Finance Bill-2015: Salient Features Of International Tax Related Proposals

The Finance Minister Arun Jaitley has presented his maiden full-fledged budget under the Narendra Modi-led NDA government on 28th February, 2015. It was expected to be "make or break" by the corporate world. Based on the trends and PM Modi's focus on development agenda, big bang reforms through the Budget were expected to revive investment, economic growth, and equity and job creations. Amidst all such high expectations, he came up with a promise of reigniting the growth engine of India and signalling the dawn of a prosperous future of India through the Budget.

The FM has postponed the implementation of general anti-avoidance rules (GAAR) by two years. He has expressed its resolve of not going ahead with the Direct Taxes Code (DTC). He has also proposed to abolish the levy of wealth tax under the Wealth-tax Act, 1957 with effect from the AY 2016-17. Regarding the amendments on direct taxes, the Finance Bill, 2015 has 79 clauses amending the various provisions on direct taxes. Unless otherwise stated, all these amendments are proposed to be effective from 1st April, 2016 i.e. assessment year 2016-17 relevant to the income earned in the financial year 2015-16. The direct tax proposals for provisions related to non-residents in the Finance Bill, 2015 are discussed herein…

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A. Reduction in rate of tax on Income by way of Royalty and Fees for technical services in case of non–residents

Royalty and Fees for Technical Services received by a non-resident from the Government or an Indian concern (in a country with which India does not have treaty) which is not effectively connected with

a permanent establishment of the non-resident in India, are taxed at the rate of 25% on a gross basis since 2013. It is proposed to amend the Act to reduce the rate of tax provided u/s 115A on royalty and FTS payments made to non-residents to 10%.

Where an Indian concern has to make a payment net of taxes (DTAA rates ignored for the sake of simplicity) -

Particulars	Existing Rate–25% (27.04%-incl. 5% surcharge and 3% cess)	Proposed Rate–10% (10.815%-incl. 5% surcharge and 3% cess)
Net payment to be made	100	100
Tax to be deposited	37.06	12.12
Out of pocket cost	**137.06**	**112.12**

This is a welcome amendment and would certainly help Indian companies to hire services of foreign/non-resident service providers at lower cost. This reduction of rate will also help suppliers in other countries such as US and UK where the tax rate under the treaty is higher than 10%.

B. Fund Managers in India not to constitute business connection of offshore funds

Finance Bill, 2015 proposes to introduce Section 9A to facilitate location of fund managers of off-shore funds in India. In the case of an "eligible investment fund", the fund management activity carried out through an "eligible fund manager" acting on behalf of such fund shall not constitute business connection in India of the said fund and such fund shall not be regarded as a resident in India.

However, this exception is provided subject to fulfilment of many conditions by the Fund and the Fund managers, *e.g.*

- The fund should have a minimum of 25 members who are not connected persons.
- The fund shall not carry on or control and manage, directly or indirectly, any business in India or from India.
- Restriction on investor commitment: Any member of the fund along with connected persons shall not have any participation interest in the fund exceeding 10% and the aggregate participation interest of ten or less members along with their connected persons in the fund shall be less than 50%.
- Fund manager cannot be an employee, *i.e.* the exemption does not extend to fund managers who are employees or connected persons of the fund.

The Finance Bill, 2015 proposes to introduce an explanation under Section 9(1)(v) to provide that any interest payable by a permanent establishment (PE) in India of a foreign bank to its head office or any other overseas branches outside India shall be deemed to accrue or arise in India and shall be chargeable to tax, in addition to any income attributable to that PE in India.

Though, it employs a number of rigid criteria, the proposal would be a big boost to the fund industry since the large quantum of such managers would relocate to India.

C. Taxability in case of indirect transfers

The Finance Act, 2012 had inserted Explanation 5 to Section 9(1)(i) which provided that shares or interest in an entity outside India will be deemed to be situated in India if the said shares or interest derive directly or indirectly their value substantially from assets located in India.

It has been now clarified that shares or interest of the foreign entity will be deemed to derive its value substantially from assets located in India, if on the specified date the value of Indian assets (i) exceeds ₹10 crore (100 million); and (ii) represents atleast 50% of the value of all assets owned by the company.

Value of an asset would mean the FMV of such asset without reduction of liabilities and specified date of valuation will be the date on which the accounting period of the company ends preceding the date of transfer. Where the book value of the assets on the date of transfer is more than 15% of the book value as on the last balance sheet date, the value as on the date of transfer should be considered. Taxation with respect to indirect transfers will be done on proportionate basis, *i.e.* only in respect of value of Indian assets. Rules shall be prescribed for determination of FMV of Indian assets *vis-à-vis* global assets and for computing proportionate income.

Small shareholders of a foreign company or entity would be exempt from the indirect transfer provisions provided such shareholders do not hold

any right of management or control and do not hold more than 5% of the voting power or the share capital of the foreign company directly holding the Indian assets.

However, indirect transfer of shares of an Indian company pursuant to an amalgamation or demerger of foreign companies is proposed to be exempt from capital gains if certain conditions are fulfilled.

A reporting obligation has also been imposed requiring an Indian entity to submit prescribed information and documents relating to indirect transfer of their shares. Non-reporting would cause a penalty.

D. Clarity regarding source rule in respect of interest received by the non-resident in certain cases

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Mumbai ITAT Special Bench had held in the case of *Sumitomo Mitsui Banking Corporation* that the income received by the HO is not liable to tax in India under the domestic law. The branch and HO are same legal entities and thus, the interest paid by branch to HO is also not deductible under the Act. Hence, TDS provisions u/s 195 are also not applicable on the interest payments.

However, it was held by the Calcutta HC in the case of *ABN AMRO Bank* that interest paid by a branch of a foreign bank (PE in India) to HO is deductible in computing taxable profits of PE in India. However, HO is not liable to pay any tax on interest earned from branch under the Act and that there is no obligation on branch to deduct tax while making remittance of interest to HO or other branches.

These controversies have been resolved now by way of a proposed amendment.

The Finance Bill, 2015 further proposes to define the POEM 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.

E. Amendment to the conditions for determining residential status in respect of Companies

Section 6(3) - Existing	Section 6(3) - Proposed
A Company is resident in India, if – Incorporated in India; or – Whole of the control and management situated in India.	A Company is resident in India, if – Incorporated in India; or – **Its Place of Effective Management (PoEM) is situated in India at any time during the financial year.**

The Finance Bill, 2015 further proposes to define the POEM 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. Once a company is treated as an Indian resident, the consequence would be that its global income will be subject to tax in India.

This change has been introduced based on international standards. Most of the tax treaties entered into by India recognises the concept of POEM for determination of residence of a company as a tie-breaker rule for avoidance of double taxation. Many countries prefer the POEM test to be an appropriate test for determination of residential status of a company.

The determination of POEM is a facts based exercise. Globally there are well recognised guiding principles for determination of POEM. The OECD commentary on model convention defines the POEM to mean the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole, are, in substance, made. However, India does not adhere to the interpretation of the same (Para 24 of commentary on Article 4). **India is of the view that the place where the main and substantial activity of the entity is carried on is also to be taken into account while determining the POEM**.

There are various decisions as to what would constitute "POEM". It was held in the case of *X Ltd., In re [1996] 86 TAXMAN 252 (AAR-DELHI)* that the words 'place of effective management' refer to

the place from where, factually and effectively, the day-to-day affairs of the companies are carried on and not to the place in which may reside the ultimate control of the company. It was held in the case of *Radharani Holdings Pvt Ltd vs. Addl CIT (110 TTJ 920) (Delhi ITAT)* that the expression "control and management" means central control and management and not carrying on of day-to-day business and that the fact that one of the directors who holds 99 % shares of the company is resident in India or that the company has invested its entire funds in India is not decisive.

Further, under the tax treaties, the POEM test is not applicable with respect to 'any time during the year' as proposed in the Bill. Thus, one may still argue that the more beneficial test under the tax treaty should apply. One can foresee considerable litigation on this account and also bilateral mutual agreement proceedings to resolve treaty applicability as both the domestic law and the tie breaker rule under the tax treaty would have the POEM test.

It may also severely complicate the situation because the effective control and management at any time in the year is relevant. This will definitely be a highly litigated issue in years to come as the identification of the POEM leaves much to the discretion of the Revenue Authorities. Further, it is not clear what would constitute the place where "key management decisions are in substance made", i.e. whether the residence of directors will be looked at, location of board meetings or other criteria. An Indian company having a subsidiary in abroad might have to take too many precautions to establish that the key management decisions pertaining to the business of the subsidiary company are made in the foreign country and those decisions are not influenced by the Indian parent company.

The CBDT is expected to issue guidelines to clarify as to what would constitute POEM.

F. Form 15CA/CB

In order to increase scrutiny of all payments to non-residents, the Finance Bill, 2015 proposes that the person responsible for paying any sum, whether chargeable to tax or not, to a non-resident, shall be required to furnish the information of the prescribed sum in such form and manner as may be prescribed.

G. Rationalisation of MAT provisions - FII

To promote investment climate in India, the Finance Bill, 2015 proposes that any income from capital gains from transactions in securities (other than short term capital gains arising on transactions on which STT is not chargeable) arising to the FII which has invested in such securities in accordance with the SEBI Act, 1992, shall be excluded from the chargeability of MAT.

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Only 'capital gains' from transactions in 'securities'(other than short term capital gains on which securities transaction tax is not payable) earned by FIIs will be excluded from the 'book profit'. All other income (including dividend and interest) earned by these FIIs will be included in the book profit by implication.

The controversy was revolving as to the applicability of MAT provisions to the foreign companies after the AAR rulings in the case of *Castleton Investments Ltd in Re [TS 607-AAR-2012]*. However, it has been implicitly clarified that foreign companies not having a presence in India and not keeping books of account in India (including FIIs) are also liable to MAT.

Conclusion

The amendments proposed in the Finance Bill, 2015 do meet some of the expectations of Non Residents and FIIs. However, the concept of POEM introduced in this budget for determining residential status of companies shall require more detailed guidelines to reduce litigations. The amendments in the indirect transfer provisions will soften the sentiments of the non-resident investors who believed in India but were scared of the tax terrorism in India. ■