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Report on Indian indirect transfer rules may benefit foreign investors

In brief

Earlier this year, India's Prime Minister established an Expert Committee (the Committee) to review legislation that would tax, retroactively, transfers of shares or interests in a foreign company when the transfer derived its value substantially from underlying Indian assets (indirect transfers). In a significant development, the Committee has recommended that the rules should apply prospectively only and that the rules should not apply to intra-group restructuring.

The legislation -- the Indian government's response to the controversial Vodafone decision -- was very broad in both language and scope, and its passage led to apprehension among foreign investors about the certainty of tax laws in India. Facing pressure from foreign investors and fearing a slowdown in growth, the Prime Minister established the Committee to review the new indirect transfer tax rules and provide recommendations to the government.

The Committee, in addition to the recommendations regarding retroactivity and intra-group restructuring, recommended that the term 'substantial' mean a value exceeding 50% of global assets. The Committee also recommended relief for small investors and listed company transactions.

This newsalert summarizes the Committee's key recommendations that could affect foreign investors in India.

Key recommendations regarding the indirect transfer rules

Prospective application only

- The Committee recognizes that the new legislation regarding taxation of indirect transfers is not intended merely to clarify current law, but also is intended to widen the tax base. The Committee therefore recommends that the rules should apply prospectively only, and not retroactively.

- The Committee states that retroactive application of tax law should 'occur in the rarest of rare cases' and only to correct apparent mistakes in the tax laws, remove technical defects (that is, to clarify the law), or to protect the tax base from highly abusive tax schemes that are designed to avoid tax and that lack economic substance.

No tax withholding obligations

- The Committee recommends that, if the government declines to apply the new rules only prospectively, these indirect transfer provisions should apply only to the transferor earning capital gains from a transfer and there should be no negative consequences to the transferee (the payor/buyer) for failing to withhold taxes (including related interest and penalty obligations).

Clarification of triggers

- The Committee recommends that the phrase 'share or interest in a company or entity registered or incorporated outside India' for the purpose of the indirect transfer rules should cover only a share or interest that results in participation in ownership, capital, control, or management.

- The Committee recommends that the term 'substantial' should be defined as at least of 50% of total value derived from the entity or company as a proportion of global assets of such company or entity. Furthermore, the term 'value' should mean fair market value determined under rules to be prescribed; the Committee currently believes that the services sector should use the discounted cash flow (DCF) and the non-services sector should use the net asset value (NAV).

- The Committee recommends that the government restrict the imposition of capital gains on indirect transfers, on a proportionality basis, to the capital gains attributable to assets located in India.

- The Committee also recommends changes to current tax law to eliminate the possibility of India taxing dividends paid by a foreign company with substantial underlying assets located in India.

Relief for small investors

- To provide relief to small shareholders, the Committee recommends that the indirect transfer tax rules should not apply when the foreign shareholding (i.e., ownership by the transferor and its associated enterprises) does not exceed 26% of the voting power of the underlying Indian entity during the preceding 12 months.

Exemption for listed companies

- The Committee recommends an exemption for foreign companies listed on recognized stock exchanges whose shares are frequently traded.

Exemption for intra-group restructuring

- The Committee recommends an exemption for transfers of shares or interest in a foreign company in the course of intra-group restructuring, but only if such transfers are not taxed in the country in which the foreign company resides.

- For the purpose of this recommendation, the Committee defines an intra-group restructuring as an amalgamation (merger) or demerger as defined under Indian domestic law with continuity of at least 75% ownership, or any other form of restructuring within the group subject to 100% ownership continuity.

Relief for foreign institutional investors (FIIs) and private equity (PE) players

- The Committee recommends that non-resident investors in FIIs should not be taxed under the indirect transfer tax rules, to avoid possible double (or more) taxation, because FII investments are subject to tax in India under Indian domestic law, subject to any tax treaty benefits.

- Recognizing the concerns of PE players about the likelihood of taxation on gains outside India to non-residents in pooling vehicles, the Committee recommends that non-residents should be outside the scope of the indirect transfer rules when:

  (1) the overseas investment in the PE fund does not provide a participation in the control and management of the fund,
  (2) the investor does not have more than 26% of the company's voting power,
  (3) the investee company does not have more than 50% of its global assets located in India,
  (4) the investee company is a listed (publicly traded) entity whose shares are frequently traded, or
  (5) the transfer occurs during an intra-group reorganization.

Access to tax treaty provisions

- To provide certainty to foreign investors, the Committee recommends that access to beneficial provisions under a tax treaty should be respected unless the treaty provides taxing rights to India under its domestic law, or the treaty specifically provides taxing rights to India with respect to indirect transfers.

Conclusion

The Committee's recommendations would lend considerable certainty to the operative aspects of the new indirect transfer tax rules.

The recommendations also would provide significant relief with respect to concluded transactions and would shift the tax burden in such cases to the transferor if the government decides to apply the new rules retroactively.

Note: The Committee's recommendations are subject to further discussions.

Taxpayers should expect final guidance on the indirect transfer rules from the Indian government in the form of amendments to the existing legislation or through appropriate Revenue instructions.

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