors owning and later disposing of an unlisted Indian company must consider preorganization or acquisition structuring because of the imposition of Indian capital gains tax, as discussed further below.

D. RBI Exchange Control Policies

Historically India, through the RBI, has been very restrictive regarding a foreign-owned business enterprise that generates a profit or a large gain transaction and intends to repatriate invested capital or profits earned in India. However, over the past 15 years the

[1] ''Restricted'' industries may not be wholly owned by foreign investors, and those industries will vary as to the maximum percentage of foreign ownership depending on the industry.

RBI has liberalized these rules; most foreign investment transactions in India are registered under the so-called automatic RBI route. Accordingly, profits generated by an unlisted Indian company may be fully repatriated in most cases, provided the company's taxes are paid; in that event, a ''no objection'' certificate may be obtained from the Indian tax authorities or a similar certificate from a chartered accountant.

E. India's Tax Treaty Network

India has a very attractive network of tax treaties, with several treaty partners providing opportunities for typically avoiding any capital gains tax upon disposition of an unlisted Indian company. Those treaties include not only the most favored inbound Indian investment treaty partner country, Mauritius, but other treaties with partners such as France, Sweden, Cyprus, and Singapore. The India-Mauritius income tax treaty is the most popular treaty ''window,'' given favorable judicial precedent in India, as well as the absence of a limitation on benefits provision in that treaty, as discussed further below.

F. Structures of U.S. Investment in India

U.S. investment in India in many cases is structured directly into India, to take advantage of the India-U.S. income tax treaty. Alternatively, U.S. investment may be structured through a Mauritius holding company, in view of the favorable India-Mauritius income tax treaty (primarily to avoid Indian capital gains tax upon sale of the shares of an Indian company, and thus avoid excess foreign tax credit exposure on the higher Indian tax levy, as discussed further below).

Recently the speculation is that the treaty may be amended to include a limitation on benefits clause, but given the recent Indian judicial precedent that reaffirms the use of Mauritius as an inbound vehicle, as discussed in Part VII.E.3 below, this seems unlikely.

Also, Mauritius seems competitively positioned regarding other inbound competitive jurisdictions such as Singapore, because under the comprehensive economic cooperation agreement between India and Singapore, a limitation on benefits clause requires some substantive conditions to be established in Singapore that seem to be lacking in the case of Mauritius, as discussed immediately below. Further, the capital gains tax exemption available under the India-Singapore income tax treaty is linked to the India-Mauritius income tax treaty, and is available only so long as the India-Mauritius income tax treaty provides for that exemption.

The 1984 India-Singapore income tax treaty was amended through the 2005 comprehensive economic cooperation agreement (as noted above), and as a result, the new protocol states that a resident of a contracting state may avoid imposition of capital gains from the other resident state so long as the selling party does not have a permanent establishment in the other country. Although at first blush this seems to be highly beneficial, this protocol also contains a limitation on benefits provision that is designed to avoid use of a ''shell'' Singapore holding company (that is, a company must have more presence than negligible or nil business operations and thus must carry on real and continuous business activities) to simply take advantage of the capital gains tax exemption provision.

> **U.S. investment in India in many cases is structured directly into India, to take advantage of the India-U.S. tax treaty.**

For this purpose, listed companies and companies having annual expenditure of at least SGD 200,000 (approximately INR 5 million) on operations in the contracting state would not be considered shell or conduit companies. Further, to seek capital gains tax exemption, the annual expenditure of SGD 200,000 must be incurred for at least two years before the date of sale of the shares of the Indian subsidiary company.

G. U.S. Outbound Investment Through Indian PLC

As noted above in Part II.B.1, most U.S. companies investing in India — whether in the form of special economic zone (SEZ) investments or export-oriented units, non-free-zone businesses, such as a chain of retail establishments (which is now possible given liberalization of Indian trade policy), or even real estate (as discussed in Part VII below) — are typically handled through an unlisted Indian private limited company.

This company may be a wholly owned subsidiary of the U.S. group, or as mentioned above, could be structured as a subsidiary of a Mauritius holding company. A U.S. company that organizes an Indian subsidiary under the Companies Act of 1956 (Companies Act) must comport with corporate law requirements, but these are usually fairly manageable.

Most important, an Indian private limited company is not considered a per se entity for U.S. entity classification purposes, and thus an Indian private limited company may make a check-the-box election. The Companies Act further states that a private company would be regarded as a public company if it is a subsidiary of a corporation incorporated outside India, (which if it were to have been incorporated in India would be regarded as a public company), and if the entire shareholding of the Indian company is not held by that corporation outside India, either alone or together with other corporations outside India. However, if even one shareholder is Indian, then such an Indian company would be construed to be a public company.

A public company would be construed as a per se entity for U.S. entity classification purposes.[2]

H. Leveraging the Indian Company

Although Indian law allows a U.S. parent to partially fund the capital structure of its Indian subsidiary in the form of indebtedness, as a practical matter, this is rarely used in the context of private inbound Indian investment transactions because of compliance issues and restrictions mostly focused on share capital under the Companies Act and related debt registration considerations associated with the RBI. Accordingly, most investments are structured in the form of regular investment capital. An alternate mode of investment called ''compulsorily convertible debentures'' is becoming a popular mode of investment.

I. Indian Company Tax Aspects

From an Indian tax planning perspective, an Indian company is taxed on its worldwide income. Furthermore, several years ago India enacted transfer pricing regulations that will affect any related-party transactions at the cross-border level.

J. Use of an Indian Branch Operation

Although a U.S. corporation may open a branch office in India, generally this is ill-advised. First and foremost, this gives rise to an array of reporting complications, as well as Indian taxation on effectively connected Indian-source income and potential tax liability from non-Indian situs activities. Further, the RBI is required to provide approval for any foreign corporation establishing an Indian branch operation (and the branch operation's profits in kind usually could be subject to exchange control guidelines). However, some branch activities would include purchasing and resale of goods, that is, sourcing goods from India, such as assembly and manufacturing in SEZs, as well as providing limited services activities.

K. Critique of the Indian Tax System, VAT

The Indian tax system has been criticized as being far behind the great progress that India has made in the past 15 years. Granted, the Indian Income Tax Act is over 47 years old, having been enacted in 1961, but overall, the Indian tax authorities have adjusted their administrative oversight of the Indian tax system in a manner consistent with the emerging Indian economy and its place in the worldwide economy.

Further, India has recently adopted a unified or national VAT system that is providing much-needed revenue and seemingly is working quite well, given all of the concerns expressed on the potential problems of adoption of a nationwide VAT. This VAT system has replaced much of the disheveled Indian state tax system, which generated great confusion and conflict among the various states, particularly regarding excise duties, customs duties, and other local levies. For example, the highway from Agra to New Delhi makes for a two-hour drive, but in prior years crossing the state line could extend this travel time to more than five hours because of state customs inspections and clearances.

III. Company Tax and Other Provisions

A. Indian Company Tax Considerations

As explained above in Part II.I, a company organized under Indian law is subject to Indian tax on a worldwide basis. Under Indian tax law principles, such a corporation is deemed to be resident in India by virtue of its Indian incorporation status. Under this rule, an Indian company is thus treated as resident in India and is taxed on its worldwide income without regard to the source of this income. Alternatively, a company that is not incorporated in India but has its control and management in India also is subject to Indian tax on a worldwide basis.

The overall company tax rate in India is 33.99 percent for a domestic entity and 42.23 percent for foreign corporations doing business in India. It should be noted that the educational cess (tax) is imposed under the Indian Income Tax Act, and this should be creditable under the India-U.S. income tax treaty.

1. Bias Against Foreign Branches

The Indian tax system clearly prefers the establishment and operation of Indian companies and penalizes foreign corporations that are subject to Indian tax. An Indian corporation is subject to a fundamental or basic income tax rate of 30 percent, plus a 10 percent surcharge and a 3 percent education cess on the basic rate and the surcharge, which adds 4 percent for a total tax rate of 34 percent (actually 33.99 percent).

In contrast, the tax rate applicable to foreign corporations having Indian taxable nexus via a branch is much steeper, at a 40 percent rate subject to a 2.5 percent surcharge and an education cess of 3 percent on the basic rate and the surcharge. Whether in the case of a domestic company or a foreign company an educational cess of 3 percent applies as a tax surcharge.

Indian companies are also liable to pay a dividend distribution tax of 16.995 percent on the repatriation of profits (that is, dividends) to their shareholders, whereas this tax is not payable by a branch set up in India.

2. Cross-Border Remittances

In the case of an Indian company remitting license fees, royalties, or technical service fees to a nonresident recipient, a series of complex and sometimes confusing rules applies. Historically, tax planning avenues for structuring payments of these types of fees and royalties without Indian withholding tax or reduced Indian

[2] Treas. reg. section 301.7701-2(b)(8)(i).

withholding tax have been very limited, except in the context of tax treaty planning. In general, payment of these amounts, other than specific categories involving government-approved agreements, would attract a withholding tax at 10.558 percent (on the gross amount paid). Contrary to U.S. tax law, India would impose its applicable withholding tax even if the services are performed outside of India. However, this rate can be reduced to nil, especially for some fees for technical or included services under the provisions of an applicable tax treaty.

In contrast, dividends paid by an Indian company, whether public or private, are exempt from Indian taxation from the perspective of the shareholder; however, the company remitting the dividend is subject to a special Indian dividend distribution tax at a historical rate of 16.995 percent. This tax is imposed on the distributing company and not on the dividend recipient; therefore, the India-U.S. tax treaty does not reduce this tax.

From a U.S. tax perspective, a strong argument can be made that article 25, paragraph 1(b) of the India-U.S. income tax treaty, together with appropriate section 902 regulatory authorities support a position that the dividend distribution tax may be claimed as a section 902 indirect foreign tax credit. (In this case, the U.S. company must own at least 10 percent of the voting stock of the company that is resident in India.) But such an argument for section 901 foreign tax credit purposes is very weak.

In the case of nonresident lenders of non-rupee-denominated foreign currency loans to Indian borrowers, the general rule is that such interest remittances are subject to a 21.115 percent withholding rate, but more importantly, those loans are subject to RBI registration and compliance regulations, which make the practicality of the loans questionable. However, in recent years, especially in the real estate context, the loans have increased in prevalence. (See Part VII.E.4 below.) Note also that the applicable withholding rate could be reduced based on an appropriate interest reduction provision of a tax treaty.

Similar to the U.S. alternative minimum tax system, the Indian minimum alternate tax is imposed on companies at a basic 10 percent rate, excluding a surcharge of 10 percent and an education cess of 3 percent.

3. Tax Holidays

For Indian-based export-oriented units, the Indian government has provided for a tax exemption for underlying export profits, and this exemption generally has applied to 100 percent of profits attributable to export transactions up to a 10-year time frame; however, this special export-oriented regime sunsets on March 31, 2010. The Finance Act 2008 extended the deadline from March 31, 2009, to March 31, 2010. Many Indian practitioners believe this sunset date may be extended, but the general consensus is that on March 31, 2010, the holiday program will end.

In 2005 the Indian government enacted the SEZ program, and as a result, qualifying SEZ operating units may qualify for a 15-year graduated tax holiday, with the first five years fully exempt from taxation on export profits, followed by a 50 percent tax reduction for the following five years. For the final five years, another 50 percent tax reduction would apply so long as conditions are met regarding the transfer of profits from the reserve account to investment in plant and machinery accounts. This SEZ regime is key to attracting U.S. investment in India.

> **The Indian tax system prefers the establishment and operation of Indian companies and penalizes foreign corporations that are subject to Indian tax.**

The Indian Parliament enacted the SEZ legislation in 2005, and the provisions became effective February 10, 2006. The classic model of the Indian SEZ regime is that of a partnership between the central government, the state government, and private investors.[3] In the usual case, a private investor enters into an agreement with a state, and under that agreement the private investor agrees to develop an SEZ and then to provide access to the zone to others to establish export-oriented goods and services businesses. Under the 2005 legislation an SEZ is not treated as being a part of Indian soil; therefore, the 15-year tax holiday program described above applies. In addition to the national-level exemptions such as from income tax, excise duty, and custom duties, the state typically provides exemptions from local taxes and levies, such as sales tax, VAT, and stamp duty.

The benefits of an SEZ are crucial because no import duty applies to goods imported into the SEZ, and goods that are acquired from Indian domestic sources are exempt from excise duty. Furthermore, any services consumed or procured within the zone are exempt from the Indian services tax, as are applicable stamp duties for some instruments generated while carrying out the purposes of the zone. A developer of an SEZ has 10 consecutive years within the first 15 years of the zone's operation to receive a full income tax holiday.

[3] *See* S. Kamath, ''India's Policy on Special Economic Zones: Some Clarity, Please,'' *Tax Notes Int'l*, March 19, 2007, p. 1081, *Doc 2007-3566*, or *2007 WTD 56-9*.

Furthermore, the developer and the SEZ unit operations are exempt from the minimum alternate tax, and the developer also is granted an exemption from the dividend distribution tax for distributions made by the Indian entity holding the development. Accordingly, both the developer and the unit operator receive these benefits (although a unit operator does not receive the benefit of the dividend distribution tax exemption enjoyed by the developer).

As noted above, a unit operator conducting a business within an SEZ that is directed toward the export of goods and/or services is granted a tax holiday of 100 percent for the first five consecutive years, and 50 percent for the next five years. In addition to these national benefits, the states involved in SEZs provide an array of benefits and exemptions.[4]

The Indian government is in turmoil over the future course of the SEZ program. In particular, the disagreement is between the Ministry of Finance, which estimates the tax losses of the SEZ system of INR 1 billion until fiscal 2009-2010, and the Ministry of Commerce, which estimates that continued economic activity in the SEZ system would lead to additional taxes in excess of INR 1.368 billion.

In a January 22, 2007, news report, India's finance minister proposed an amendment to the SEZ law to reduce or even deny tax benefits unless the SEZ units fulfilled export obligations. According to one leading commentator, as of early 2007, the pending applications for SEZ development projects have been put on the back burner pending resolution of the conflict. This is sending a shock wave throughout the foreign investment community and could leave India at a competitive disadvantage vis-à-vis other Asian countries, such as China.[5]

A very important consideration is that even though the SEZ tax holiday system is highly popular for purposes of foreign investment in India, the historical 16.995 percent dividend distribution tax is still applicable to zone operations (but not qualifying zone developers), as are income allocations as a result of transfer pricing examinations. The latter is a particularly significant surprise to the foreign investor, and thus it is crucial to carefully review transfer pricing policies.

IV. Recent Developments

A. Introduction

On February 29, 2008, India's ruling United Progressive Alliance government presented to the Indian Parliament the party's Finance Act 2008. Unlike in the U.S. tax legislative process, in India the ruling party submits its budget, aka tax reform package, which later is approved by Parliament as a matter of course. The 2008-2009 budget was enacted on May 10, 2008, with effect from April 1, 2008.

India is trying to carefully balance its continuing need to attract foreign investment while upholding its fiscal integrity and raising much-needed tax revenues. For anyone who has spent time doing business in and traveling throughout India, it is crystal clear that significant infrastructure development is required. Over 50 percent of the Indian population lives off agriculture, and the sector grew very little over the past several years. Poverty exists everywhere in India. Driving the streets of New Delhi versus driving in Shanghai is like comparing driving on Madison Avenue to driving in the slums of America.

B. Income Tax Rates and Related Changes

The Finance Act 2008 did not materially alter the income tax regime for companies. Accordingly, for locally incorporated companies, the basic income tax rate remains at 30 percent, although the effective rate will be slightly increased as a result of the 10 percent surcharge rule and the 3 percent education cess rule. However, no surcharge is applicable for companies with income of INR 10 million or less. Based on this rate structure, the maximum company income tax rate increases from 33.66 percent to 33.99 percent. For companies with INR 10 million or less of taxable income, the overall effective rate will be 30.9 percent.

For foreign companies doing business in India, the company income tax rate is 42.23 percent, but for foreign companies that have Indian taxable income of INR 10 million or less, the rate would level off at 41.2 percent.

In the case of the minimum alternate tax, the levy is 11.33 percent for locally organized companies, and 10.55 percent for foreign companies doing business in India, again subject to a reduction for companies that do not generate taxable income in excess of INR 10 million.

While the Finance Act 2008 did not make any changes regarding the corporate income tax rates, the tax rate on short-term capital gains on an equity share in a company or a unit of an equity-oriented fund has been increased from 10 percent to 15 percent (excluding applicable surcharge and education cess), if the sale takes place on a recognized Indian stock exchange and securities transaction tax is paid on the transaction.

C. Interest, Royalties, and Technical Service Fees

The earlier Finance Act 2007 also modified section 9 of the Indian Income Tax Act, 1961, to provide that India has the right to impose taxes on interest, royalties, and technical service fees paid to nonresidents, and this taxing right would apply whether the nonresident recipient of the fees has a place of business, residence, or other business connection in India. Accordingly, the fees paid to nonresident service providers

[4] *Id.*

[5] *Id.*

rendering technical services wholly outside of India would be subject to Indian taxation. This proposal also provides for a retroactive effect to June 1, 1976. This budget proposal would overrule the Indian Supreme Court decision in which the Court held that India does not have the legal right to impose taxation for offshore services unless those services are rendered in or otherwise consumed in India.[6]

> **India is trying to balance its continuing need to attract foreign investment while upholding its fiscal integrity and raising much-needed tax revenues.**

Of key concern is the dividend distribution tax imposed at a base rate on locally organized companies. The aggregate dividend distribution tax tops out at 16.99 percent. As discussed above in Part III.A.2, because of the questionable status of this tax as constituting a creditable tax for U.S. tax purposes, this represents a significant risk factor to U.S. investors in India. The Finance Act 2008 provides some relief to certain companies from the dividend distribution tax payable. A locally organized company can now deduct the dividends received from its Indian subsidiary from the amount of dividends distributed by it for the purposes of calculating the dividend distribution tax payable. This relief is available subject to the conditions that the Indian subsidiary should have paid the dividend distribution tax on the amount of dividends distributed to its parent company, and that the latter should not be a subsidiary of any other company.

D. Finance Act 2007's Provisions Relevant to VCFs

Before the enactment of the Finance Act 2007, a venture capital fund (VCF) was able to receive tax advantages so long as the VCF was registered with the Securities and Exchange Board of India (SEBI) and other conditions were met. A VCF, under these circumstances, was treated as a passthrough or flow-through vehicle, and thus income from its investments was not subject to a separate layer of tax at the VCF level.

Under the Finance Act 2007, this special flow-through status and nonentity level tax would be limited to the following investments in some domestic companies that are not publicly traded: nanotechnology; information technology of qualifying forms; seed research and development; biotechnology; pharmaceutical research; production of biofuels; construction and operation of some hotel/convention centers having more than 3,000 in seating capacity; and dairy and poultry industries. This represents a major shift that will revoke the otherwise tax-free status of VCFs investing outside of these designated categories.

E. Minimum Alternate Tax

Under the former Indian tax law, export-oriented operating units are subject to tax holiday treatment through March 31, 2010, and are not subject to the Indian minimum alternate tax. Under the Finance Act 2007, the 10 percent minimum alternate tax is applicable to some of these otherwise tax-favored companies based on the company's book profits. This represents a major reversal of the Indian tax holiday regime that encouraged foreign investment and provided significant labor opportunities for the unemployed and underemployed in India.

Even though the minimum alternate tax is being imposed in some tax holiday situations, the Finance Act 2007 in a separate proposal enables an SEZ unit to be eligible for tax holiday treatment regarding this tax, if it was not formed by the splitting up or reconstruction of a business already in existence, or was not otherwise created through the transfer of used machinery; this special transitional rule is retroactive to February 10, 2006, the date under Indian law that the SEZ regime became effective.

The imposition of a minimum alternate tax would apply to business entities located in software technology parks but not necessarily to SEZ-based companies. Accordingly, for business process outsourcing, call centers, and software service companies established under the software technology park regime of India, this 10 percent minimum alternate tax will apply.

F. Employee Stock Option Changes

Before the enactment of the Finance Act 2007, India did not impose a tax on the granting or issuance of employee stock options, and typically, under governmental regulations India capital gains tax applied only when the shares were sold by the employee. Further, India did not impose a fringe benefits tax on the employer if employee stock options were provided to employees.

Under the Finance Act 2007, employers are subject to a fringe benefits tax on the value of any of the granted options (measured by the difference between the fair market value of the option shares on the date of vesting of the shares and the price actually paid by the employee) at 30 percent, subject to increase by applicable surcharge and education cess. This fringe benefit tax is imposed at the employer level and not at the employee level.

[6] *See Ishikawajima-Harima*, as discussed in S.S. Palwe and J. Kariya, ''Indian Supreme Court Issues Novel Ruling on Turnkey Contracts,'' *Tax Notes Int'l*, Feb. 19, 2007, p. 675, *Doc 2007-2260*, or *2007 WTD 40-8*.

The Finance Act 2007 has also given the employer a right to recover the fringe benefit tax from the employee, and thus ultimately shifts the burden from the employer to the employee. Any fringe benefits tax, or at least the value on which it is applied, would increase the cost basis in the hands of the employee to avoid double taxation at the time of sale of the shares. The government also recently introduced rules for valuation of the shares for the purpose of calculation of the fringe benefit tax, and as per these rules, a U.S. corporation granting stock options in India, irrespective of whether it is listed, would be required to get a valuation done in India by a merchant banker registered with the SEBI.

G. New Hotel Tax Holiday Regime

The Finance Act 2007 provided for a five-year tax holiday for profits generated in connection with two-star, three-star, or four-star hotels or certain-size convention centers constructed and functional between April 1, 2007, and March 31, 2010. However, this special tax holiday applied only to qualifying hotels and convention centers built in New Delhi and other designated districts: Faridabid, Gurgaon, Gautam Budha Nagar, and Ghaziabad.

The Finance Act 2008 extended this exemption to hotels established in specified districts having a World Heritage Site. The hotels can claim the tax holiday if they are constructed and functional between April 1, 2008, and March 31, 2013.

H. Income Tax Exemption for Hospitals

To encourage investments into hospitals, the Finance Act 2008 provides an exemption to hospitals established in rural/nonurban areas for five years from operation. The hospitals can claim exemption if they have at least 100 beds, are constructed and functional between April 1, 2008, and March 31, 2013, and fulfill other criteria.

I. Proposed Overhaul of the Indian Tax System?

In the wake of the Indian Finance Act 2008, a significant movement is underway in India to overhaul the 1961 Indian Income Tax Act. Leading commentators have maintained that tax code reform in India is crucial to India's continued advancement in the world economy and is a way of implementing anti-tax-avoidance measures.[7]

In comparison to the rest of the developing world, which has sophisticated international tax laws, rules, and regulations, India's tax system is somewhat anachronistic because globalization has occurred so late in India. The current income tax law was enacted in 1961, when India was in a completely different political, economic, and social position. Because of problems caused by the antiquated Indian tax law, both inbound and outbound investors must tiptoe through the Indian tax minefield, although establishing an operation in an SEZ provides some relief from India's complex tax rules.

According to one leading commentator, the new Indian tax code would draw heavily from Australia, the United Kingdom, and the United States, with a focus on corporate taxation, nonresident taxation, SEZs, and outbound and inbound international investment.[8] One of the main goals is to simplify the Indian tax regime, with a shorter and more concise series of tax rules. It is likely that the Indian tax code would introduce antiavoidance laws against treaty misuse, especially those treaties between India and Cyprus, Denmark, France, Mauritius, the Netherlands, Singapore, and Sweden.

V. Outbound Tax Structuring

A. Material India-U.S. Tax Treaty Considerations

Structuring U.S. investment in India depends on consideration of several factors:

- What is the nature of the U.S. investor? If the U.S. investor is a public versus a closely held corporation, this will be a key consideration.
- Assuming the U.S. investor is a closely held business, is the business structured as a limited liability company, a partnership, or a corporation treated as a C corporation or S corporation?
- What is the nature and level of capital required to make the investment in India, and is the investment going to be structured as a wholly owned operation or as a contractual joint venture with another U.S. or perhaps a non-U.S. partner, that is, an in-country Indian joint venture partner, or perhaps a third-country joint venture partner? Caution: In many Indian investments, having an Indian partner is crucial, but this also represents a major hazard. The key is to conduct significant due diligence and have a comprehensive joint venture agreement.
- To what extent should the U.S. investor go the ''direct route'' under the India-U.S. tax treaty by directly organizing an Indian company, or should it take the ''Mauritius route'' to position investment for the benefits of the India-Mauritius income tax treaty (or possibly another treaty jurisdiction such as Singapore or Cyprus)?
- Should the Indian entity be treated as a foreign C corporation for U.S. federal tax purposes, or

[7] *See* S. Kapoor, ''Thoughts on India's New Tax Code,'' *Tax Notes Int'l*, Nov. 5, 2007, p. 573, *Doc 2007-22631*, or *2007 WTD 218-9*.

[8] *Id.*

would it be preferable to make a check-the-box election to treat the Indian entity as either a foreign disregarded entity or as a partnership and thus generate flow-through treatment for the underlying Indian business and tax activities?

- Will the Indian investment be structured in a tax holiday environment, such as an Indian company operating in an SEZ or in the final phases of an export-oriented unit (which has a sunset of March 31, 2010)?
- Is the investment in India required to be made by way of equity or by debt? The choice could have serious tax and regulatory implications.
- A key consideration is how to deal with the Indian dividend distribution tax, which applies to both tax holiday operations and fully taxable operations. In the latter case, the combination of the dividend distribution tax with the regular Indian tax would result in the Indian tax rate being at an effectively higher rate than the U.S. 35 percent tax rate, and thus, excess foreign tax credit exposure would emerge. (This assumes that the dividend distribution tax is creditable for U.S. tax purposes, which outside the use of a section 902 credit position, also means that this otherwise creditable tax is locked in.)

B. Additional Tax Planning Considerations

Assuming the Indian investment can be structured as a private limited company operating in an SEZ tax holiday environment, and despite the imposition of the dividend distribution tax, the U.S. owner of the Indian operation should be able to generate low-taxed foreign-source income in the Indian operation. But in absence of a tax holiday, to generate an effective flow-through of the underlying Indian company tax as well as the dividend distribution tax — and to avoid the complexities of subpart F — it is advisable for the Indian company to check the box and be treated as either a foreign disregarded entity in the case of the wholly owned U.S. parent corporation, or as a partnership in the event of a joint venture structured Indian company.

The use of India's two favorite treaty jurisdictions (at least from a perspective of foreign investment in India), Mauritius and Singapore, is very popular. The Indian Supreme Court decision in *Union of India v. Azadi Bachao Andolan* (263 ITR 706) generally establishes that a Mauritius holding company will stand scrutiny under Indian tax law challenges for treaty shopping, primarily because of an absence of a limitation on benefits provision in the treaty together with the Indian domestic tax code having no antiabuse statutory weapon. However, despite this decision, recent media comments indicate that India is closely watching the Mauritius window, and could take action to narrow this treaty benefit, although the Indian government has expressed an opinion to shy away from treaty override legislation similar to that used in the United States. Furthermore, the use of a Mauritius company such as in *Nat West* (220 ITR 377) presents a potential concern to Mauritius companies that have very little if any substance and are mere holding vehicles.

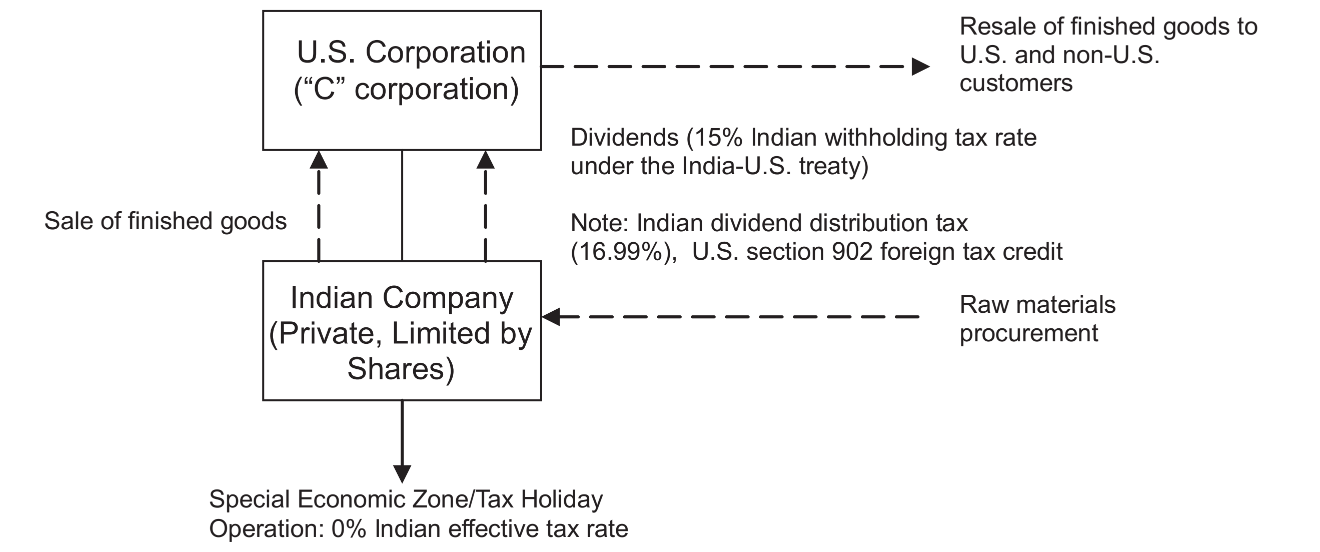
Further, the aggressiveness of the Indian Income Tax authorities is evident from the notice issued by the tax authorities in the $11.1 billion *Vodafone* case in which the Indian government hopes to rake in $2 billion as capital gains tax. Here, the transfer of shares was between two nonresidents and pertained to a company that was based abroad but held shares of an India-based company. The tax authorities have sought to lift the corporate veil and stretch principles of agency and business connection to their limits so as to ensure that transactions of this nature do not escape the Indian tax net. The case was adjudicated upon by the Bombay High Court, which upheld the validity of the notice. Thereafter, Vodafone approached the Supreme Court of India, wherein the petition was dismissed and the matter remanded back to the tax authorities.

In light of these developments and motivated by the possibility of success in the *Vodafone* battle, the Central Board of Direct Taxes has reopened about 400 cases of large and mid-sized transactions that took place during the past six to seven years. If the income tax authorities succeed, the use of sales of offshore holding companies holding Indian shares could well be under question and affect billons of dollars worth of investments made into India.

Another often overlooked tax planning consideration is that a Mauritius holding company benefits from Mauritius's excellent treaty network, including favorable treaties with the P.R.C. and many African countries, such as South Africa. Thus, Mauritius could be looked upon as a regional holding company and not merely for investment in India. However, as in any tax planning regarding treaties appropriate substance should be added to the company's operation to minimize the risk that a treaty partner could disallow treaty benefits based on sham and conduit principles.

Although the Singapore protocol provides another opportunity for holding company investment in India, several cautions need to be kept in mind. First, the India-Singapore protocol to the 1994 treaty contains a limitation on benefits provision and most commentators believe that the Singapore entity must have a more significant degree of substance, unlike its Mauritius counterpart. Also, Singapore could subject the profits of the Singapore holding company to the Singapore company rate of 18 percent, as well as potential holding tax exposure on payments back to the U.S. parent. The special Singapore holding company regime could avoid the internal Singapore company tax, but the Indian dividend distribution tax could represent an incremental cost of doing business because of the potential ''credit lock'' of this tax payment. But use of a tax-free redemption at the Singapore level is not nearly as clear as is the case of a Mauritius holding company. Other treaties to seriously

Figure 1. Classic U.S.-India Parent-Subsidiary Structure With Tax Holiday


U.S. Corporation ("C" corporation)
Resale of finished goods to U.S. and non-U.S. customers
Dividends (15% Indian withholding tax rate under the India-U.S. treaty)
Note: Indian dividend distribution tax (16.99%), U.S. section 902 foreign tax credit
Sale of finished goods
Indian Company (Private, Limited by Shares)
Raw materials procurement
Special Economic Zone/Tax Holiday Operation: 0% Indian effective tax rate

consider for investment in India include those with the Netherlands, Sweden, and Cyprus.

Regarding Indian base erosion planning, the use of debt and equity for the capital investment in an Indian subsidiary should be considered. The withholding tax rate paid by the Indian borrower to the U.S. parent corporation would be subject to the reduced treaty rate of 15 percent, and this would be fully creditable in the United States. However, use of a Mauritius resident parent company or holding company would not be subject to treaty benefit or reduction under the India-Mauritius income tax treaty, and the Indian withholding tax rate that is ordinarily applicable, 21.115 percent, would apply if interest payments are made in connection with a foreign currency denominated borrowing by the Indian company from its Mauritius parent group. This rate would be increased to 42.23 percent if the loan is made in rupees. And any structural debt transaction would be regarded as external commercial borrowings (ECB) and would need to be considered in light of RBI restrictions and Indian company law restrictions on the appropriate level of the capital structure.

The ECB guidelines that regulate foreign borrowings are very restrictive. For example, the guidelines prescribe several restrictions on the end use of ECB. One of the restrictions is that use of ECB proceeds is not permitted for working capital purposes, on-lending or investment in capital market, or for acquiring a company (or a part thereof) in India. Also, the ECB guidelines permit borrowings for rupee expenditure up to $20 million, with the approval of the RBI. ECB of more than $20 million per Indian borrowing company is permitted only for foreign currency expenditure.

VI. Alternative Investment Vehicles

A. Indian-U.S. Planning Considerations

One of the principal U.S. tax considerations taken into account is whether the Indian operation would be subject to a tax holiday benefit, both in the short and long term. As discussed above, the Indian SEZ program can provide tax holiday benefits for up to 15 years. Despite this tax holiday benefit, the dividend distribution tax and potential credit lock tax cost of this special tax will need to be considered. Furthermore, the U.S. company needs to be mindful of Indian transfer pricing rules as well as U.S. transfer pricing rules. As discussed earlier, if the Indian tax authorities make a transfer pricing adjustment to an in-country tax holiday operation, the adjusted profits are not subject to the Indian tax benefits.[9]

Of course, all of these issues are moot in the context of a classic contractual outsourcing arrangement whereby the U.S. principal appoints its unrelated Indian agent to perform specified services, such as the typical LPO transaction, although due care must be given to several other issues, such as avoiding Indian permanent establishment status.

B. U.S.-India Parent-Subsidiary With Tax Holiday

Figure 1 is an illustration of the classic U.S. investment vehicle into a tax holiday Indian investment.

[9] For an excellent overview of U.S. tax planning for Indian investments, see J. Tobin and J. Levenstan, ''Tax Strategies for Investing in India,'' *Tax Management International Journal* 283 (April 2006).

1. *U.S.-Indian Tax Results*

Assuming applicability of the SEZ tax holiday environment from an overall global transfer pricing perspective, the objective would be to shift more income to the low-taxed (or zero-taxed) Indian operation. Because in the above example the Indian company is engaging in a related-party sale with U.S. Corporation, appropriate attention would need to be given to U.S. transfer pricing rules (under section 482) as well as applicable Indian transfer pricing rules. In recent years the Indian government has become much more aggressive in pursuing transfer pricing cases and withholding tax cases, and a good example of this aggressiveness can be found in the widely known decision in *Morgan Stanley*. The Indian tax authorities are not permitted to make a downward transfer pricing adjustment to reduce the profits of the Indian entity. From a U.S. tax perspective, Indian Company should not generate section 954(d) foreign base company income because of the manufacturing exception.

If U.S. Corporation is a C corporation, any Indian taxes eventually imposed should qualify for section 902 treatment. But if U.S. Corporation is a flow-through vehicle, the credit lock issue arises. Under article 25, paragraph 1(b) of the India-U.S. tax treaty, credit is allowed for income taxes paid on profits of which an Indian company pays tax. And arguably, under Treas. reg. section 1.901-2(a)(2)(i), which provides that a foreign levy will be considered a tax if it requires a payment under the foreign countries authority to levy taxes, and in light of Treas. reg. section 1.901-2(b)(i) (providing the qualified positions for determining a creditable tax resulting from the realization of income after application of the deductions), a reasonable good-faith position may be taken that the Indian dividend distribution tax is creditable under section 902.

2. *Start-Up Losses, Transfer Pricing, Income Allocations*

Many companies beginning operations in India will have significant start-up losses, which must be taken into account. Whether the start-up losses will burn a significant portion of the initial SEZ's 0 percent, five-year tax-free phase is a key consideration. Furthermore, skewing the transfer pricing in such a manner to maximize the Indian allocation could represent swimming into an oyster trap, because as and when the tax holiday changes and Indian Company becomes a high-tax-rate entity, the Indian Company tax rate transaction with the dividend distribution tax would in the aggregate exceed a 40 percent tax rate. Also, as mentioned above, any Indian transfer pricing adjustment that results in a reallocation of profit of the Indian company would not be subject to tax holiday benefits.

3. *Whether to Structure 'Leverage'*

It is important for the practitioner to bear in mind that when operating in a 0 percent tax holiday environment, the use of traditional debt equity structuring may not be feasible. For example, if U.S. Corporation structured a part of the capital contribution as indebtedness, and Indian Company generated interest expense, this tax deduction would not provide any tax benefit given the tax holiday from an Indian tax perspective. Furthermore, it would generate interest income in the hands of a U.S. corporation. With Indian transfer pricing rules it may be appropriate to increase the transfer price of Indian Company's sale of finished goods to U.S. Corporation to reflect this financing cost.

4. *Indian Legal Considerations in Using Leverage*

In the event leverage is desirable, appropriate registration and compliance with the RBI must occur to avoid later exchange control restrictions. Also, as long as U.S. Corporation has a majority stake in Indian Company, such a registered loan should be permissible. But keep in mind that when the interest is paid by Indian Company to U.S. Corporation, the otherwise applicable Indian withholding tax, reduced to 15 percent under the India-U.S. income tax treaty, would need to be taken into account. This would represent a direct section 901 foreign tax credit to U.S. Corporation.

5. *Possible Check the Box*

To avoid the complexities of some of the above planning issues, and also to allow for full U.S. foreign tax credit treatment for the Indian dividend distribution tax, it may be advisable to check the box on Indian Company so it is treated as a foreign disregarded entity and hence a branch of U.S. Corporation. Although treated as a foreign disregarded entity for U.S. federal tax purposes, Indian Company would still be treated as an entity for Indian tax purposes, so appropriate care and attention would need to be given to the Indian transfer pricing considerations as well as other Indian tax considerations, including payment of the internal Indian Company tax.

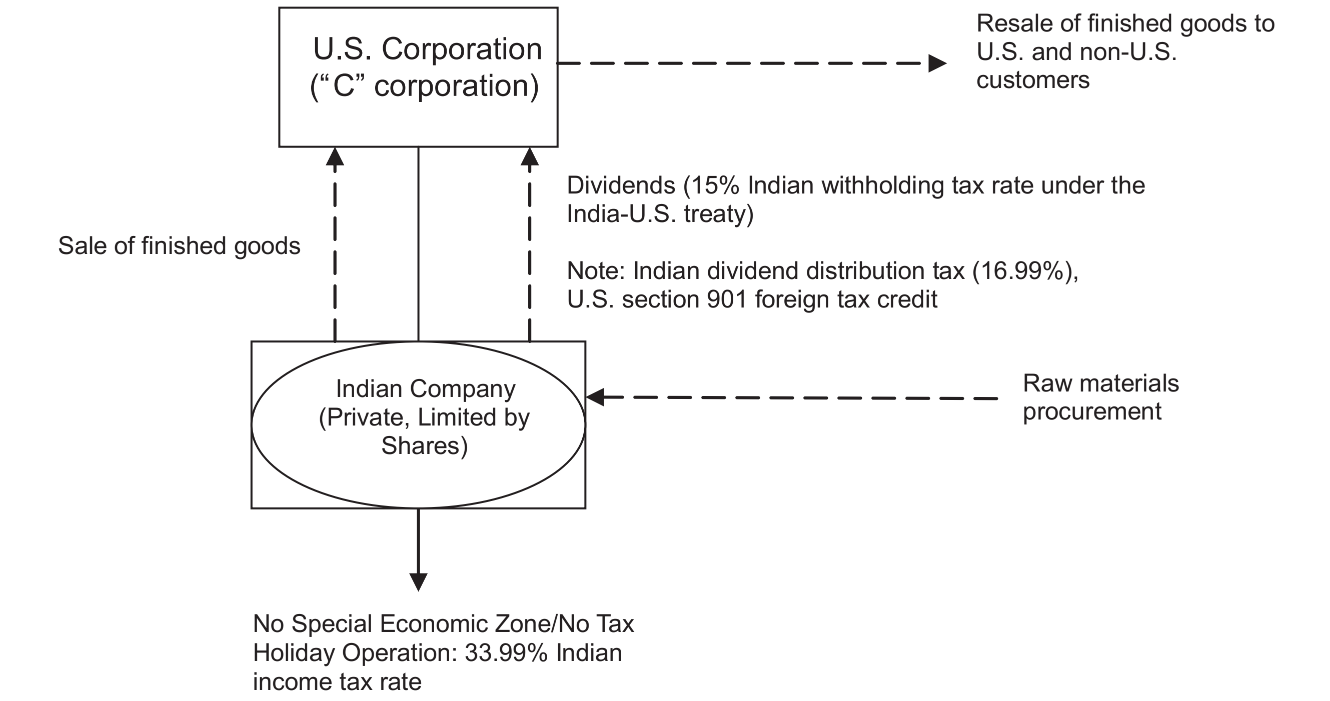
C. U.S.-Indian Parent-Sub Without Tax Holiday

Under this structure, assume that Indian Company does not enjoy the benefit of a tax holiday. In this case, the strategy discussed above of making a check-the-box election would definitely need to be considered. Under this scenario, the Indian taxes imposed on company profits, as well as the dividend distribution tax, would be treated as direct section 901 foreign tax credits. However, the overall combined tax rate would exceed the overall U.S. corporate income tax rate, and thus it is likely that excess foreign tax exposure would be generated (the combined Indian rate would exceed 40 percent, and thus this rate disparity would need to be appropriately addressed). Accordingly, U.S. Corporation would need to match this high-tax income with low-tax foreign-source income within the general limitation basket to soak up the excess credit. This structure is illustrated in Figure 2.

1. *Consider Checking the Box*

By making a check-the-box election upon formation of Indian Company, any start-up losses could be used

Figure 2. Classic U.S.-Indian Parent Subsidiary Without a Tax Holiday


U.S. Corporation
("C" corporation)
Resale of finished goods to U.S. and non-U.S. customers
Sale of finished goods
Dividends (15% Indian withholding tax rate under the India-U.S. treaty)
Note: Indian dividend distribution tax (16.99%), U.S. section 901 foreign tax credit
Indian Company
(Private, Limited by Shares)
Raw materials procurement
No Special Economic Zone/No Tax Holiday Operation: 33.99% Indian income tax rate

at the U.S. entity level to offset other U.S.-source income. Furthermore, the dual consolidated loss provisions should not come into play here because under Indian law, no consolidated group filings are permitted, and each Indian company is required to file its own return with no offsetting of income and losses among affiliated Indian companies. Although this could generate incremental Indian tax when dealing with a group of Indian companies with some generating income and others losses, this should avoid any U.S. dual consolidated loss exposure.

D. Using a Non-U.S. Holding Company

1. Capital Gains Exemption Benefits

The idea of using a non-U.S. holding company interposed between U.S. Corporation and Indian Company is driven by several factors. First, this holding company could be established in a jurisdiction such as Mauritius to tap into the benefit of the India-Mauritius income tax treaty. Typically this structure would enable the shares of Indian Company to be sold free of capital gains tax under the India-Mauritius income tax treaty, which is discussed above in Part II.E. Another threshold fundamental issue to consider is whether a flow-through structure should be adopted similar to the illustration above involving a classic investment structure with no tax holiday. This structure is illustrated in Figure 3. Similar to that analysis, if the non-U.S. holding company is checked as a foreign disregarded entity and a similar election is made for the Indian company, the same flow-through treatment as discussed above would occur, as illustrated in Figure 4.

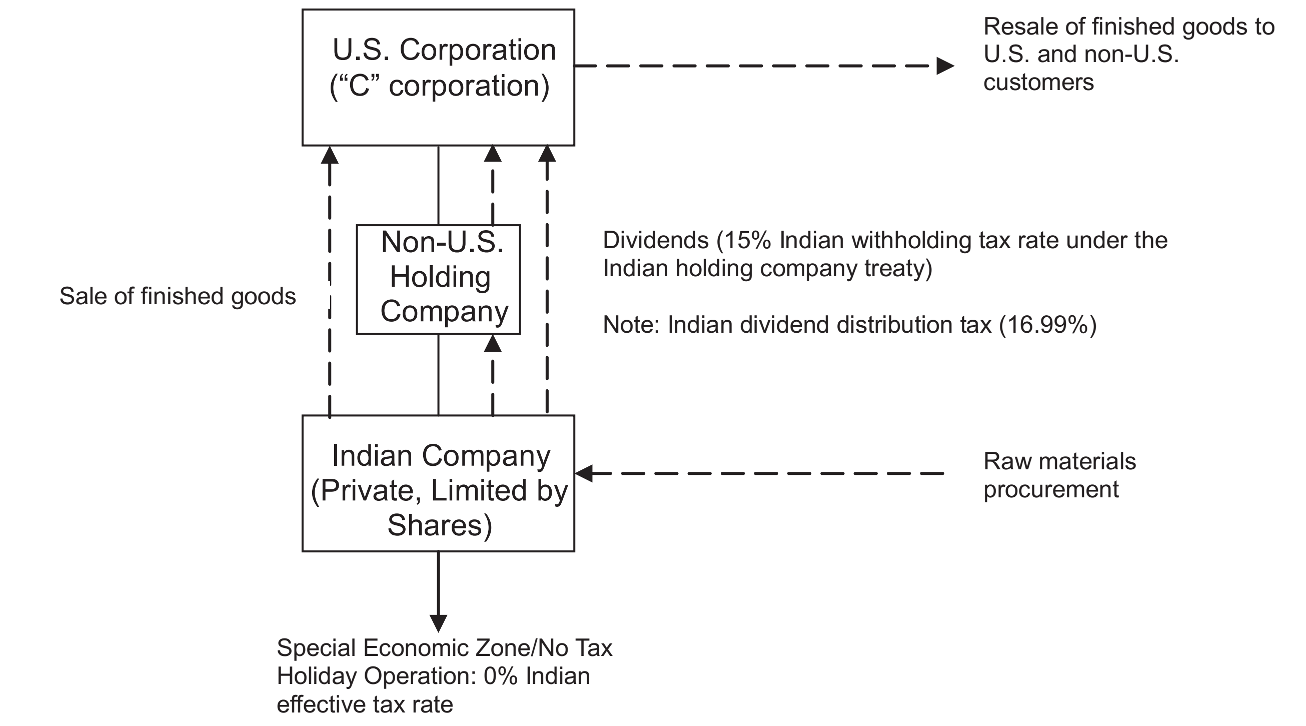
2. Minimization of Dividend Distribution Tax

An intermediate Mauritius company can also be used to minimize the dividend distribution tax by structuring distribution of profits of Indian Company by way of a buyback of shares. Any premium paid on a buyback of shares is considered capital gains as per the provisions of the Indian Income Tax Act, 1961, and will hence be exempt from tax in India in accordance with the India-Mauritius income tax treaty. However, a buyback is subject to corporate restrictions that may need to be kept in mind.

3. Structuring for Debt Investments

Using debt for investment in an Indian entity is always a good idea in the event the Indian entity does not have a tax holiday. While the Indian entity is able to take a deduction for interest payments made to the foreign entity, taxes can also be minimized by using an appropriate intermediate jurisdiction for inserting the debt that helps in lowering the rate of withholding tax in the interest income. Cyprus is a jurisdiction that offers both a capital gains tax exemption benefit and a lower withholding tax rate on interest income (10 percent) under the Cyprus-India income tax treaty. In this

Figure 3. Structuring Through a Non-U.S. Holding Company That Owns the Indian Subsidiary


U.S. Corporation
("C" corporation)
Resale of finished goods to U.S. and non-U.S. customers
Non-U.S. Holding Company
Sale of finished goods
Dividends (15% Indian withholding tax rate under the Indian holding company treaty)
Note: Indian dividend distribution tax (16.99%)
Indian Company (Private, Limited by Shares)
Raw materials procurement
Special Economic Zone/No Tax Holiday Operation: 0% Indian effective tax rate

respect, while borrowing from a foreign company may pose foreign control restrictions, a popular mechanism of pushing debt in the Indian entity is by way of subscription to mandatory convertible debentures. The interest rate that may be paid out on those instruments, however, would be subject to transfer pricing.

VII. U.S. Investment in Indian Real Estate

A. Introduction

Unlike the U.S. real estate markets, India's real estate section is experiencing robust growth — however, at a much slower rate in comparison to previous years — and this has attracted considerable interest from the foreign investment community.[10] As the largest democracy in the world, India is projected to construct an estimated 80 million to 90 million new residential units over the next 10 to 15 years, according to comments by the chair of the Housing and Public Works Committee at the Seminar on Tax and Regulatory Environment and FDI Regulations Governing the Real Estate Sector.[11]

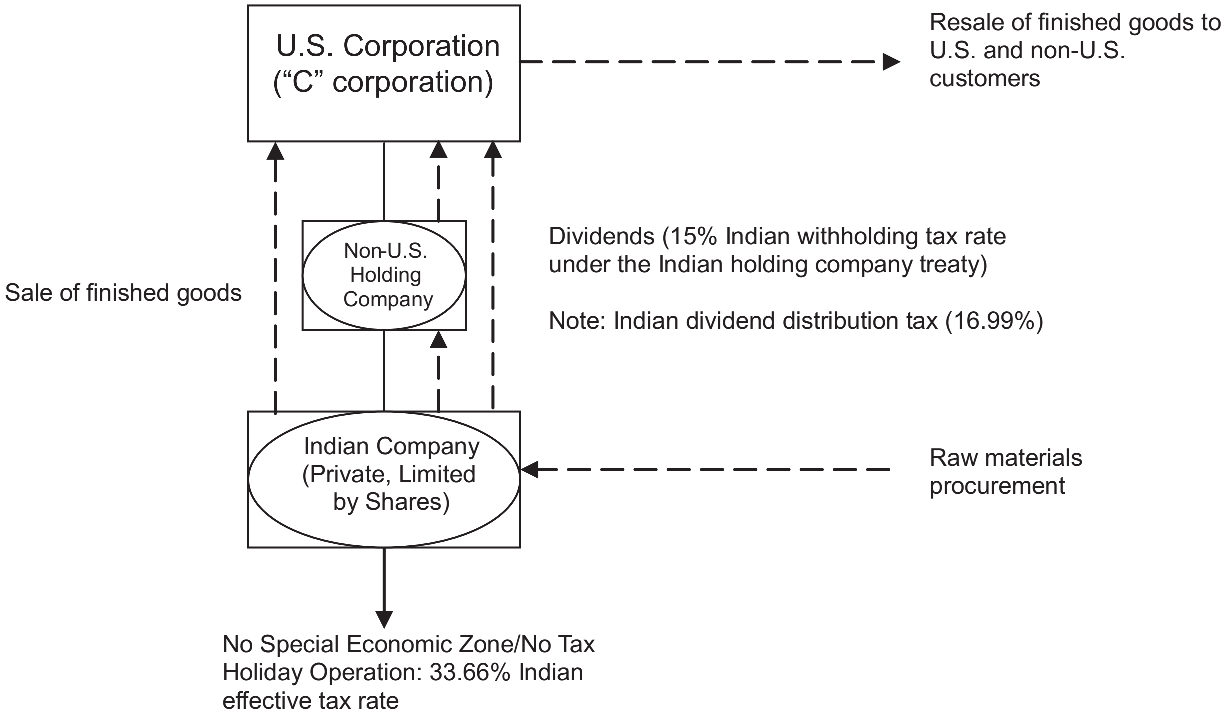
In addition to the residential market, India is also expected to see huge growth in commercial property, infrastructure projects, industrial parks, and the hospitality sector. This is primarily triggered by India's governmental policies that have liberalized its retail sector and have also promoted growth in the services sector (which now accounts for over 50 percent of GDP in India).

Despite these long-term investment opportunities, India has an array of government restrictions designed to limit foreign investment in Indian real estate. For example, as a general rule, foreign individuals may not own title to Indian real estate, known in India as ''freehold'' and ''leasehold'' ownership. Accordingly, most foreign persons structure their Indian real estate investments via shares of separate legal entities, such as companies, which in turn own the real estate.

[10] *See* P. Paulson, H. Wadhwani, and A. Bradshaw, ''Taxation of Investment in Real Property in India,'' *Tax Notes Int'l*, Apr. 24, 2006, p. 343, *Doc 2006-6432*, or *2006 WTD 80-6*.

[11] *Id.* at footnote 1.

Figure 4. Structuring Through a Non-U.S. 'Checked' Holding Company That Owns the 'Checked' Indian Subsidiary


U.S. Corporation
("C" corporation)
Resale of finished goods to U.S. and non-U.S. customers
Sale of finished goods
Non-U.S. Holding Company
Dividends (15% Indian withholding tax rate under the Indian holding company treaty)
Note: Indian dividend distribution tax (16.99%)
Indian Company (Private, Limited by Shares)
Raw materials procurement
No Special Economic Zone/No Tax Holiday Operation: 33.66% Indian effective tax rate

As a threshold matter, the Indian taxation rules applicable to foreign investors using either the FDI or FVCI investment structures must be carefully considered. It is important to understand the Indian regulations that control FDI and FVCI Indian real estate transactions. It should be noted that special rules can apply to Indian citizens resident outside India and persons resident outside India who are persons of Indian origin, but these rules ordinarily do not apply to regular U.S. citizen-structured Indian investments.[12]

B. Foreign Investment in Indian Real Estate

As a result of Press Note 2 (PN 2), in March 2005 heavy barriers on foreign investment in India were reduced. It should be noted that Indian investment policy changes are announced via press notes promulgated by the Secretariat for Industrial Assistance in the Department of Industrial Policy and Promotion.[13]

1. Open Indian Real Estate Sectors

Since the release of PN 2, foreign investors are now allowed to engage in several previously prohibited real estate activities, including the following key areas:

- development of townships;
- residential housing;
- built-up infrastructure; and
- construction development projects, which in general includes housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, and city- and regional-level infrastructure.

Also, foreign investors are only permitted to invest in Indian companies carrying on the above activities, and they are not allowed to directly engage in those real estate activities.

2. RBI Exchange Control Legislation Considerations

PN 2 provides for an automatic rule that enables the foreign investor to invest in Indian real estate companies with limited foreign exchange restrictions, and this requires the investor to notify the RBI, but no RBI prior approvals are required. However, for each project, PN 2 requires conditions to be satisfied, including:

[12] *Id.* at footnote 3.

[13] National Manufacturing Competitiveness Council, Government of India, *available at* http://www.dipp.nic.in (last updated Nov. 18, 2008); *see* Paulson et al., *supra* note 10, at footnote 3.

- minimum investment amounts;
- minimum area of development;
- prohibition against selling undeveloped land;
- substantial (at least 50 percent) completion of the project generally within five years of obtaining approvals; and
- a three-year lock-in period on invested capital.

3. Special Purpose Funding Vehicles

Depending on the guidelines and in particular, the three-year lock-in period, the RBI and related governmental regulators may require the project funding to be contributed in advance to a special purpose vehicle that in turn would serve as the funding vehicle for the project. Furthermore, investors must comply with permit requirements and other provisions generally applicable to real estate development.

4. FEMA Considerations

As addressed in PN 2, the Foreign Exchange Management Act (FEMA) must be taken into account. The act regulates shares and securities transactions involving persons outside India, and under FEMA the price paid by a foreign person for the purchase of shares in an Indian company not listed on a recognized securities exchange in India must comply with pricing guidelines issued by the former controller of capital issues.[14] Furthermore, the pricing of shares is restricted in that the proposed pricing must be supported by two valuation reports.

C. India's Investor and Capital Formation Rules

In 2000 the SEBI issued regulations to launch the FVCI regime to encourage foreign investors to participate in venture capital in India. The foreign venture capital fund rules provide that a foreign entity organized either as a trust or corporation may qualify as an FVCI and may be granted general permission to invest in equity and some debt instruments of Indian domestic venture capital funds or Indian venture capital undertakings, which are nonlisted companies permitted to engage in real estate development consistent with the provisions of PN 2 (or other activities that may be allowed under the FVCI regime).

1. Advantages of FVCI Investments

Why structure the investment as FVCI? FVCI rules permit the acquisition and sale of securities at a negotiated market price not subject to the exchange control pricing guidelines discussed above, and equally important, FVCI investors can avoid a lockout period otherwise applicable to shares held in a company. Nearly 200 foreign and domestic funds reported to be registered at the end of 2005 (although few of those involve real property), and many applications under the FVCI regime are pending for proposed real estate funds — believed to involve in excess of $1 billion of proposed investments. However, the SEBI has not been granting FVCI license for investments into real estate. Further, there have been media reports citing the Indian government's intention to close the automatic route available for real estate investments into India.

D. Foreign Institutional Investor

Indian regulations also contain a foreign institutional investor arrangement whereby approved asset management companies, pension funds, mutual funds, investment trusts, portfolio managers, university funds, endowment foundations, and charitable trusts can invest in shares in Indian companies. Investments under the FII regime must still meet limits for investment (such as those applicable to real property discussed above). Also, individual FIIs are generally restricted from acquiring more than 10 percent of the capital of any single company. However, the ability to obtain broad real estate exposure through the FII route may be limited and could be subject to restrictions.

E. FDI Regime

In summary, foreign investment in Indian real estate may be structured through the FVCI regime or the FII regime. However, as noted above, because of limitations on the FII regime, as well as red tape associated with processing FVCI approvals, most foreign investment in Indian real property is structured through the FDI regime generally applicable to investment by foreign persons in shares in Indian companies.[15] Similar in principle to U.S. inbound planning under the 1980 Foreign Investment in Real Property Tax Act (FIRPTA), in the case of Indian inbound foreign investment in the shares of a nonlisted Indian company, the following issues need to be carefully reviewed:

- What are the applicable Indian taxes on the nonlisted Indian company's earnings?
- What are the applicable Indian taxes on the nonlisted Indian company's receipts of distributions (whether in the form of dividends or interest on intercompany debt)?
- What are the applicable Indian taxes on the nonlisted Indian company's disposition of its investment, either in the form of assets or shares?

1. Indian Tax Results/Tax Holidays on FDI Transactions

As discussed above in Part III.A, a company resident in India is subject to a 33.99 percent income tax, which includes a corporate surcharge and education levy. Also, a minimum tax is imposed on an Indian resident company's financial earnings if the minimum

[14] *See* Paulson et al., *supra* note 10, at footnote 8, citing Indian Regulation 10.A of Notification No. FEMA.20/2000 RB, May 2000.

[15] *Id.* at footnotes 8, 9.

tax is greater than the regular tax for the assessment year (the minimum tax paid is allowed to be carried forward to offset regular tax with some limits).[16]

Unlike other Indian industries, very few tax holidays are available in the real estate sector. For example, some residential projects approved by March 31, 2007, were eligible for exemption for profits incentives. Accordingly, it is important to claim all available deductions and credits, including depreciation. Under Indian tax law, most real property (but not land) may be depreciated for tax purposes at a rate of 10 percent per year, based on a declining balance method.

2. *Indian Taxation of Sale of Local Company Shares*

Unlike U.S. tax rules dealing with foreign investors selling non-FIRPTA shares of U.S. company stock, India's domestic law imposes a tax on the sale of shares of an Indian company even if the company holds no Indian real property; however, no tax is imposed on the disposition of listed shares held for more than 12 months, assuming a securities transfer tax is paid. This tax is generally imposed at 0.125 percent of the transaction value on both the buyer and seller of shares traded on a recognized Indian stock exchange. For short-term gains, the sale is subject to a 15.836 percent capital gains tax. It should be noted that a 12-month holding period is used to determine short-term or long-term status for shares and listed securities, but this can be as long as 36 months in other cases.

In contrast, for dispositions of nonlisted shares (as well as debt securities) by a foreign company, India's domestic law imposes a tax of 21.115 percent for long-term gains (the rate skyrockets to 42.23 percent for short-term gains). This rate is reduced in the case of FIIs selling nonlisted shares and securities, which are subject to capital gains taxation of 10.558 percent for long-term gains and 31.6725 percent for short-term gains.

In the case of a U.S. investor who otherwise qualifies for U.S. treaty benefits, the Indian 21.115 percent tax rate for long-term gains and 31.672 percent rate for short-term gains for dispositions of nonlisted Indian shares are not reduced because under the treaty, Indian domestic law governs.

3. *Tax Treaty Overrides*

India has other income tax treaties that override internal Indian law and thus provide for a reduced or zero rate. As discussed earlier, one of the most well-known inbound Indian investment structures involves Mauritius, and if properly structured, the India-Mauritius income tax treaty provides that capital gains realized on the sale of Indian company-issued securities by a Mauritius company will not be subject to tax in India, as long as the Mauritius company was issued a valid certificate of tax residency.

For many years a significant question existed in FDI Indian tax circles as to whether the India-Mauritius tax treaty capital gains exemption was legally valid. As discussed earlier, this question was answered in the Indian Supreme Court decision in *Union of India v. Azadi Bachao Andolan*, which held that the treaty allows eligible persons to benefit from the capital gains exemption provision. (See discussion in Part V.B above.)

The most common inbound Indian structure involves the formation of a Mauritius holding company, which is typically organized as a Global Business License Category 1 (GBL 1) company under the Mauritius Financial Services Development Act 2001. For GBL 1 companies, no Mauritius tax is levied on capital gains from the sales of shares of an Indian company. Furthermore, no tax is imposed on the receipt of dividend distributions by a GBL 1 Mauritius holding company from an Indian company. It should be noted that Mauritius imposes a maximum effective tax rate on GBL 1 Mauritius holding companies on nondividend and capital gains income of 3 percent.

> **The most common inbound Indian structure involves the formation of a Mauritius holding company.**

In the event a U.S. investor in Indian real estate structures the sale of its shares in the Indian company in a manner to avoid Indian taxation (such as using the Mauritius treaty), the sophisticated purchaser will understand this scenario and will realize that upon purchasing the shares at a premium value, the underlying basis of the property held inside the Indian company will not be subject to a step-up in basis, similar to the U.S. tax results in the absence of making a section 338 election.

Accordingly, the acquiring party will generate significantly lower depreciation deductions as opposed to a step-up in the basis of the property through an acquisition of the property itself. However, the advantage of disposition of the shares involves a trade-off because the built-in tax liability in the appreciation of the property on the books of the Indian company at a lower depreciable tax basis may be benefited through the avoidance of Indian stamp duties through the transfer of shares versus the transfer of land itself. Under Indian law, stamp duties can range from a few percentage points to up to 15 percent, and under current law the stamp duty is not applicable to transfer of shares of a company, even though the company owns Indian real estate. (In comparison, other common-law jurisdiction

[16] *Id.* at footnote 10.

companies have adopted measures to impose the stamp duty on such entities that own underlying real estate, such as the Cayman Islands.)

4. Leveraging Indian Real Estate Investments

Because India allows any company engaging in customary borrowings to claim a deduction for interest paid in determining taxable income, structuring an Indian real estate investment by foreign investors could generate significant tax benefits. Furthermore, highly leveraging these investments may also be possible because Indian tax rules do not prohibit thin capitalization of companies. Also, while leveraging of the Indian assets directly would require a prior approval of the RBI, offshore leveraging at the holding company may be possible. Furthermore, many foreign investors in Indian real estate are attracted to borrowing funds denominated in rupees from Indian-based lenders, as this represents in usual cases a cost-effective borrowing vehicle, although a currency exchange risk must be assumed by the non-Indian owner. Given the relative strength of the rupee in recent years, such borrowings have been opportunistic, and thus represent somewhat of a hedge that if the rupee should depreciate, the cost of generating those rupees to repay the loan would be cheaper in relation to the original proceeds of the borrowing.

In many cases, foreign investors will seek to borrow in nonrupee currencies, which under Indian law are subject to the external commercial borrowings rules and to the foreign exchange management regulations of 2000. This area has been greatly liberalized in recent years, and the RBI in 2005 issued a circular to allow Indian companies to borrow up to $500 million in nonrupee currency denominations as long as the funds are used for capital expenditures. In this case, the Indian borrowing company is not required to obtain prior approval of the RBI. Other conditions are prescribed by the RBI circular, and this would need to be carefully reviewed. Furthermore, in the context of foreign-denominated borrowings by Indian companies in the context of real estate development, it is likely not subject to this automatic approval route, except in some narrow contexts (such as so-called sanction integrated townships).

From a U.S. treaty planning perspective, the India-U.S. tax treaty would reduce the Indian withholding rate to 15 percent on interest payments to a U.S. lender, and in the case of the other Indian treaties, such as with Mauritius, a complete exemption from withholding tax would apply to interest paid to a bank established in Mauritius and to a resident in Mauritius. However, other Mauritius-based lenders, as a general rule, would be subject to the domestic nontreaty withholding rates of 21.115 percent on gross interest and as high as 42.23 percent on net interest for debt denominated in rupees. The 21.115 percent would apply to interest paid in connection with external commercial borrowings, that is, nonrupee borrowings. Further, appropriate structuring through Cyprus may also be possible to reduce the tax withholding on interest income to 10 percent. (See discussions above in Part VI.D.)

F. Repatriation of Real Estate Profits

Most foreign investment transactions in Indian real estate are structured as equity contributions, primarily because of the limitations on cross-border indebtedness planning as summarized above. In most cases, the foreign investor will generate annual operating profits through collections of rental or other activities, and, in other cases, a foreign investor will generate a substantial capital gain from the disposition of the underlying property. Alternatively, the shares in the Indian company could be sold (hence the need for appropriate treaty planning). In any form of repatriation planning, whether repatriating operating profits or repatriating extraordinary gains from disposition of the project, both Indian and U.S. tax planning considerations need to be taken into account.

1. Indian Exchange Control and Company Law Issues

Indian exchange control rules have been liberalized over the past several years, and as a general rule, an Indian company may freely remit earnings under the RBI exchange control rules. Also, Indian corporate law needs to carefully be taken into account apart from the exchange control rules. Finally, as noted above, real estate investments are also subject to a lock-in, typically of three years. Indian corporate law, under the Indian Companies Act, closely safeguards the capital safety of any Indian company, which is significantly different from U.S. corporate practice.

2. Share Buybacks

Also, Indian law allows a company to buy back up to 25 percent of its total paid-up capital in a given year, and this also is subject to a maximum 2-1 debt-to-equity ratio following the buyback. The goal of the Indian government is to make sure the company is financially solvent and that creditors are protected.

G. Maximizing Benefits Under U.S.-Indian Law

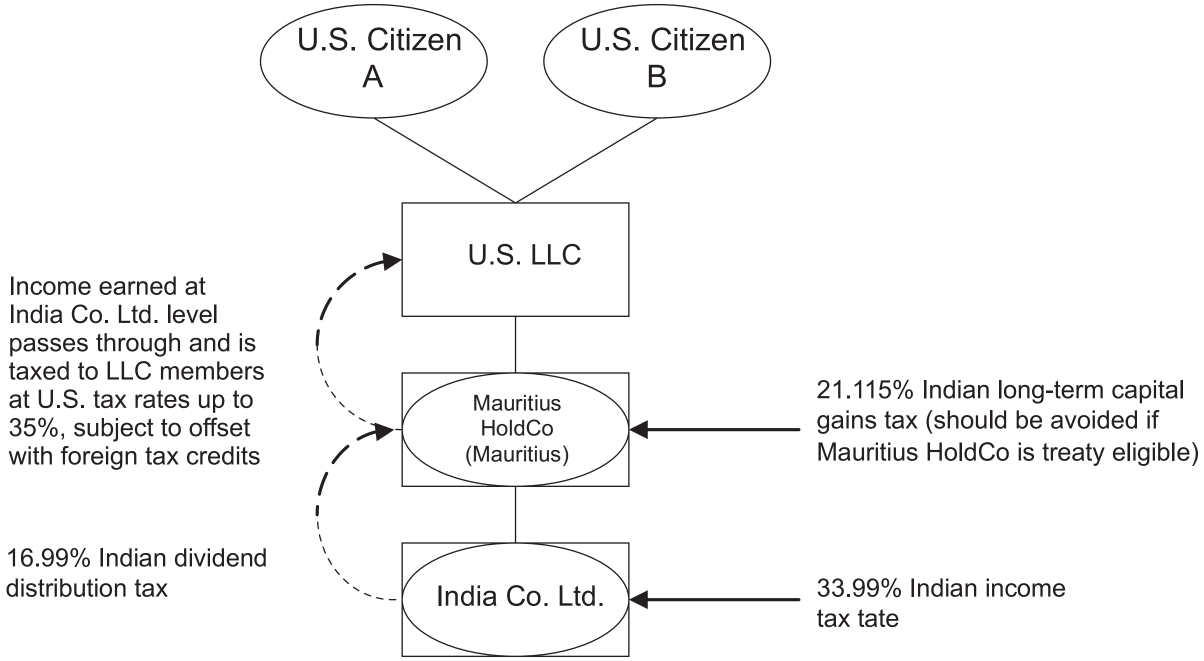
1. Factual Overview

Assume that India Co. Ltd. (IL) will embark on a new construction project in India to develop and sell luxury homes. Suppose U.S. Citizen A and U.S. Citizen B will contribute $10 million of initial capital to the construction venture. U.S. Citizen A and U.S. Citizen B proposed to structure the investment in IL through a Mauritius holding company to minimize future Indian income tax on a disposition of IL shares, as shown in Figure 5.

2. U.S.-India Tax Considerations

Subject to confirmation of non-U.S. tax aspects related to the planned venture, U.S. LLC would likely want to operate in India through a foreign passthrough structure. In a passthrough structure, the partners of

Figure 5. Structuring Indian Real Estate Investment Through A U.S. LLC-Controlled 'Checked' Mauritius Holding Company



Income earned at India Co. Ltd. level passes through and is taxed to LLC members at U.S. tax rates up to 35%, subject to offset with foreign tax credits

21.115% Indian long-term capital gains tax (should be avoided if Mauritius HoldCo is treaty eligible)

16.99% Indian dividend distribution tax

33.99% Indian income tax tate

It is important to note that use of Mauritius holding company in this structure does not provide any U.S. income tax deferral benefits. Rather, Mauritius would be used only to reduce the overall amount of Indian taxes and maximize U.S. foreign tax credit benefits.

U.S. LLC should be entitled to claim foreign tax credits for taxes paid in India. Depending on future exit strategy, use of a Mauritius HoldCo may help minimize the overall Indian tax burden. As noted above, a treaty-eligible GBL 1 Mauritius holding company may avoid the Indian 21.115 percent tax rate for long-term gains imposed on nonresident shareholders in connection with a future disposition of IL. Mauritius HoldCo must satisfy criteria to be eligible for full treaty benefits under the treaty between Mauritius and India.

Distributions of earnings are subject to a dividend distribution tax at the rate of 16.99 percent, including surtaxes (and may not be subject to reduction under the India-Mauritius income tax treaty). However, this may be avoided in the event that the distribution of profits is structured by the buyback of shares. ◆