

Legislative developments in India: New tax code and limited liability partnership legislation

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New Indian tax code

As announced in the India budget presented in July 2009, the Indian authorities have circulated for public comment a draft of the proposed Direct Tax Code (DTC).

The DTC is intended to replace India's existing income tax laws and represents a significant structural change in Indian direct taxation. The code aims to moderate tax rates, remove certain exemptions, and simplify current tax laws to align them more closely with global tax principles.

Provisions in the DTC will affect specific financial services sectors, including investment vehicles such as mutual funds, venture capital funds, and domestic investment trusts; banks and other financial institutions; insurance companies; and foreign institutional investors (FII). In addition, general provisions will impact cross-border transactions across the financial services industry. New general provisions (detailed below) expected to affect all investors include changes in criteria for determining the residential status of foreign companies and the introduction of general anti-abuse provisions.

One significant proposed change affects private equity funds and hedge funds investing in India under the FII regime. The proposed DTC eliminates the current FII regime and mandates that FIIs be governed by the general provisions applicable to other nonresidents. This change would eliminate the favorable capital gains taxation currently available to FIIs and result in capital gains being taxed at the proposed uniform rate of 30 percent.

Other significant highlights from the proposed DTC include:

Tax rates

- The tax rate for domestic and foreign corporations is proposed to be reduced to 25 percent from the existing rates of 33.99 percent and 42.23 percent, respectively.
- Foreign companies will be subject to branch profits tax of 15 percent.
- Dividend distribution tax levied on Indian companies declaring dividends would be retained at a marginally reduced rate of 15 percent.
- Following these proposals, the effective tax rate for Indian companies (after considering the dividend distribution tax) and for Indian branches of foreign companies (after considering the branch profits tax) will be approximately 34.78 percent and 40 percent, respectively, versus the current approximate rate of 42 percent.
- The base for computing minimum alternative tax (MAT) is proposed to be shifted from "book profits" to the "value of gross assets." MAT will be levied at 0.25 percent on banking companies and 2 percent on all other companies. MAT will now be a final tax and will not be allowed as a tax credit in subsequent years.

Residency rules

- Currently, foreign companies are treated as resident in India if their control and management during the year are situated wholly in India. A proposed change in the residency rules would deem foreign companies as tax resident in India even if only partial control and management of their affairs is in India at any time during the year.

Capital gains

- The DTC proposes to eliminate the existing distinction between short-term and long-term capital gains based on the period of holding an asset. In addition, capital gains will no longer be taxed at concessional rates.
- The proposed abolition of the Securities Transaction Tax will also eliminate the rule allowing for the exemption/lower rate of tax on capital gains on listed shares.
- Currently, unused capital losses can be carried forward eight years. Under the new DTC, unused capital losses may be carried forward indefinitely.
- The deemed cost of acquisition of an investment asset will be nil if it is not capable of determination, and capital gains will be computed accordingly.
- The DTC proposes to construe income accrued from the direct or indirect transfer of any capital asset situated in India as income “deemed to accrue” in India.

Transfer pricing

- The DTC proposes to introduce an advance pricing agreement (APA). The APA will represent an arm’s-length price as prescribed under the DTC, subject to necessary adjustments, and will be valid for a maximum of five consecutive years. An APA will not be binding in case a law changes, and that law formed the basis for entering into the APA.
- The DTC would tighten the threshold limits for considering two enterprises as “Associated Enterprises,” and therefore subject to the transfer pricing regulations.

General anti-avoidance rules (GAAR) to counter tax avoidance

- The DTC proposes to introduce GAAR, empowering the commissioner of income tax (CIT) to declare an arrangement as impermissible if it has been entered into with the objective of obtaining a tax benefit and lacks commercial substance. The onus of establishing substance lies with the taxpayer.
- The concept of thin capitalization is proposed to be introduced to disregard specific types of debt arrangements and recharacterize interest as dividends in certain circumstances.
- Other arrangements covered by GAAR include round-trip financing and lifting of the corporate veil.

Tax treaty provisions

- Currently, Indian domestic law provides taxpayers the option of applying the provisions of applicable tax treaties to the extent such provisions are more beneficial.
- The DTC proposes a treaty override provision that determines the interaction between the DTC and the treaty and states that the provision that is later in point of time shall prevail.
- In addition, the DTC proposes to mandate the furnishing of a tax residency certificate for claiming relief under a tax treaty.

Limited Liability Partnership Act of 2008

Limited liability partnerships (LLPs), introduced in 2008 through the Limited Liability Partnership Act of 2008 (LLP act), are relatively new entities from an Indian perspective and may provide investors with greater flexibility in structuring investments in India. However, it should be noted that Indian regulatory authorities have yet to provide clarity with respect to whether foreign investors can be partners in the LLP.

Similar to corporations, LLPs are considered separate legal entities and allow for perpetual succession. However, LLPs are not subject to India’s onerous tax and regulatory compliance requirements, nor are they required to appoint independent directors. Further, LLPs can have an unlimited number of partners with limited liability but must designate at least two partners as unlimited partners.

Although the tax treatment of LLPs is still unclear in certain respects, they offer a number of tax advantages compared with traditional vehicles used to invest in India:

- LLPs are viewed as partnerships from an Indian tax perspective. Thus, Indian corporate income tax is payable at a rate of 30.90 percent only at the LLP level.
- Distributions of profits by the LLP are exempt from tax in the hands of the partners.
- No surcharge, resulting in 3.09 percent savings on the base tax rate (30.90 percent vs. 33.99 percent for corporations)
- No dividend distribution tax
- No minimum alternative tax
- Mitigating the cash trap that occurs as a result of the requirement for companies to transfer to a reserve 10 percent of their net profit (after tax) prior to the declaration of dividends
- No tax with respect to distribution of profits or capital
- No deemed dividend issues

On an Indian legislative front, several key proposals are being considered that would have a significant impact on the financial services industry. These proposals should be carefully examined to determine the impact on operations and investments in India.

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