India update – Keeping up with change
Gagan Malik
Broad discussion agenda

► Rapidly changing tax environment
► Transfer pricing landscape
► Planning opportunities in a dynamic tax environment
► Q&A
Rapidly changing tax environment
Indian tax landscape

▶ Indian economy recorded lower-than-expected growth:
  ▶ Uncertain global economic environment
  ▶ Domestic challenges

▶ Lower revenue collections as a result of economic slowdown

▶ In line with global trends, authorities focusing on areas such as:
  ▶ Cross-border transactions
  ▶ Transfer pricing
  ▶ Aggressive tax planning
Indian tax landscape

Top tax demands in India
($ in billion)

- Vodafone B.V.: US$ 2.5
- Vodafone India Services: US$ 1.5
- Shell: US$ 1.0
- Nokia: US$ 0.5
- Sanofi: US$ 0.2
- Idea Cellular: US$ 0.5

More than 50% of disputed taxes are asked to be paid during litigation

Interest (12% per annum) and penalty (100% to 300%) implications

Severe impact of tax adjustments

Sometimes, can make business unviable with huge tax demands

Significant time of top management consumed in large tax disputes – Litigation can last for 8-10 years
So what has changed in the last two years … ?

Introduction of General Anti Avoidance Rule (GAAR):

- Originally part of draft Direct Tax Code
- Introduced in Finance Act 2012
- Recommendations of Shome Committee
- Developments in Finance Act 2013
- Effective from 1 April 2015
- Arrangements with “main purpose” as obtaining tax benefit is covered
- Treaty override possible if GAAR triggered
- GAAR Rules
- Several issues yet to be clarified
- Way forward
Rules for application of GAAR notified

A snapshot

► GAAR not to apply:
  ► Aggregate tax benefit does not exceed INR 30 Million.
  ► FII not claiming Treaty benefits
  ► A non resident investor in an FII by way of an offshore derivative instrument or otherwise
  ► Any income derived from transfer of investment made prior 30 August 2010

► Where only a part of an arrangement is GAAR-infected, the tax consequences would be determined with reference to such infected part only

Procedural steps notified in rules
So what has changed in the last two years … ?

► Tax Residency Certificate (TRC):
  ► Circular 789 of April 2000
  ► Developments in Finance Act 2012 and Finance Act 2013
  ► “Necessary, but not sufficient” for claiming treaty benefits – finally not enacted
  ► TRC in “prescribed” form – replaced by self declaration

► Taxation of “indirect transfers”:
  ► Decision by Supreme Court in the case of Vodafone
  ► Introduced in Finance Act 2012
  ► Effective from 1 April 1962
  ► If, *inter-alia*, “substantial value” test is met
  ► Recommendations of Shome Committee
  ► Government yet to firm up position on many aspects
So what has changed in the last two years …?

- Practical impact of TRC issues, indirect transfer provisions, etc:
  - Is Mauritius’ structure still viable and, if so, for how much longer?
  - Is there an alternative for a Mauritius structure?
  - Challenges in cross-border deals
    - Uncertainties as regards withholding tax
    - Various alternatives

- Taxation of “buy-back” of shares:
  - Introduced in Finance Act 2013
  - Applicable wef 1 June 2013
  - Applicable to “unlisted companies”
  - Tax burden on Indian company instead of investor
    - Profit repatriation through use of appropriate “holding company” impacted
So what has changed in the last two years … ?

- Taxation of “software payments”:
  - Royalty-related provisions amended in Finance Act 2012
  - Applicable retrospectively from 1 June 1976
  - Transactions previously considered as “sale” now covered in definition of “royalty”
  - Different position under relevant treaty is possible

- Withholding tax on royalty and fees for technical services (FTS):
  - Rate increased from 10% to 25% in Finance Act 2013
  - Different position under relevant tax treaty is possible

- Withholding tax on Interest – concessional tax rate
Key developments in the TP landscape

- Transfer pricing enforcement environment
  - Number, complexity and monetary consequences of TP disputes have increased
  - Estimated transfer pricing adjustments in India

<table>
<thead>
<tr>
<th>Financial year</th>
<th>No. of cases</th>
<th>Cases adjusted</th>
<th>Cases adjusted (%)</th>
<th>Estimated adjustment (in million USD)</th>
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<tr>
<td>2001-02</td>
<td>1,061</td>
<td>239</td>
<td>23</td>
<td>203</td>
</tr>
<tr>
<td>2002-03</td>
<td>1,501</td>
<td>337</td>
<td>22</td>
<td>381</td>
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<tr>
<td>2003-04</td>
<td>1,768</td>
<td>471</td>
<td>27</td>
<td>572</td>
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<tr>
<td>2004-05</td>
<td>218</td>
<td>84</td>
<td>39</td>
<td>269</td>
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<tr>
<td>2005-06</td>
<td>1,726</td>
<td>670</td>
<td>39</td>
<td>1,023</td>
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<td>2006-07</td>
<td>1,830</td>
<td>813</td>
<td>44</td>
<td>1,818</td>
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<td>2007-08</td>
<td>2,301</td>
<td>1,138</td>
<td>49</td>
<td>3,873</td>
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<tr>
<td>2008-09</td>
<td>2,638</td>
<td>1,343</td>
<td>52</td>
<td>7,422</td>
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</table>

Source: First report of the Rangachary Committee to review taxation of development centers and the IT sector
Key developments in the TP landscape

► Significant increase in quantum of TP disputes
  ► Estimate of total quantum of TP adjustments made in the latest audit cycle - US$ 12B

► Some new contentious issues
  ► Transactions involving infusion of equity capital
  ► Profit split in case of R&D centres
  ► Location savings
  ► Marketing intangibles
  ► Intra-group services
  ► Corporate guarantees
  ► Interest rates on outbound loans
Some positive developments
- APAs – a new ray of hope
- Circular for TP of R&D centres
- Safe harbors
- Revival of MAP process

Domestic TP regulations
Evolving jurisprudence
Penalties for non disclosure of transactions in TP certificate
Electronic filing of TP certificate
Some recent controversies

TP implication on issue of shares

- One of the most controversial issues in recent TP audits
- TPO examines the valuation of shares for computation of share premium amount
- TPO applies DCF method of valuation and changes the cash flow assumptions and arrives at a high valuation
- TPO determines that for the number of shares issued, the total quantum of inward capital remittance is less
- Difference between the quantum of capital as determined by the TPO and the actual capital infused is treated as income
- Further, the fact that a portion of the capital was not received by the Indian company, an interest is also imposed (secondary adjustment).
- Currently under litigation at High Court and Dispute Resolution Panel
Some recent controversies

► Location savings
  ► Arising out of India’s comments in the UN TP Manual
  ► TPOs in some jurisdictions have made some adjustments based on location savings
  ► Cost of manufacture in India compared with the cost of manufacture in the jurisdiction of the buyer
  ► Difference deemed to be location savings and 50% of the savings attributed to the contract manufacturer in India
  ► No cognisance to bargaining power and price charged by comparable third party manufacturers in ordinary course of business
Some recent controversies

► Marketing intangibles

► Special Bench of the Tribunal ruled that excess AMP spend by distributor needs to reimbursed by legal owner of trademark or brand
► Ruling relies on the premise that there is no concept of economic ownership under the Indian tax and TP provisions and hence, distributor shall not spend more than the bright line
► Bright line to be determined by applying the right comparable set
► The Tribunal has laid down a set of 14 conditions to select the comparable set for applying bright line
► Practically it may be a challenge to meet the 14 conditions
► Subsequent ruling has recognized that AMP adjustment may not be required where the distributor is an LRD and makes more net margin as compared to comparables
Some positive developments

- Safe harbors (SH)
  - SH Rules shall be applicable for a period of five fiscal years (i.e., tax AY 2013-14 onwards)
  - Taxpayer can opt for a period not exceeding five years
  - Taxpayer can opt out of the SH for any of the subsequent years
  - SH do not apply to specified domestic transactions
- Conditions
  - Benefit of range not available
  - No MAP recourse
  - Taxpayer cannot elect if the foreign Associated Enterprise is located:
    - In a country or notified territory (section 94A - Finance Act, 2011); or
    - In a low tax or no tax country - Country with maximum marginal rate of tax less than 15 percent
  - Need to maintain transfer pricing documentation
## Safe harbor rules

### Sector wise analysis

<table>
<thead>
<tr>
<th>S. No.</th>
<th>International Transaction</th>
<th>Condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>ITS and ITeS – Max INR 500 crores (Insignificant risk bearer)</td>
<td>OP/ OC &gt;= 20%</td>
</tr>
<tr>
<td>2</td>
<td>ITS and ITeS – Above INR 500 crores (Insignificant risk bearer)</td>
<td>OP/ OC &gt;= 22%</td>
</tr>
<tr>
<td>3</td>
<td>ITES – KPO services - (Insignificant risk bearer)</td>
<td>OP/ OC &gt;= 25%</td>
</tr>
<tr>
<td>4</td>
<td>Intra Group Loan to WOS &lt;= INR 50 crores</td>
<td>Base rate on 30 June of PY (SBI) + 150 bp</td>
</tr>
<tr>
<td>5</td>
<td>Intra Group Loan to WOS &gt; INR 50 Crores</td>
<td>Base rate on 30 June of PY (SBI) + 300 bsp</td>
</tr>
<tr>
<td>6</td>
<td>Explicit Corporate Guarantee to WOS &lt;= INR 100 Crores</td>
<td>2% or more P.A on amount guaranteed</td>
</tr>
<tr>
<td>7</td>
<td>Explicit Corporate Guarantee to WOS &gt; INR 100 crores (WOS rated to be of adequate to highest safety)</td>
<td>1.75% or more P.A on amount guaranteed</td>
</tr>
<tr>
<td>8</td>
<td>Contract R&amp;D for software development (Insignificant risk bearer)</td>
<td>OP/ OC &gt;= 30%</td>
</tr>
<tr>
<td>9</td>
<td>Contract R&amp;D for generic pharmaceutical drugs (Insignificant risk bearer)</td>
<td>OP/ OC &gt;= 29%</td>
</tr>
<tr>
<td>10</td>
<td>Manufacture and export of core auto Components</td>
<td>OP/ OC &gt;= 12%</td>
</tr>
<tr>
<td>11</td>
<td>Manufacture and export of non core auto components</td>
<td>OP/ OC &gt;= 8.5%</td>
</tr>
</tbody>
</table>
Planning opportunities in a dynamic environment
Use of LLP

Considerations:

► Regulatory approval required for setting up LLP
► Practical issues in operating an LLP structure
► Taxation in FCo’s jurisdiction
► Converting an existing company into LLP

ICo subject to corporate tax or Minimum Alternate Tax ("MAT")

In addition, ICo subject to Dividend Distribution Tax ("DDT") or shares buyback tax

LLP subject to corporate tax

No MAT, DDT or share buyback tax
## Financing Indian operations

Typically used financing strategies:
- **Equity**
- **Repayable debt**
- **Debt that converts into equity at maturity (compulsorily convertible debt or “CCDs”)**

### Table

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Equity</th>
<th>Debt</th>
<th>CCDs</th>
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</thead>
<tbody>
<tr>
<td><strong>Regulatory issues</strong></td>
<td>• No end use restrictions</td>
<td>• End use restrictions, minimum maturity period, etc.</td>
<td>• No end use restrictions</td>
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<tr>
<td><strong>Tax treatment of dividend and interest</strong></td>
<td>• No deduction for dividend</td>
<td>• ICo can claim deduction for interest paid at 33.99%</td>
<td>• ICo can claim deduction for interest paid at 33.99%</td>
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<tr>
<td></td>
<td>• DDT at 16.995%</td>
<td>• Interest subject to withholding tax in India at 5 – 15%</td>
<td>• Interest subject to withholding tax in India at 10 – 15%</td>
</tr>
<tr>
<td></td>
<td>• Often exempt in shareholder’s country</td>
<td>• Often taxed in lender’s jurisdiction</td>
<td>• Exemption in CCD-holder’s country could be explored</td>
</tr>
<tr>
<td><strong>Principle repayment</strong></td>
<td>• Buyback tax may apply</td>
<td>• Not taxable</td>
<td>• Buyback tax may apply</td>
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</tbody>
</table>
### Financing Indian operations

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Equity Amt</th>
<th>Particulars</th>
<th>CCDs Amt</th>
</tr>
</thead>
<tbody>
<tr>
<td>PBIT of ICo</td>
<td>100.00</td>
<td>PBIT of ICo</td>
<td>100.00</td>
</tr>
<tr>
<td>(-) Interest</td>
<td>0.00</td>
<td>(-) Interest</td>
<td>30.00</td>
</tr>
<tr>
<td>PBT</td>
<td>100.00</td>
<td>PBT</td>
<td>70.00</td>
</tr>
<tr>
<td>(-) Tax</td>
<td>33.99</td>
<td>(-) Tax</td>
<td>23.80</td>
</tr>
<tr>
<td>PAT</td>
<td>66.01</td>
<td>PAT</td>
<td>46.20</td>
</tr>
<tr>
<td>(-) DDT</td>
<td>9.58</td>
<td>(-) DDT</td>
<td>6.71</td>
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<tr>
<td>Profit available for distribution</td>
<td>56.41</td>
<td>Profit available for distribution</td>
<td>39.49</td>
</tr>
<tr>
<td>Dividend</td>
<td>56.41</td>
<td>Dividend</td>
<td>39.49</td>
</tr>
<tr>
<td>Tax for shareholder</td>
<td>0.00</td>
<td>Tax for shareholder</td>
<td>0.00</td>
</tr>
<tr>
<td>Net tax cost</td>
<td>43.57</td>
<td>Net tax cost</td>
<td>33.51</td>
</tr>
</tbody>
</table>

### Considerations:

- Use of CCDs in specific situations
- Determining arm’s length interest on CCD
- Possibility of CCD qualifying as equity in the investor country
Concluding remarks

► Increased awareness of tax in board rooms

► Legislative changes may cause changes in ways in which groups have structured themselves historically:
  ► Significant challenges and opportunities

► Potential departure from OECD principles may cause uncertainty

► International tax planning continues in this environment

► Implementation more important than ever
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