

Newsalert

International Tax Services – INDIA

September 2009

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For issues relating to this news alert please contact your local international tax services advisor, Christoph Schreiber at +49 69 9585 6300 or the specialists listed at the end of this article.

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New Direct Taxes Code Proposed

On August 12, 2009 India's government released a draft of a new Direct Taxes Code. A version of the draft Code is expected to be introduced during the parliamentary winter session and to be enacted into law thereafter. The Code would enter into force for the financial year beginning April 1, 2011.

Corporate Tax Changes - Generally

The corporate tax rate is to be lowered to 25% for both domestic companies (from 33.99% inclusive of surcharge and cess) and non-resident companies operating in India through a branch (from 42.23%). Tax incentive provisions have been largely eliminated, with no grandfathering provisions for certain entities in the export sector (e.g., IT/ITeS businesses). The draft Code generally proposes to tax capital gains at regular tax rates (removing the current distinction between long-term and short-term capital gains); however, a 30% tax rate would apply to capital gains for non-residents. Gains on the transfer of investment assets will continue to be taxed as capital gains, but gains on the transfer of business capital assets and slump sales are to be taxed as business income.

The 15% dividend distribution tax generally remains intact for dividends distributed by domestic companies. The securities transaction tax, which is levied on the purchase or sale of equity shares on stock exchanges, is proposed to be abolished in its entirety.

Revised Minimum Alternative Tax ("MAT")

The Code materially changes the basis for computing MAT, which would be calculated with reference to a company's gross assets, instead of book profits as under current law (and taxed at 16.995%). The proposed MAT would be calculated at a 2% rate on the value of gross assets (except for banking companies which would be subject to a 0.25% rate). The value of gross assets would be the aggregate value of the gross block of fixed assets and capital work-in-progress, and the book value of all other assets, less accumulated depreciation on fixed assets and the debit balance of the profit and loss account. As currently drafted, the Code does not provide for any reduction on the account of liabilities incurred. MAT would only be payable to the extent that its amount exceeds the regular income tax amount calculated at 25% of taxable income. Unlike current law, any MAT paid under the new regime would not be available as a tax credit in subsequent years.

New Branch Profit Tax

The Code newly introduces the concept of a branch profits tax, which would be applicable to branches of foreign companies operating in India. The 15% branch profits tax is calculated based on net profits remaining after reduction for the 25% regular corporate income tax.

Foreign Companies - Residency Test

The definition of a “resident” company for tax purposes would be greatly expanded under the new Code. While current law limits the definition of an Indian resident company to one that is formed in India, or one that has control and management of its affairs “situated wholly” in India, the Code would alter the definition to include a company if control and management, at any time during the year, is wholly “or partly” in India.

Transfer Pricing Changes

The Code introduces inter alia a new Advance Pricing Agreement (APA) mechanism that would permit taxpayers to obtain an upfront determination from the tax authorities with regard to arm’s length pricing on international transactions, with a validity of five years. The Code also enlarges the potential scope of the transfer pricing rules by reducing the benchmark for determining associated enterprises (from a minimum shareholding of 26% under current law to a shareholding of 10% and from an appointment of 50% of the board of directors under current law to one-third). Finally, the Code significantly revises the penalty provisions by reducing the penalty for failure to maintain documentation and the accountant’s report to a maximum of INR 200,000 instead of 2% of the transaction value.

New Anti Avoidance Rules

The Code seeks to introduce a “General Anti Avoidance Rule” (“GAAR”). The respective provisions would empower the tax authorities to declare an ar-

angement as impermissible if entered into with the objective of obtaining tax benefit and which lacks commercial substance. If GAAR is invoked, the tax authorities could determine the tax consequences by amending, disregarding or recharacterising the arrangement. GAAR could also override an otherwise applicable tax treaty. Arrangements potentially covered by GAAR include, for example, transactions involving round trip financing.

M&A Changes

By definition, the Code describes a tax-neutral “business reorganisation” as an amalgamation or merger transaction involving two or more “residents”. Exempt from tax would be any gains arising on the transfer of investment assets under a business reorganisation as well as any shareholder gain. The draft Code would also extend the carry forward of losses of the predecessor to the successor upon any amalgamation, subject to satisfying business continuity requirements. It would also extend the same business continuity conditions to demergers, unlike under current law.

Indirect Transfer

The Code would expand the tax net by taxing income from an “indirect” transfer of a capital asset in India. Such income would be construed as income deemed to accrue in India in the hands of a non-resident.

Fees for Technical Service (“FTS”) and Royalties

The Code would raise the rate of tax imposed on the gross amount of FTS/royalties earned by non-residents from 10% under current law to 20%. The draft Code would also eliminate “net basis” taxation for FTS/royalties under current law for payments that are linked to a permanent establishment (“PE”) of a foreign company in India - specifically, current law provides that PE-linked amounts are taxable on a net basis at the non-resident rate of 42.23%.

For more detailed information, please do not hesitate to contact your tax services team:

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