Asia Pacific Tax Newsalert

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India

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India announces 2012 budget proposals

The Indian Finance Minister presented the Union Budget ("the budget") for the Indian tax year 2012-2013 in Parliament today. The budget proposals will be effective once approved by both houses of Parliament and upon receiving Presidential assent.

This newsalert summarizes the key tax proposals which are likely to impact US investors in India.

Key international tax proposals

Taxation of indirect transfers of Indian company shares

- The budget proposes an amendment to deem shares of, or interest in, an entity outside India as being situated in India if the value of such shares or interest is derived substantially from assets located in India. The proposal does not appear to clarify what would be considered as "substantial" for this purpose. Further, the term "property" has been defined to include (and deemed to have always included) any rights in, or in relation to, an Indian company, including management or control rights or any other rights.

- The proposal would subject the transfer of such shares or interest to Indian tax. The definition of the term "transfer" has been expanded to include disposing of any asset or interest in an asset, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily through an agreement or otherwise. This amendment apparently would apply retroactively from April 1, 1961.

- The amendment to tax indirect transfers of Indian shares appears to tax overseas transactions involving a transfer of Indian interests. This proposal would overrule the Indian Supreme Court's recent taxpayer-favorable decision in the Vodafone case. If passed as currently proposed, this could have very serious consequences to multinationals that have carried out any internal re-organizations or external sales in the past. Although there is no clarity on what constitutes a "substantial" interest for this purpose, given that the amendment would cover all rights related to an Indian entity, apparently the government seeks to expand the tax net to cover most of these overseas transactions.

General Anti-Avoidance Rules ("GAAR")

- The budget proposes the introduction of GAAR provisions in domestic law. The GAAR provisions appear largely based on the government's proposals in the Direct Taxes Code in 2010.

- Some key features of the GAAR proposals include:

    - The GAAR provisions will include an arrangement that lacks commercial substance or is deemed to lack commercial substance in whole or in part if the main purpose, or one of its main purposes, is to obtain a tax benefit. Note that the provisions also prescribe other situations that would invoke GAAR.

    - An arrangement is deemed to lack commercial substance, *inter-alia*, if the effect of the arrangement as a whole is inconsistent with, or differs significantly from, the form of its individual steps or part.

    - A transaction will be presumed to have been undertaken for the main purpose of obtaining a tax benefit unless the taxpayer is able to prove otherwise.

    - An arrangement will be presumed to have been undertaken for the main purpose of obtaining a tax benefit if the main purpose, a step, or a part of the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit.

    - If an arrangement is declared an impermissible avoidance arrangement, the tax authorities will be empowered to determine its consequences, which could include denying treaty benefits, re-characterizing equity to debt or *vice-versa* and treating capital receipts as revenue in nature or *vice-versa*.

    - The tax authorities will be empowered to determine the consequences of a transaction regarded as resulting in tax avoidance, including through denying treaty benefits.

- The budget also proposes to create a three member panel (of senior income-tax officials) to review transactions which have been challenged by the tax authorities under the GAAR framework.

- The GAAR proposals would be effective April 1, 2012 once the budget is approved.

Tax residency certificates for claim of treaty benefits

- The budget proposes to require taxpayers to furnish a tax residency certificate containing information prescribed by the tax authorities in order to claim treaty benefits.

- The proposal also suggests that the tax residency certificate alone will not be sufficient for making a treaty claim and the tax authorities may conduct further inquiries or apply additional tests when reviewing the claim.

Advance pricing arrangements ("APA")

- In a positive and significant move, the budget introduces APAs for transfer pricing transactions. The APA would be binding on the taxpayer and the tax authorities for the transaction barring a change in law or facts from the time the APA was entered into. APA's are proposed to be valid for a five year period.

- This proposal is slated to be effective July 1, 2012 once approved.

Statute of limitations

- The budget proposes to extend the existing statute of limitations of seven years from the end of the Indian financial year for re-opening audits to 17 years from the end of the Indian financial year where income relating to any capital asset located outside India (including financial interest in an entity outside India) has escaped audit.

Key domestic tax proposals impacting US investors

Domestic transfer pricing

- The budget introduces transfer pricing regulations to prescribed domestic transactions with a value exceeding Rs 50,000,000 (approx. US$ 1 million) between related parties.

- These provisions specifically include transactions involving a business restructuring or re-organization between related parties. These provisions also include transactions involving the purchase, sale, lease or use of any intangible property (including marketing rights, goodwill and other intangibles).

- The proposal to apply transfer pricing to domestic transactions would be effective April 1, 2012 and could significantly impact domestic restructuring transactions involving subsidiaries of US multinationals.

Removal of cascading effect of dividend distribution tax ("DDT")

- Under current law, dividends declared by an Indian corporation are subject to a 16.223% DDT. However, in its current form, multiple-tier India structures often incur DDT upon a distribution at each level without corresponding credit.

- The budget proposes to remove the multi-level impact of DDT in the case of multi-tiered Indian holding structures, effective July 1, 2012.

Weighted deduction for research & development ("R&D")

- As a means to promote R&D activity in the country, the budget proposes a 200% weighted deduction for R&D expenses (revenue & capital expenses) incurred in an in-house facility for expenses incurred through March 31, 2017.

- The current law benefit expires March 31, 2012; this provision extends this benefit.

Venture capital fund investment

- Current law permits funds to invest in Indian venture capital funds ("VCF") registered with the Securities & Exchange Board of India. However, a VCF is only permitted to invest in certain specified sectors or industries.

- The budget would remove the restriction on VCF investments, allowing them to invest in any industry.

Other key changes

Service tax

- A 10% service tax (plus applicable surcharge) currently applies on the provision of several specified services in India (and is, in some cases, applicable to an Indian recipient).

- The government has proposed to expand the service tax regime to all services (barring specific exemptions) instead of following an inclusive definition by prescribing specific services subject to this charge. In addition, the service tax rate would increase to 12% (plus applicable surcharge).

Conclusion

Several of the budget proposals apparently would widen the tax base through measures such as taxing international transactions retroactively, empowering tax officials to scrutinize and question the commercial rationale of transactions, and introducing new provisions to check tax leakage. While the introduction of an APA regime or the extension of the R&D deduction are certainly positive factors, some of the proposals could impact both the overall perception of the Indian taxing system in the eyes of foreign investors and the inflow of foreign investment into the country. Taxpayers should review past as well as proposed transactions in light of the budget and consider the potential impact.

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