India Budget 2015 defers GAAR, addresses offshore transfers

March 3, 2015

In brief

The Finance Minister of India presented the Indian Budget 2015 on February 28, 2015. Budget 2015 was the first full-fledged Budget of the new government and has focused emphatically on growth and creating an enabling environment by introducing measures to ease doing business in India.

On the tax front, the government has addressed some of the key concerns of foreign investors and multinational companies. These include clarifying certain aspects of offshore share transfer taxation, deferring the implementation of general anti-avoidance rules (GAAR) to provide certainty and a non-adversarial environment, and announcing the intent to simplify the law and reduce the corporate tax rate to 25% over four years.

If both houses of Parliament pass the budget proposals they would be effective on the day they receive Presidential assent.

In detail

The key Budget proposals are discussed below.

Deferment of GAAR

The Budget defers GAAR for two years in order to implement it as part of a comprehensive regime that addresses the OECD's base erosion and profit shifting (BEPS) project. India is an active participant in the BEPS project. Importantly, the Budget clarifies that the GAAR would apply prospectively to investments made on or after April 1, 2017.

This is a welcome move by the government, given the concerns around the lack of clarity on the GAAR provisions in its current form and the adversarial tax environment in India.

Offshore transfer taxation – certain aspects clarified

The introduction of indirect transfer taxation provisions in Budget 2012 resulted in several ambiguities on the applicability of these provisions.

In order to address some of these issues, the Budget proposes the following key amendments:

- An offshore share transfer of a foreign entity is taxable in India if the shares or interest in the foreign entity derives its value 'substantially' from assets located in India.
- The Budget clarifies that the offshore transfer taxation provisions would be triggered where the shares or interest in the foreign entity:
  - derive 50% of their value from assets located in India, and
  - the value of assets in India exceeds INR 100 million (approx. USD 1.7 million)
- In this respect, Indian assets would include both tangible

assets (without reduction for liabilities).

Computation mechanism:

- With regard to the computation mechanism, the Budget proposes that the capital gains arising as a result of an offshore share transfer would be taxable in India in proportion to the value of assets located in India.

Minority shareholders exempt:

- the transferor (along with its associated enterprises) is granted an exemption if it does not hold:
  - right of control or management, and
  - voting rights or share capital or interest exceeding 5% in the foreign company or entity, at any time in the 12 months preceding the transfer date.

Indirect minority shareholders will also receive a similar exemption.

Clarifications to be prescribed:

The following aspects will be clarified separately:

- manner for determining the Fair Market Value of the Indian assets vis-a-vis global assets
- method for determining the proportionate value of Indian assets
- applicability of indirect transfer taxation provisions to a dividend distribution by a foreign entity deriving substantial value from India.

Transfer through merger / demerger:

The transfer of shares of a foreign company, deriving value substantially from assets in India, through a merger or demerger of foreign companies will not be subject to tax in India, subject to fulfilling these conditions:

- continuation of prescribed shareholding percentage, and
- the transfer does not attract capital gains tax in the country of the merging / demerging company.

Reporting requirements:

The Indian concern / investee company is obliged to furnish necessary information on offshore transfers. The manner of reporting will be prescribed in due course.

The Budget proposes a specific penalty for non-compliance with the above reporting obligation.

All of the above referred provisions would apply effective April 1, 2015.

Change in domestic corporate tax rate

The government has proposed reducing the domestic corporate tax rate from 30% to 25% in a phased manner, over the next four years starting from financial year 2016-17.

However, for current financial year 2015-16, the government has increased the surcharge by 2%. This increases the effective corporate tax and dividend distribution tax rate for domestic companies.

Change in residency test for foreign companies

Presently, a foreign company is considered resident in India if the control and management of its affairs is situated wholly in India.

The Budget has now proposed to introduce the concept of 'place of effective management' (PoEM) which is an internationally recognized concept and accepted even by the OECD.

The Budget proposes that a foreign company will be resident in India if its PoEM is in India at any time during the year. The term 'PoEM' has been explained to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made.

The Budget also proposes that in due course the government will issue a set of guiding principles for determining the PoEM.

Reduction in the tax rate for royalty / fees for technical services (FTS) earned by a non-resident

The rate of taxation for royalty / FTS earned by a non-resident increased to 25% two years ago. To facilitate technology inflows, the tax rate has now been reduced to 10%.

This is another welcome amendment, which in addition to encouraging technology inflows, will address concerns of non-resident technology and service providers given the difficulty to avail of treaty rates in certain cases.

Beneficial tax rate for interest on debt investments

The Budget extends the sunset clause for provisions relating to the applicability of the 5% tax rate to foreign portfolio investors on income from certain corporate bonds and government securities from May 31, 2015 to June 30, 2017.

Intended 'safe harbor' rules for fund managers

The Budget proposes that fund management activity carried out through eligible fund managers in India shall not constitute a business connection (i.e., a permanent establishment (PE)) of the said fund in India. Also, the investment fund shall not be considered resident in

India merely because the fund manager undertaking fund management activities is situated in India.

The 'safe harbor' benefits mentioned above will be available to investment funds and fund managers who fulfill various onerous conditions as specified. These include diversified holdings at the fund level, registration by fund manager with appropriate authority in India, etc.

Other amendments:

- The Budget introduces beneficial tax treatment to the Sponsor in *Real Estate Investment Trust (REIT) and Investment Infrastructure Trust (InvIT)* and clarification on taxability of rental / lease income in the hands of investors and not the REIT.
- Foreign Institutional Investors (FIIs) / Foreign Portfolio Investors (FPIs) will be exempt from payment of Minimum Alternate Tax (i.e., MAT – alternative mode of taxation based on book profit) on capital gains arising on specified transactions.

  However, the introduction of such specific exemptions raises ambiguity on whether MAT will apply to other income earned by FIIs / FPIs or other foreign investors. A foreign enterprise was typically not subject to MAT unless it had a PE or due to certain other reasons was required to maintain books of accounts in India.
- Any person responsible for making any payment to a non-resident (in relation to India-sourced income) must report specific information in the prescribed form, whether or not such payment is subject to tax in India.
- Additional incentives when setting up manufacturing operations in certain Indian states (Andhra Pradesh and Telangana), are available for investment in plant and machinery:
  - 15% investment allowance
  - 35% additional depreciation.
- The Budget increased the Resident Service Tax rate to 14% (from 12.36%) with an enabling provision to further increase the rate by 2%.

The takeaway

The first full-fledged Budget of the new government addresses long-standing concerns in order to gain the confidence of foreign investors. This Budget provides the long-term vision of this government towards growth of the Indian economy with more stability and less governance.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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