Indian budget proposal retains indirect transfer tax rules but defers GAAR until 2015

February 28, 2013

In brief

The Indian Finance Minister presented the Union Budget for 2013-2014 in Parliament on February 28, 2013. Although the budget had been widely expected to contain proposals that would boost investor confidence, the Finance Minister appears to have adopted a conservative approach. Significantly, as the government previously announced, the budget would defer the introduction of general anti-avoidance rules (GAAR) to April 1, 2015. The budget also does not include changes or clarifications to the rules regarding the taxation of indirect transfers of Indian entities. The budget also contains proposals to tax share buybacks by unlisted Indian companies and to increase the scrutiny of Tax Residency Certificates.

The budget proposals generally would be effective on April 1, 2013, if they are passed by both houses of Parliament and receive Presidential assent. Some of the proposals, as noted in this newsalert, would take effect on other dates.

This newsalert summarizes the key budget proposals that could affect foreign investors in India.

In detail

GAAR deferred to 2015

- In accordance with the government's January announcements, the Finance Minister has proposed deferring the proposed GAAR regime until April 1, 2015 (See Asia Pacific Tax Newsalert, "Indian Finance Minister announces decisions on Indian GAAR regime," January 15, 2013).
- Many taxpayers also hoped that the Finance Minister would seek to implement some of the Shome Committee's recommendations[1] through the budget proposals. However, the budget largely retains the GAAR provisions in their existing form. Significantly, the taxpayer will retain the burden of proof for establishing that a transaction is not abusive.

Taxation of share buybacks

- The budget includes specific provisions to tax unlisted Indian companies that buy back shares from their shareholders. This provision would be effective on June 1, 2013.

[1]The Indian government had formed an expert committee chaired by Dr Parthasarathi Shome (Shome committee) to look into the GAAR proposals and make recommendations on its application and implementation. The Shome committee submitted its final report to the government in January 2013.

- The proposals would treat a share buyback like a dividend and tax it at a 22.66% effective rate (comprised of a 20% base rate, a 10% surcharge and 3% education cess or additional surcharge).
- Similar to the existing dividend distribution tax, the Indian company would have to pay tax on the share buyback, so foreign shareholders participating in a buyback would have to consider whether this tax would be creditable in their respective jurisdictions.
- ***Note:*** The proposals also would increase the surcharge on the dividend distribution tax from the current rate of 5% to 10%. This would increase the effective dividend distribution tax rate to 16.995% from the current effective rate of 16.223%.

Increased rate of withholding tax under domestic law

- The budget would increase the withholding tax rate on royalty or fee payments for technical services to 25%. This rate also would increase by a surcharge (up to 5%) and a 3% education cess. This would result in a maximum effective rate of 27.0375%.
- Foreign companies receiving royalties or fees for technical services from India currently are subject to an effective withholding tax rate of 10.506% (including surcharge and education cess) if they obtain a Permanent Account Number (tax-payer ID) in India.
- ***Note:*** This proposal would affect only domestic Indian law; so recipients of such income in treaty jurisdictions should be able to benefit from treaty rates, if they can demonstrate treaty eligibility under the applicable treaty and domestic law requirements noted below.
- The budget also would introduce a 1% withholding tax on payments for the purchase from Indian residents of land or buildings valued at INR 5,000,000 or more (approx. US$ 95,000).

Tax Residency Certificates

- The budget proposals would require taxpayers to produce a Tax Residency Certificate to claim treaty benefits. However, under the proposal, this certificate alone would not be sufficient evidence of tax residency.
- This amendment would essentially permit Indian taxing officials to examine a taxpayer's beneficial ownership before allowing treaty benefits.
- In 2012 the Indian government listed the disclosures required on a Tax Residency Certificate. This created difficulty in countries that had predetermined formats for issuing Residency Certificates. Absent further clarification on whether the Indian government would respect Tax Residency Certificates that may not contain all the requirements, this new proposal would make it significantly more difficult for taxpayers to demonstrate their tax residency to the Indian tax authorities.
- These two proposals together also would significantly affect M&A activity involving Indian targets.

Investment allowance

- In a bid to boost manufacturing sector investments, the government has proposed an additional 15% depreciation allowance for companies investing in new assets of at least INR 1 billion (approx. US$ 19 million) between April 1, 2013, and March 31, 2015. The proposal would permit this allowance in addition to normal depreciation claims on such assets.
- The proposals also provide for a clawback of the additional depreciation when the assets are sold within a five-year period from their installation.

Changes to tax rates

- The Finance Minister proposed certain tax rate increases for corporations by increasing applicable surcharge rates. ***Note:*** the current 3% education cess (applied on the sum of the tax rate and surcharge) would continue to apply to all Indian and foreign companies.
- In addition to the 30% basic tax rate on Indian companies, the budget proposes the following surcharges:
  - A 5% surcharge for companies with incomes between INR 10 million (US$ 190,000) and INR 100 million (approx. US$ 1.9 million), increasing the effective tax rate for such companies to 32.445%.
  - A 10% surcharge for Indian companies with income exceeding INR 100 million (approx. US$ 1.9 million), increasing the effective tax rate for such companies to 33.99%.

- Foreign companies (including those operating through a branch or a permanent establishment in India) would continue to be subject to a 40% tax rate, with the following proposed surcharges:
  - 2% surcharge for companies with incomes between INR 10 million (US$ 190,000) and INR 100 million (approx. US$ 1.9 million). This will take the effective tax rate for such companies to 42.024%
  - 5% surcharge for foreign companies with income exceeding INR 100 million (approx. US$ 1.9 million). This will take the effective tax rate for such companies to 43.26%.

Other proposals

- The Finance Minister proposed a new Commodities Transaction Tax of 0.01% on the sale of non-agricultural commodity derivatives payable by seller.
- In addition, the budget proposes to reduce the securities transaction tax rate in certain cases.
- In addition, the Finance Minister indicated that the government will finalize safe harbor rules relating to transfer pricing shortly.
- The Finance Minister has also proposed a beneficial 5% withholding tax rate on interest received by foreign investors in long-term infrastructure bonds, subject to certain conditions.

The takeaway

Foreign investors will likely appreciate the formal deferral of GAAR until April 1, 2015. However, the government's decision not to adopt any of the Shome Committee's additional recommendations both for GAAR and for indirect transfer taxation might disappoint some of those investors. The Finance Minister also indicated in his budget speech that the government is likely to introduce the Direct Taxes Code for Parliament approval during the current session. In 2012 the government deferred introduction of the Direct Taxes Code, which was designed to replace existing Indian tax law after it decided to first push amendments such as GAAR and the taxation of indirect transfers in the existing law.

Foreign investors should monitor progress of these budget proposals through Parliament and final enactment. In addition, investors should pay attention to the wording of the Direct Taxes Code when it is introduced in Parliament.

Let's talk

For a deeper discussion, please contact:

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