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Tax

# Citi Global Transaction Services

## Revised Direct Taxes Code, 2010 - India

October 12, 2010

BMR Advisors

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# Introduction to the revised Code

## Introduction

- First draft of the Direct Taxes Code Bill, 2009 released on August 12, 2009
- Revised discussion paper ('RDP') addressing select key points released on June 15, 2010
- The government presented the revised Code in the parliament on August 30, 2010
- The new Code expected to be effective from April 1, 2012 (FY 2012-13)
- Key features of the revised Code are:
  - Overhauls the extant income tax and wealth tax regime
  - Rationalizes tax rates
  - Reduces corporate tax rate to 30% for Indian and foreign companies
  - Introduces branch profit tax at 15% for foreign companies
  - Dividend distribution tax rate retained at 15%
  - Minimum alternate tax increased to 20%
  - No additional surcharge or cess

# Taxation of FIs

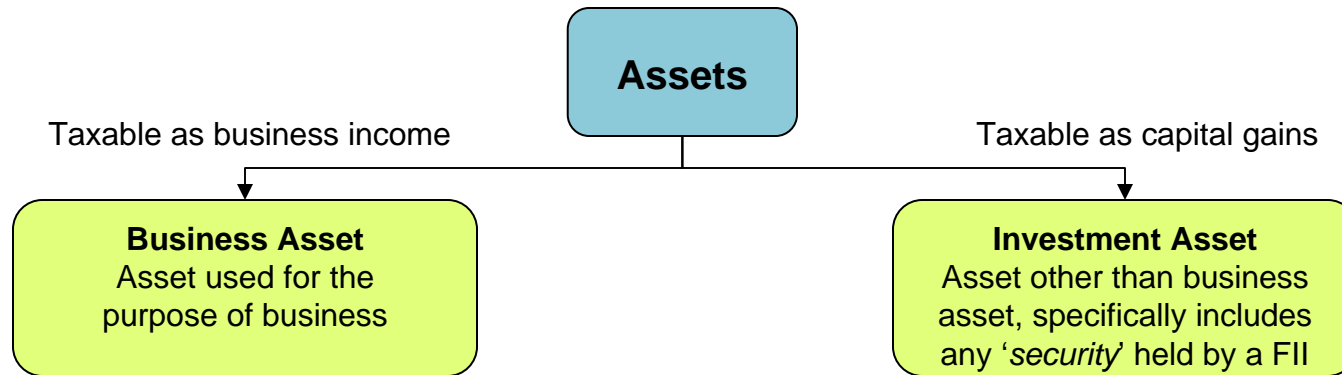
## Taxation of FIIs under the current regime

- Gains on sale of shares are generally characterized as capital gains taxable as under:

| Particulars  | Rate of tax (excluding surcharge and cess) |
|--|--|
| Long-term capital gains arising on shares sold on a recognized stock exchange  | Nil  |
| Long-term capital gains arising on shares sold off the exchange                | 10%  |
| Short-term capital gains arising on shares sold on a recognized stock exchange | 15%  |
| Short-term capital gains arising on shares sold off the exchange               | 30%  |

- These rates may be reduced under a favourable tax treaty; some FIIs claim their gains as business income under the applicable tax treaty
- Securities transaction tax ('STT') is payable on all transactions executed on the stock exchanges

# Taxation of FIIs under the revised Code



| Particulars   | Rate of tax                          |
|---|--------------------------------------|
| Capital gains arising on shares and units of mutual funds sold on a recognized stock exchange after holding for <i>more than 1 year</i> | Nil<br>(100% deduction)              |
| Capital gains arising on shares and units of mutual funds sold on a recognized stock exchange after holding for <i>1 year or less</i>   | 15%<br>(50% deduction)               |
| Capital gains arising on sale of other investment assets after holding for <i>1 year from end of the financial year of purchase</i>     | 30% - gain computed after indexation |
| Capital gains arising on sale of other investment assets before holding for <i>1 year from end of the financial year of purchase</i>    | 30% - no indexation                  |

## Taxation of FIIs under the revised Code

- STT will continue to apply
- Gains on sale of bonds or GDRs by a non-resident to another outside India will continue to be exempt
- As under the current regime, no tax withholding to apply on consideration for sale of listed securities
- Interest income to be subject to tax withholding at 20%
- No provision for carry forward and set off for losses accumulated prior to April 1, 2012
- Long term losses which are 100% deductible, no set off or carry forward possible
- Short term losses will be allowed to be set off and carried forward to the extent of 50%

## Income from Derivatives and ODIs

### *Derivatives*

- Income from derivatives is currently treated as business income
- Exempt if trading from a treaty country and if there is no PE
- Under the revised Code, income from derivatives will be taxed as 'capital gains'
- Income to be taxed at 30% under the revised Code (indexation benefit available for contracts above 1 year)
- Income may continue to be exempt if treaty benefits available
- Losses can be set off against income from ordinary sources (ie business income, capital gains) and carried forward

### *ODIs*

- Indirect transfer made liable to tax, though only covers share or interest in a foreign company with 50% or more Indian assets at any time in 12 months prior to transfer
- GAAR implications

# **Income from investments in Mutual Funds**

## Taxation of investments in Mutual Funds

| Particulars                        | Under the current regime | Under the revised Code                        |
|------------------------------------|--------------------------|---|
| <b>Money market / liquid funds</b> |                          |   |
| DDT                                | 25% (Nil*)               | Nil (20%*)                                    |
| Sale/redemption of units           | LTCG – 10%<br>STCG – 30% | 30%   |
| <b>Equity oriented funds</b>       |                          |   |
| DDT                                | Nil (Nil*)               | 5% (Nil*)                                     |
| Sale/redemption of units           | LTCG – Nil<br>STCG – 15% | LTCG – 100% deduction<br>STCG – 50% deduction |
| <b>Other funds</b>                 |                          |   |
| DDT                                | 25% (Nil*)               | Nil (20%*)                                    |
| Sale/redemption of units           | LTCG – 10%<br>STCG – 30% | 30%   |

\*Figures in brackets represent withholding rates applicable to FII investors on income from mutual fund units

## **GAAR and treaty override**

## GAAR and treaty override

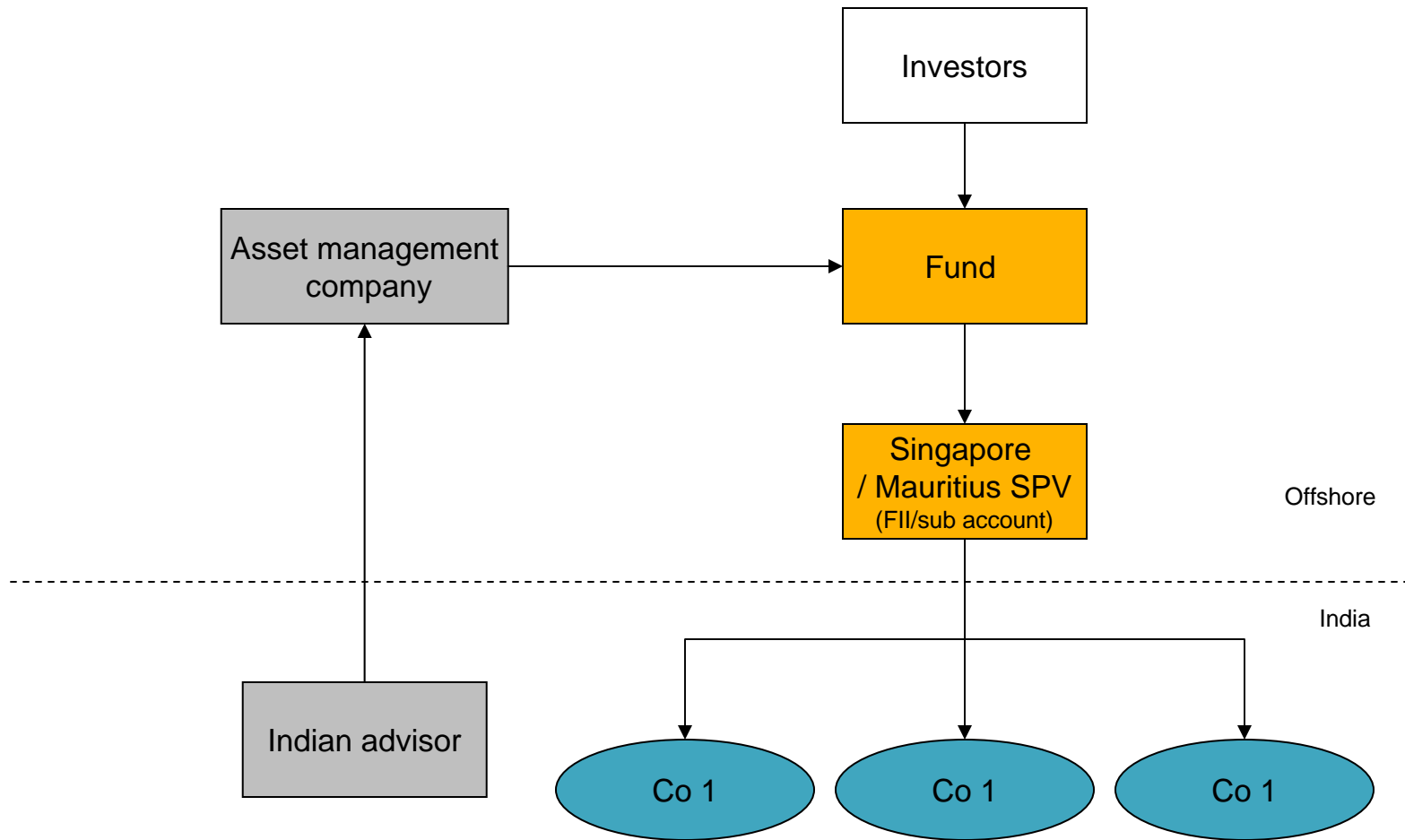
- Applies to a tax avoidance transaction, if undertaken with the main purpose of obtaining a 'tax benefit' and it:
  - creates rights or obligations, which would not be created if the transaction was implemented at arm's length; or
  - results in, directly or indirectly, misuse of the provisions of the Code; or
  - lacks commercial substance in whole or in part; or
  - is implemented by means, which would not be normally adopted for bonafide purposes
- A transaction is deemed to be lacking commercial substance if the transaction results in:
  - a significant tax benefit without having a significant impact on the business risks, or
  - net cash flows from a situation where the transaction would have been implemented at arm's length
  - if the form of the transaction significantly differs, in whole or in part, from its legal substance or involves round tripping
- Revenue may disregard parties, reallocate/re-characterize income or disregard the arrangement or deny treaty benefits

## GAAR and treaty override

- Onus to prove that the transaction is not an avoidance transaction is on the tax payer
- RDP provided for the following to reduce the impact of GAAR:
  - The CBDT will issue guidelines to govern when GAAR provisions should / could be invoked
  - A safe harbor, possibly a monetary one, to be included for invoking GAAR
  - Option to approach Dispute Resolution Panel if GAAR applied
- The provisions of the revised Code or treaty whichever is more beneficial to the tax payer to apply except *inter alia* where GAAR is invoked

## **Implications on common current structures**

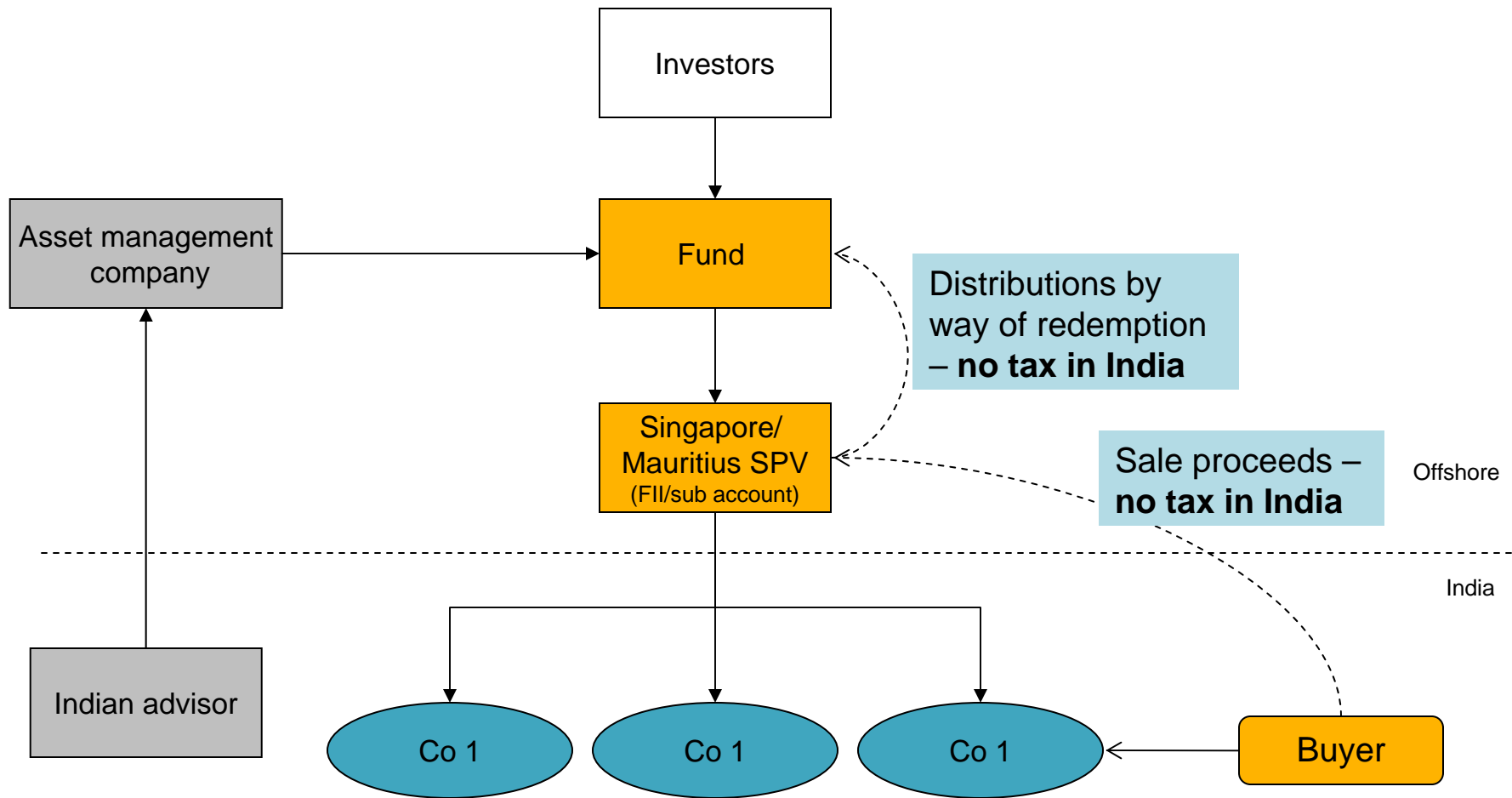
# Typical current fund structure



## Tax rationale for current structures

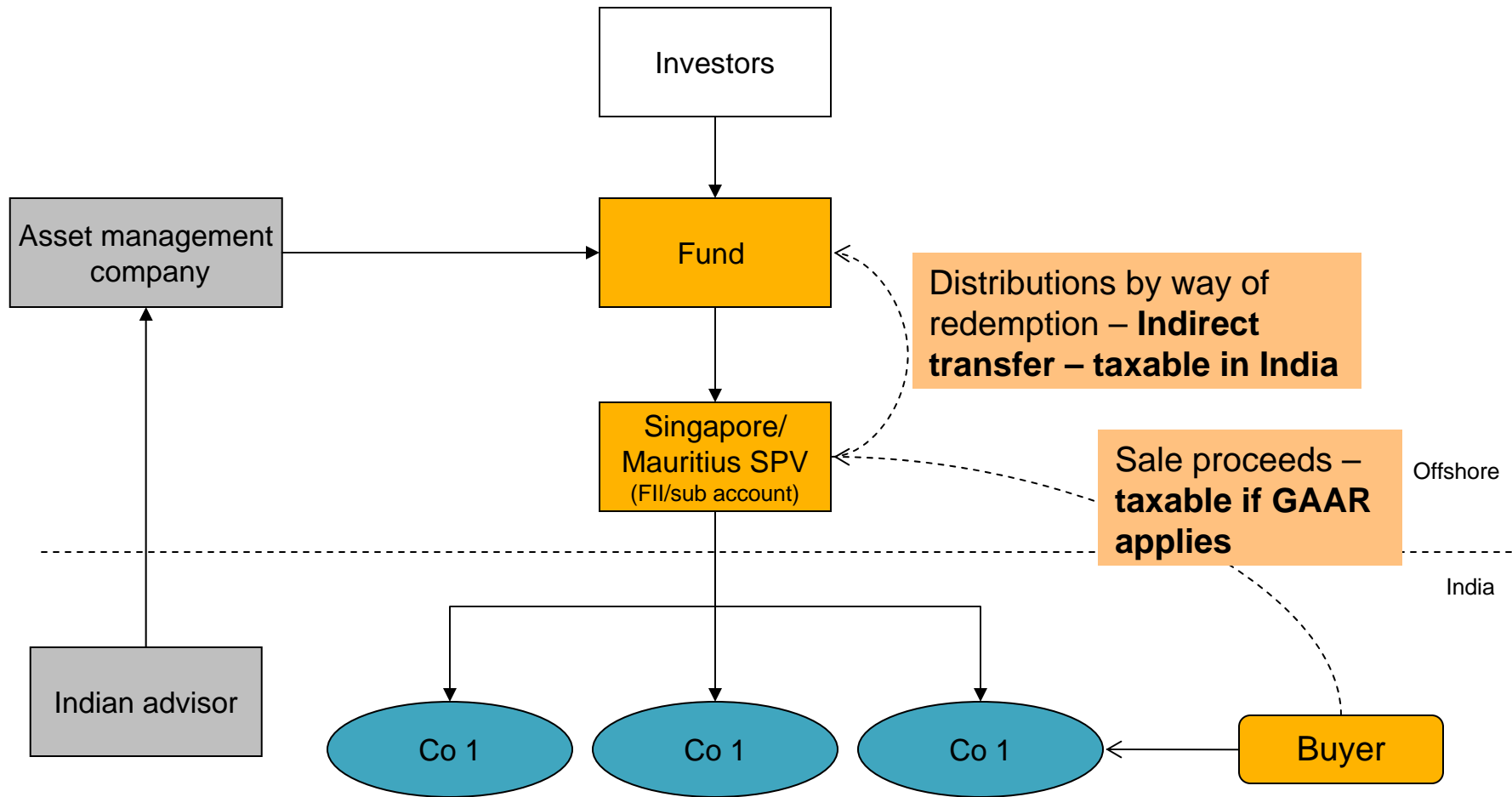
- Investments typically made through Singapore / Mauritius to avail capital gains tax exemption in India
- Little or no substance in holding company
- Treaty relief available on the basis of Mauritius tax residency certificate
  - Central Board of Direct Taxes ('CBDT') circular no 333 – Treaty overrides domestic law
  - CBDT circular no 789 – Relief to be provided if tax residence established
  - Supreme Court ruling – Treaty relief to be provided based on treaty and circular no 789; substance test cannot be applied
- Tax treaty benefits for capital gains available to Singapore entities if :
  - Entity not set up for taking advantage of the treaty
  - Annual expenditure of S\$ 200,000 for 2 years or listed on a stock exchange

# Taxation under the current regime



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# Tax implications under the revised Code



## Planning considerations

- Establishing the investment manager in the SPV jurisdiction
- Pooling of funds into the SPV
- Holding multiple investments through one SPV
- Holding investments in jurisdictions beyond India
- Treaties with limitation condition may be a safer bet
- Have appropriate number of local directors with relevant experience and expertise on the board of SPV
- Conduct at least one physical board meeting in Mauritius
- Conduct annual general meeting in Mauritius
- Take day-to-day management decisions of the company in Mauritius and not elsewhere

## Planning considerations

- Adhere to the corporate governance and procedural aspects like
  - signing of agreements by Mauritius directors or in Mauritius by foreign directors
  - procurement of services invoices in Mauritius
  - office should be in Mauritius
  - company to appoint consultants / advisors
  - to have employees on payroll for critical functions
- All transactions to have business purpose and economic substance
- All payments should be routed through Mauritius
- Make disclosures about the tax risk to the investors
- Watch for any treaty development

## Credentials

- Shefali Goradia is a partner with BMR Advisor's corporate tax practice. Having over 19 years' experience in international tax; Shefali specializes in cross-border taxation
- She advises multinational corporations in designing global holding and operating structures, structuring inbound and outbound investments, cross border mergers, acquisitions and other corporate reorganizations
- She has worked extensively with leading investment and private equity fund houses on developing and implementing domestic and international fund structures. She has assisted multinational companies doing business in and with India in obtaining private rulings on their taxability in India
- Shefali is seen featured as one of the pre-eminent practitioners in the 2010 Guide to the World's Leading Investment Funds Lawyers and is also listed in The International Who's Who of Corporate Tax Lawyers and The Private Funds Lawyers for the year 2009 and 2010



## Credentials

- She is recognized as among the eight best Indian tax advisers by *Legal 500* and the *Tax Directors Handbook 2009*. Shefali also represents India in the Legal Media Group *Guide to the World's Leading Tax Advisers* and has been recognized as among the top 10 tax advisers in India in *World Tax 2004*, 2005 and 2006. She has also been recognized as a leading adviser in capital markets and financial products in 2006.



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