# handbook on direct taxes

## a primer 1st edition

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# I. Introduction

Indian domestic laws relating to income tax are contained in the define in Glossary. The Act covers within its ambit, all types of income including capital gains. The Act is a central Act of Parliament and is reviewed annually when the Finance Bill (part of the Union Budget) is presented.

The purpose of this handbook is to provide a broad overview of the Indian domestic tax regulations dealing with income tax and seeks to highlight the key income tax provisions that may impact foreign investors investing in India.

For the purpose of this handbook, we have considered the provisions of the Act, as amended up to October 31, 2015. Further, all the tax rates mentioned herein are inclusive of applicable surcharge and educational cess.

We present this handbook as an introduction to the broad features of the Indian tax system. It is only meant as a reference guide on various direct tax related matters that may be considered by a foreign investor while transacting business with India. This handbook may be read in conjunction with our other primers on Doing Business in India (first edition) and for a holistic understanding of the Indian business environment and regulations therein.

**NOTE:** All information given in this handbook has been compiled from credible and reliable sources. Although reasonable care has been taken to ensure that the information in this handbook is true and accurate, such information is provided 'as is', without any warranty, express or implied, as to the accuracy or completeness of any such information. Cyril Amarchand Mangaldas shall not be liable for any losses incurred by any person from the use of this publication or its contents. This handbook does not constitute legal or any other form of advice by Cyril Amarchand Mangaldas. Readers should consult their legal, tax and other advisors before making any investment or other decision with regard to any business in India or any investment from India on the basis of this Handbook. We are not responsible for any losses suffered by any person on account of any action taken on the basis of this Handbook.

# II. General

## 1. Who is an assessee under the Act?

An assessee (i.e. taxpayer) is a person who is liable to pay tax (or any other sum(s) of money) under the Act. A 'person' is defined to include:

- Individuals;
- Hindu Undivided Family;
- Companies;
- Firms (including a LLP);
- Association of persons or body of individuals;
- Local authorities; and
- Every artificial juridical person.

## 2. What is charged to income tax?

Income tax is payable on income accruing, arising or received by the assessee in India or on income deemed to be accruing, arising or received in India. Such income is classified into five different heads for the purposes of taxation:

- Income from salary;
- Income from house property;
- Income from business or profession;
- Income from capital gains; and
- Income from other sources.

## 3. What is the incidence of tax?

Income tax is payable on the total income earned in the relevant tax year (the period commencing from April 1 to March 31) by an assessee. The total income tax payable is dependent on the assessee's residential status and nature of income.

For an assessee resident in India, his global income (i.e., income that is derived from India as well as outside India) is taxable in India, whereas income of a non-resident is subject to tax in India only if it is received/deemed to be received in

India or accrues/arises/is deemed to accrue or arise to him in India. For an assessee who is not ordinarily resident in India, income accruing or arising to him outside India will not be taxable in India unless it is derived from a business controlled from/profession set up in India.

## 4. How is the residential status of the assessee determined under the Act?

(a) An individual is treated as resident in India, if he satisfies any of the following two basic conditions:

- He stays in India for 182 days or more during the tax year under consideration; or
- He stays in India for 60 days or more during the tax year under consideration, after having stayed in India for 365 days or more during the 4 tax years preceding the tax year under consideration.

The abovementioned period of 60 days is increased to 182 days in case of a citizen of India or a person of Indian origin who comes on a visit to India from abroad.

An individual, who does not satisfy either of the above basic conditions is a 'non-resident'.

A resident individual may also qualify as 'not ordinarily resident', if he satisfies either or both of the following additional conditions:

- He has been a non-resident in India in 9 out of 10 tax years preceding the tax year under consideration, or
- He has been in India for an aggregate period of 729 days or less in 7 tax years preceding the tax year under consideration.

(b) A company is said to be resident in India if:

- It is an Indian company (as defined in the Companies Act, 1956); or
- Its place of effective management, in that year, is in India (place of effective management means 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).

(c) A firm, an association of persons and any other person (not included above) is considered to be resident in India in any relevant tax year, if the control and management of its affairs is situated wholly or partly in India.

## 5. Tax rates

### What are the tax rates applicable to individuals, LLP, and companies?

*A. Individual tax rates:*

The tax rates for individuals for the financial year 2015-16 (i.e., from April 1, 2015 to March 31, 2016) are as follows:

| Taxable Income Slabs | Tax Rates for individual assessee |
|---|---|
| Up to INR 2,50,000 | Nil |
| INR. 2,50,001 - Up to INR 5,00,000 | 10.3% |
| INR 5,00,001 - Up to INR 10,00,000 | 20.6% plus INR 25,750 |
| INR 10,00,001 and above | 30.9% plus INR 1,28,750 |

In case the taxable income exceeds INR 10 million, a surcharge @ 12% is payable on the amount of tax computed as per the above income slabs. Thus, the effective tax rate for taxpayers having income in excess of INR 10 million would be 34.61%. There are separate tax rates provided for income earned by senior citizens.

*B. LLP*

Domestic LLP is liable to pay tax @ 30.9%[1] on taxable income if the taxable income is up to INR 10 million and is liable to pay tax @ 34.61% if the taxable income exceeds INR 10 million.

[1] All tax rates specified in this note are inclusive of the applicable surcharge and education cess unless otherwise specified and have been rounded off to the nearest two decimal points.

### C. *Corporate Tax*

| Companies | For taxable income exceeding INR 100 million Rate of Tax (%) | For taxable income exceeding INR 10 million up to 100 million Rate of Tax (%) | For taxable income up to INR 10 million Rate of Tax (%) |
|---|---|---|---|
| Domestic company | 34.61 | 33.06 | 30.9 |
| Foreign company having a PE in India (i.e. including a branch and project office) | 43.26 | 42.02 | 41.2 |

The dividend received by a domestic company from a foreign company, in which the domestic company holds 26% or more of the nominal value of the equity share capital, is taxable @ 17.3% on a gross basis.

### D. *MAT*

In the event a company's tax liability is less than 18.5% of its book profits, then instead of paying income tax at the above rates, the company is required to pay MAT on the adjusted book profits (as prescribed) at the following tax rates:

| Companies | For taxable income exceeding INR 100 million | For taxable income exceeding INR 10 million up to 100 million Rate of Tax (%) | For taxable income up to INR 10 million Rate of Tax (%) |
|---|---|---|---|
| Domestic company | 21.34 | 20.39 | 19.06 |

| Companies | For taxable income exceeding INR 100 million | For taxable income exceeding INR 10 million up to 100 million Rate of Tax (%) | For taxable income up to INR 10 million Rate of Tax (%) |
|---|---|---|---|
| Foreign company having a PE in India (i.e. including a branch and project office) | 20.01 | 19.44 | 19.06 |

Tax credit is available in respect of tax paid under MAT, for a period of ten years.

## *G. DDT*

Dividend income is exempt in the hands of the shareholders, provided that DDT of 20.36% is paid by the Indian company declaring dividends.

To mitigate the cascading effect of DDT, an Indian holding company is entitled to DDT credit when paying dividends, on the dividend received by the holding company, to the extent DDT has already been paid on such dividend by its Indian subsidiary. This would be applicable where dividends are paid out by the Indian subsidiary and Indian holding company in the same financial year.

## *H. AMT*

In the event an assessee's (other than a company) tax liability is less than 18.5% of the adjusted total income, then instead of paying income tax at the normal tax rate, the assessee is required to pay AMT on the adjusted total income.

AMT is not applicable to an individual, HUF, AOP, BOI or an artificial juridical person, if the adjusted total income of such a person does not exceed INR 2 million.

Tax credit will be available in respect of tax paid under AMT, for a period of ten years.

### I *Income Distribution Tax by Mutual Funds*

Dividend income received by unit holders from a Mutual Fund is exempt from income tax. The Mutual Fund (other than equity oriented Mutual Fund) will pay income distribution tax as follows:

| Particulars | Rate of Tax (%) |
|---|---|
| Income distributed to any person being an individual or a HUF by a money market Mutual Fund or a liquid fund | 28.84 |
| Income distributed to any other person by a money market Mutual Fund or a liquid fund | 34.61 |
| Income distributed to any person being an individual or a HUF by a debt fund, other than a money market Mutual Fund or a liquid fund | 28.84 |
| Income distributed to any other person by a debt fund, other than a money market Mutual Fund or a liquid fund | 34.61 |
| Income distributed to a non-resident investor by a Mutual Fund under an Infrastructure Debt Fund scheme | 5.77 |

### J. *Interest payable by Indian companies on foreign currency borrowings in the hands of the non-resident lender*

Interest payable by Indian companies on foreign currency borrowings from a non-resident is liable to tax in India as follows (subject to any beneficial rate provided under the DTAA between India and the country of residence of the non-resident) -

- Interest on foreign currency loans, made during the period from July 1, 2012 to June 30, 2017 is taxable at a concessional rate of 5.41%, subject to fulfilment of certain conditions.
- Interest on foreign currency long-term infrastructure bonds made during the period from July 1, 2012 to October 1, 2014 is taxable at a concessional rate of 5.41%, subject to fulfilment of certain conditions.
- Interest on foreign currency long-term bonds, including long term infrastructure bonds, made during the period from October 1, 2014 to June 30, 2017 is taxable at a concessional rate of 5.41%, subject to fulfilment of certain conditions.
- Interest on foreign currency loans received from the Government or an Indian concern not covered by the above is taxable @ 21.63%.
- Interest on FCCB of an Indian company issued in accordance with the FCCB Scheme is taxable @ 10.82%.

### K. *Royalties and/or fees for technical services received by a foreign company*

Royalties and/or fees for technical services received by a foreign company (not having a PE in India) are liable to tax in India @ 10.82% as per the Act. However, this rate is subject to any concessional rate available under any DTAA between India and the country of residence of the non-resident.

### L. *Other significant taxes are payable in India*

Wealth Tax - Companies are liable to pay wealth tax @ 1% of the net wealth of such specified assets as held by the company, on the last day of the tax year. The wealth tax is payable if the net wealth exceeds INR 3 million.

The Finance Act, 2015 has now abolished wealth tax. As a result, wealth tax would not be applicable from financial year 2015-16.

M. ***STT - STT is payable on the taxable securities transaction at the specified calculated rates on the value of such transactions. To illustrate:***

- STT @ 0.1% is payable on sale and purchase of equity shares on the stock exchange;
- STT @ 0.2% is payable on sale of unlisted shares in an Initial Public Offering.

## 6. What are the anti-avoidance measures provided under the Act?

The Finance Act, 2012 had introduced the GAAR to curb aggressive tax planning with the use of sophisticated structures. The GAAR provisions were introduced to codify the doctrine of "substance over form", where the real intention of the parties, the effect of transaction and purpose of an arrangement are taken into account for determining the tax consequences.

The Finance Act, 2015 has deferred the implementation of GAAR and it would be applicable from the financial year starting from April 1, 2017 onwards. Further, the Finance Minister has also stated that investments made up to March 31, 2017 would not be subject to the provisions of GAAR. Amendments to the law in this regard are awaited.

GAAR applies to "impermissible avoidance arrangements", which is defined as an arrangement whose main purpose is to obtain a tax benefit and which satisfies at least one of the four additional tests:

- Creates rights or obligations, which are not ordinarily created between previous dealings at arm's length; or
- Results, directly or indirectly in misuse or abuse of the provisions of the Act; or
- Lacks commercial substance or is deemed to lack commercial substance, in whole or in part; or
- Is entered into or carried out other than for bona fide purposes.

In case GAAR is invoked, the consequences could be severe and could include[2] -

- Denial of DTAA benefits;
- Disregarding, combining or re-characterizing steps in the transactions;
- Disregarding accommodating parties;
- Reallocating income or expenditure;
- Revising the place of residence of any party or situs of an asset;
- Looking through corporate structure; and
- Re-characterizing equity or debt or accrual of receipts or expenditure, etc.

Both residents and non-residents may approach the AAR to determine whether GAAR is applicable to their transaction.

[2] The list mentioned here is illustrative in nature

# III. Taxation of Various Heads of Income

Under the Act, income which falls under any of the specified five heads of income will be taxed in India, as per the provisions of the Act. In addition, the Act also provides that where a DTAA exists with a relevant country, the provisions of the Act or DTAA, whichever is beneficial to the taxpayer, would apply.

## A. SALARIES

### 1. What does Salary include?

Salary has been inclusively defined under the Act, covering wages, fees, commission, perquisites, profits in lieu of salary, and allowances.

### 2. What are the allowances/perquisites which are generally given to employees?

An allowance is generally a fixed amount of money given regularly by the employer, in addition to salary, for meeting specific expenses of employees. As a general rule, all allowances are to be included in total income, unless specifically exempted under the Act.

Perquisites are benefits in addition to salary which the employee is entitled to by virtue of his employment. As regards such perquisites, separate rules have been prescribed for the valuation of the 'amount of benefit' received for income tax purposes.

The following are some of the typical allowances and perquisites granted to employees in India:

- House rent allowance;
- Rent free accommodation;
- Leave travel allowance;
- Conveyance allowance;
- Medical allowance;

- Interest free or concessional loan;
- Reimbursement of certain personal expenses like a driver's salary and fuel costs; and
- ESOPs

## 3. Are stock options granted to employees taxable?

Any benefits granted under an 'employee stock option scheme' formulated by an employer or as sweat equity shares, are taxed as 'perquisites' in the hands of the employees.

As per applicable perquisite valuation rules, the difference between the FMV of shares allotted (i.e. on the date of exercise of the option) and the exercise price paid (if any) by the employee for acquiring the shares, is regarded as the 'value of the perquisite'. Any subsequent profit on the sale of such shares by the employee is taxable as capital gains, (not employment income) with the cost of acquisition (for the purposes of computing the capital gains) being the FMV referred to earlier.

## 4. What is the tax treatment for employer's contribution towards overseas social security schemes in which employees working in India participate?

In cases of expatriates working in India, employers and employees generally make contributions to overseas social security schemes. A question arises whether such employer's (whether Indian or foreign) contribution to the overseas social security scheme is taxable in India.

Some judicial precedents on this issue have held that the employer's contribution towards overseas social security schemes that are mandatory in nature is not liable to tax in India as perquisite in the hands of the employee. However, a detailed review of the overseas social security plan will have to be carried out in each case to ascertain whether the facts of these judicial precedents may be applied in order to claim that the employer's contribution will not be taxed in India. Also, the employer's contribution is generally allowed as tax deductible expenditure in the hands of the employer.

## 5. Is any remuneration given to foreign nationals exempt from tax in India?

The Act, *inter alia*, exempts from tax, the following income received in India by foreign nationals, subject to fulfilment of certain conditions:

- Remuneration received as an official of an embassy, high commission, legation, commission, consulate, trade representation of a foreign state or as a member of staff of any of these officials for service;
- Remuneration received as an employee of a foreign enterprise which is not engaged in any trade or business in India provided, *inter alia*, that his stay in India does not exceed 90 days and such remuneration is not liable to be deducted from the income of the employer under the Act;
- Salary received by a non-resident employed on a foreign ship, subject to the 90 days limitation stated above; and
- Remuneration received as an employee of the Government of a foreign state in connection with his training in any Government or specified establishment.

## 6. What are the tax implications in the event an employer bears the tax cost of an expatriate employee?

When the employer agrees to bear the tax cost of the expatriate employee in India, it will be regarded as a tax perquisite and form part of the total salary income of the employee. Similarly, in the case of tax equalization offered to an expat employee by the employer, the difference between actual tax paid by the employer and the hypothetical tax payable by an employee in his home country will be considered as a tax perquisite. Under the Act, a tax perquisite is considered income taxable in India and therefore, this perquisite is grossed up and included as part of the taxable salary income.

## B. INCOME FROM HOUSE PROPERTY

### 7. How is income from house property taxed?

In order to compute income from house property, the Act provides for the concept of 'annual value' of the property. This annual value is dependent on whether the house property is self occupied or let-out.

House property consists of buildings (including a residential house, office or factory) or land appurtenant to such buildings that are owned by the assessee. However, if such building (or portion thereof) is held by the owner as stock-in-trade of a property dealing business, then income from the same (or such portion thereof), will not constitute income from house property.

### 8. What are the admissible deductions while computing house property income?

The deductions admissible from the 'annual value' of house property are:

- Taxes levied by local authorities on the house property;
- A sum equal to 30% of the annual value (arrived after deducting taxes) towards repairs and maintenance of the house property. In this regard, it is irrelevant whether any actual expenditure has been incurred on repairs and maintenance; and
- Actual interest payable on a loan taken for the acquisition or construction or repairs or renewal or reconstruction of the house property (subject to certain restrictions).

## C. CAPITAL GAINS

### 9. What is the basis of charging capital gains?

Generally, any profits or gains arising in India from the transfer of a capital asset situated in India are chargeable to income tax under the head of capital gains. Thus, the essential conditions for taxing capital gains are:

- Existence of a capital asset in India;

- Transfer of such a capital asset during the relevant tax year;
- Profits or gains arising in India pursuant to such a transfer; and
- Such capital gains not being exempt under relevant provisions of the Act.

Irrespective of the residential status, the transferor is required to pay tax in India in respect of any capital gains earned by him from the transfer of a capital asset situated in India. However, in case the transferor is a resident of a country with which India has signed DTAA then the taxability of such capital gains shall be subject to the provisions of the DTAA.

## 10. What is the meaning of term 'capital asset'?

A capital asset is essentially property of an enduring nature. The definition of a capital asset under the Act includes property of any kind (irrespective of whether it is held in connection with the persons business or profession) unless it has been specifically excluded as prescribed (for instance, (a) property for personal use, excluding jewellery, works of art and archaeological collections; (b) agricultural land and gold bonds). Therefore, generally, shares, bonds, immovable property, intellectual property etc. could constitute a capital asset. In addition, the Act has also widened the scope of a capital asset to include rights of management and control or any other rights in relation to an Indian company. Capital assets, thus, include both tangible and intangible assets.

## 11. What constitutes 'transfer' of a capital asset?

The Act defines 'transfer' in relation to a capital asset in a very broad manner, covering both voluntary and involuntary actions. A transfer is said to occur, *inter alia*, in the following situations:

- On sale, exchange or relinquishment of a capital asset (which includes redemption of shares);
- On extinguishment of any rights in a capital asset - This includes a variety of situations like receipt of money such as insurance proceeds on the destruction of the

asset itself, reduction of a company's share capital and conversion of one form of securities into another; and

- On conversion of a capital asset into stock-in-trade - When the owner of a capital asset converts it/treats it as stock-in-trade of a business carried on by him, any profit arising from such conversion/treatment of a capital asset is subject to income tax on capital gains only, in the tax year in which such a stock-in-trade is sold, and not earlier. The consideration in this case, is the FMV of the asset on the date of its conversion / treatment as stock-in-trade.

In addition, transactions involving the indirect transfer of shares of an Indian company, through the transfer of a foreign parent company, will also be regarded as a transfer of a capital asset in India, subject to the fulfillment of certain conditions.

## 12. Are all transfers of capital assets liable to income tax in India?

All transfers of capital assets are not liable to tax in India. Certain specific types of transfers, subject to the conditions specified therein, have been exempt from tax in India. Certain illustrative examples have been enumerated below:

- Transfer of a capital asset by an Indian holding company to its Indian subsidiary or vice versa;
- Transfer of a capital asset pursuant to an amalgamation, demerger, etc. subject to fulfilment of prescribed conditions;
- Transfer of GDRs outside India between non-residents; and
- Transfer by way of conversion of bonds or debentures including foreign currency bonds into shares.

## 13. How are capital gains taxed in India? What is the manner of computation of capital gains?

The capital gains are computed by reducing the cost of acquisition, cost of improvement and sale-related expenses from the sale consideration. The capital gains can be classified into (a) short-term or (b) long- term, depending on the period of holding.

| Nature of gains | Period of Holding (listed securities (other than units), UTI units or mutual fund equity oriented units or zero upon bonds) | Period of holding (all other assets) |
|---|---|---|
| Long-term | > 1 year | > 3 years |
| Short-term | $\leqslant$ 1 year | $\leqslant$ 3 years |

In certain situations, the period of holding of a previous owner of the asset is counted for the purpose of ascertaining whether the capital asset is short-term or long-term.

Further, in case of long-term capital gains, the cost of acquisition and cost of improvement is subject to indexation, which is the cost inflation multiplier prescribed for each year to increase the original cost of acquisition/cost of improvement for inflation, subject to the residential status of the seller and the nature of asset being alienated.

Tax incidence is generally higher in the case of short-term capital gains as compared to long-term capital gains.

The manner of computation is summarized in the below table -

| Particulars | Amount (INR) | Amount (INR) |
|---|---|---|
| Sale proceeds/full value of consideration received or accruing as a result of the transfer of a capital asset | | XXX |
| Less:Indexed cost/Cost of acquisition of the asset | (X) | |
| Less:Indexed cost/Cost of improvement of the asset | (X) | |
| Less:Expenditure incurred wholly and exclusively in connection with such a transfer | (X) | XX |
| Capital gains chargeable to tax (subject to any available exemptions) | | XX |

In case of long-term capital gains arising to a non-resident in respect of investment in convertible foreign exchange, the gains can be computed after taking into account the foreign exchange fluctuation as per the prescribed formula.

The manner of computation is summarized in the below table -

| Particulars | Amount | Amount | Amount (in convertible forex |
|---|---|---|---|
| Sale proceeds/full value of consideration received or accruing as a result of the transfer of a capital asset | | XXX | |
| <u>Less</u>: Expenditure incurred wholly and exclusively in connection with such transfer(X) | | | |
| Net sale consideration *(to be converted by using the average of telegraphic transfer ('TT') buying and TT selling rate on the date of sale)* | | XXX | XXX (A) |
| <u>Less:</u> Cost of acquisition of the asset | | | XXX (B) |
| Capital gains/(loss) chargeable to tax in forex - **(A-B)** | | | XX/(XX) |
| Capital gains/(loss) chargeable to tax in INR *(to be converted by using TT buying rate on the date of sale)* | | XX / (XX) | |

If the above benefit is availed, no indexation benefit will be available.

### Sale Consideration of an asset

The amount received on sale of an asset is the sale consideration of the asset. The FMV of the asset on the date of transfer of a capital asset is to be considered as the full value of consideration, in case the sale consideration for such a transfer is not determinable.

## 14. What are the tax rates applicable to companies on capital gains?

The tax rates on capital gains arising from the transfer of a capital asset by a resident company and non-resident company is given as follows:

*Resident Company*

| Particulars | Listed Securities Rate of Tax (%) | | Other securities including Unlisted securities Rate of Tax (%) |
|---|---|---|---|
| | Where STT has been paid | Where STT has not been paid | |
| Long-term capital gains | Exempt from tax[3] | 11.54%[4] | 23.07% |
| Short-term capital gains | 17.30% | 34.61% | 34.61% |

*Non-Resident Company*

| Particulars | Listed Securities Rate of Tax (%) | | Unlisted Securities Rate of Tax (%) | Other Assets Rate of Tax (%) |
|---|---|---|---|---|
| | Where STT has been paid | Where STT has not been paid | | |
| Long-term capital gains | Exempt from tax[5] | 10.82%[6] | 10.82% | 21.63% |
| Short-term capital gains | 16.22% | 43.26% | 43.26% | 43.26% |

3 This is applicable only to listed securities being equity shares and units of an equity-oriented fund. In case of other listed securities, the rates provided in cases where no STT is paid, would be applicable.

4 In case of long-term capital gains arising from sale of listed securities, an option is available to the assessee to compute the tax at the rate of 11.54% without taking the indexation benefit. Alternatively, the assessee can compute his tax liability at the rate of 23.07% after taking the indexation benefit.

5 This is applicable only to listed securities being equity shares and units of an equity-oriented fund. In case of other listed securities, the rates provided in cases where no STT is paid, would be applicable.

6 In case of long-term capital gains arising from sale of listed securities, an option is available to the assessee to compute the tax at the rate of 10.82% without taking the indexation benefit. Alternatively, the assessee can compute his tax liability at the rate of 21.63% after taking the indexation benefit.

In case, the sale consideration is payable to a non-resident, then the buyer is required to withhold tax at the time of credit or payment, whichever is earlier. Further, the non-resident would be entitled to DTAA benefits, only if it obtains a tax residency certificate from its Government authorities and provides necessary documents prescribed under the Act.

## 15. Is tax payable on distribution of assets by a company at the time of its liquidation?

### *(a) In the hands of the company*

Distribution of assets by a company amongst its shareholders at the time of liquidation is not subject to income tax in the hands of the company. However, where the liquidator sells the assets of the company and distributes the money to the shareholders, then the company will be subject to tax on the sum received from the sale of its assets, after reducing the cost of such assets.

In addition, the amount attributable to the accumulated profits of a company that is distributed to its shareholders on liquidation, is considered as 'dividend' and the company is required to pay DDT on such amount.

### *(b) In the hands of the shareholder*

The shareholder, who receives the assets of the company and/or money, at the time of liquidation, is liable to pay tax on capital gains as described below:

| Particulars | Amount (INR) |
|---|---|
| Market value of the assets/money received from the company | XX |
| Less:Cost of acquisition/indexed cost of acquisition of the assets | (XX) |
| Less:Amount of dividend on which company has paid DDT | (XX) |
| Capital Gains chargeable to tax | XX |

## D. PROFITS AND GAINS FROM BUSINESS

### 16. Types of incomes classified under the head 'business income'

Generally, the profits and gains from any business (i.e., the surplus receipts from business, over and above expenditure incurred) carried on by the assessee at any time during the relevant tax year, is taxed as business income.

Additionally, the following are, *inter alia*, specifically enumerated as business income:

- Any compensation due to or received by a person in connection with the termination or the modification of the terms and conditions of his management of a company;
- Income derived by a trade, professional or similar association from specific services performed for its members;
- Value of any benefit or perquisite, whether convertible into money or not, arising from business; and
- Amount of liability for expenses waived by the creditors, etc.

### 17. Is a non-compete fee taxable as business income?

Any sums receivable (in cash/kind) in consideration of restrictive covenants (like non-compete) to not carry out any activity in relation to any business, are taxed as business receipts. Also, any sums received for not sharing any know-how, patent, copyright, trade-mark, license, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services are taxed as business receipts.

The Act does not contain any specific provision for allowability of any expenditure incurred towards non-compete fees paid by the assessee. Certain judicial precedents have held that non-compete fees intrinsically linked to business may be allowed as business expenditure, while those linked to the acquisition of a capital asset may be considered as capital expenditure. Given the above, deductibility of expenditure towards non-compete fees will depend upon the facts of each situation.

## 18. Computation of 'Business Income'

The taxable business income is computed after considering various deductions and allowances. Typically, deductions in respect of expenses or losses are allowed, if they are revenue in nature and are incurred in the relevant tax year in connection with the assessee's business. Also, there are certain restrictions for the allowability of anticipated expenditure. Under the Act, the onus is on the assessee to prove that the expenditure or loss claimed by him is an admissible deduction.

## 19. What are the different types of expenses that are allowed as deductions?

The following is an illustrative list of various expenses that are allowed as deductions:

- Salaries, rent paid, municipal and other taxes paid for the premises occupied by the assessee and used by him for business purposes;
- Amounts spent on current repairs (other than capital expenditure). Current repairs are generally those repairs undertaken in the normal course for preserving and maintaining the buildings, plant or furniture for the purposes of business;
- Depreciation of assets, including intangible assets like intellectual property, licenses and franchises;
- Interest paid in respect of capital borrowed for the purposes of a business or profession;
- Amount of bad debts written off as irrevocable, including provision for bad and doubtful debts made by banks and financial institutions; and
- Head office expenditure of non-resident companies, subject to certain conditions.

Generally, only expenses of a revenue nature incurred in connection with the running of a business qualify for deductions, subject to certain conditions. Certain capital expenditure will be eligible for depreciation at prescribed rates.

## 20. Are all expenses allowed as deductions under the Act?

No. The following is an illustrative list of various expenses that are not allowed as deductions, while computing taxable business income:

- Prior period expenses;
- Expenses incurred for earning income that is exempt from tax;
- Income tax and interest thereon;
- Share issue expenses;
- Expenses on which tax has not been withheld (where it should have been);
- Excessive or unreasonable payments made to related persons:
- Capital expenses; and
- Contributions to non-statutory funds.

## 21. What is the tax treatment of expenses towards Corporate Social Responsibility ("CSR")?

The Companies Act, 2013 mandates compulsory expenditure of at least 2% of the average net profits of the company made during the three immediately preceding financial years by large companies (which have net worth over INR 5 billion or turnover over of INR 10 billion, or a net profit over of INR 50 million, during any FY) on prescribed activities as CSR expenditure.

Any expenditure incurred by an assessee towards activities related to CSR as provided under the Companies Act, 2013 will not be deemed to have been incurred for the purposes of business and will not be allowed as a deduction.

However, companies may claim deduction of CSR expenses under Section 80G of the Act, if the CSR expenditure is by way of contribution to the Prime Minister's National Relief Fund, eradication of poverty and malnutrition, promotion of preventive healthcare and empowerment of women, training to promote rural/Olympic sports, etc.

However, in cases where any expenditure of a specified nature is incurred by a company, then the same may be claimed as a tax-deductible expenditure. To illustrate, if a company engaged in agro industry incurs expenditure on scientific research for improving soil quality or ensuring environmental sustainability, since this is an eligible CSR expenditure under the Companies Act 2013, the same may be claimed as a tax-deductible expense under the Act.

## 22. Which rules to follow for claiming depreciation on assets?

Depreciation is allowed on both (a) tangible assets, like building, plant and machinery and furniture, and (b) intangible assets like know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature acquired on or after April 1, 1998.

In order to claim depreciation, the assets must be owned (either wholly or partly) by the assessee and must be used by him for the purpose of his business in the relevant tax year.

Depreciation allowance is calculated (a) as a specified percentage of the actual cost, in the case of assets of an undertaking engaged in generation/generation and distribution of power; (b) as a prescribed percentage of the written down value, in the case of any other assets.

## 23. Is any special deduction available for expenditure incurred on prospecting or extraction or production of minerals?

Under the Act, a special deduction is allowed to a resident assessee for expenditure incurred on prospecting for or extraction or production of certain specified minerals (including aluminium ore, coal and lignite, copper, gold, iron ore, lead, silver, tin, and zinc) or groups of associated minerals. Expenses incurred during the year of commencement of commercial production and the immediately preceding four years are eligible for deduction.

This deduction is the lower of:

- An amount equal to 1/10th of the expenditure; or
- An amount equal to the income in the relevant tax year arising from commercial exploitation of the mine or other natural deposit of the mineral (including any one of the specified associated minerals) in respect of which the expenses were incurred; and this may be carried forward for ten years from the year of commercial production.

However, certain expenditure which is capital in nature, like expenditure for the acquisition of the site, acquisition of the deposits (including rights in or over such deposits) of the specified minerals or group of associated minerals, is not deductible.

## 24. What are the special provisions for deductions in the case of business of prospecting and producing mineral oil?

Companies involved in prospecting for or extraction or production of mineral oils (including petroleum and natural gas), under production sharing contracts entered into with the Government of India, are eligible for certain deductions. In the event two companies are parties to a production sharing contract, each of them will separately be eligible for the deductions, as their taxable income will be computed individually. The following deductions are, *inter alia* allowed, in the manner specified in the production sharing contract:

- Expenditure on infructuous/abortive exploration incurred prior to commercial production;
- Capital and revenue expenditure incurred for exploration and drilling, after commencement of commercial production; and

- Allowances relating to the depletion of mineral oil in the mining area, after commencement of commercial production.

## 25. Are there special tax provisions in respect of business income earned by non-residents?

There are certain deeming provisions that seek to presumptively tax (for the purpose of administrative convenience) income earned by non-residents from the following businesses:

| Nature of business | % of receipts taxed as business profits |
|---|---|
| Operating ships | 7.5 |
| Operating aircraft | 5 |
| Providing services or facilities in connection with (including supplying plant and machinery on hire) prospecting for or extraction or production of mineral oils | 10 |
| Civil construction or erection/testing /commissioning of plant and machinery in connection with a turnkey project approved by the Indian Central Government | 10 |

Further, the Act provides that where a non-resident having a PE in India earns royalties or fees for technical services from an Indian company and such royalties/fees for technical services are effectively connected to the activities of the PE, then presumptive taxation would not apply and its income would be taxed on net basis i.e. total income minus allowable deductions. However, certain deductions will not be allowed to such non-resident:-

- Any expenditure which is not wholly and exclusively incurred for the business of the PE in India; or
- Amounts paid (other than reimbursement of actual expenses) by the PE to its head office/other offices.

## E. INCOME FROM OTHER SOURCES

### 26. What types of income are classified under the head 'Income from Other Sources'?

Income from other sources generally comprises residual taxable income that is not chargeable to tax under any of the other four heads of income. It includes:

- Dividends, other than on which DDT is paid by the Indian company;
- Interest on securities, if not chargeable as profits and gains of a business or profession;
- Shares of a closely held company whose FMV exceeds INR 50,000 received by a firm or another closely held company without consideration. The FMV of the shares will be considered as income of the assessee;
- Shares of a closely held company received by a firm or another closely held company for a consideration which is less than the FMV of the shares by amount exceeding INR 50,000; and
- Share premium in excess of FMV of shares, received by a closely held company on issue of its shares to a resident person. This does not apply where the consideration for issue of shares is received by a venture capital undertaking from a venture capital fund/company and by a company from a class of persons as to be notified by the Central Government.

### 27. How to compute taxable income under the head 'Income from Other Sources'?

Income under the head 'Income from Other Sources' is computed after deducting expenses incurred wholly and exclusively for the purposes of earning such income. Expenses which are capital or personal in nature are not allowed as deductions.

In the case of shares of a closely held company that are transferred to another closely held company below FMV, the difference between the FMV of the shares and amount paid is subject to tax.

# IV. Set-off and Carry Forward

## 1. It is possible to set-off loss from different sources under the same head of income?

As stated, there are five heads specified in the Act under which the income of an assessee may be taxed in India. In certain cases, the assessee may incur a loss from one source and have chargeable profits from another source under the same head. Such losses (other than 'capital losses') can be set-off against taxable income from any other source under the same head.

Losses in respect of short term capital assets can be set-off against the capital gains from any other capital asset. However, losses arising from the transfer of a long term capital asset can be set-off against gains arising from a long term capital asset only.

Further, losses arising in a speculation business can only be set-off against profits arising from a speculation business and not against profits from any other business.

## 2. Can an assessee set-off losses amongst different heads of income?

- Salary income of the assessee cannot be adjusted against losses under any other head of income except 'Income from House Property'.
- Losses incurred under the head 'Capital Gains' cannot be set-off against any other head of income.
- Losses incurred under the head 'Income from House Property' can be set-off against any other income in the same year.
- Losses incurred under the head 'Income from Other Sources', other than loss from owning and maintaining race horses, can be adjusted against income under any other head in the same year.
- Business losses (other than speculation or specified business loss) can be set-off against income from any other head (other than 'Salaries') in the same year.

## 3. Can affiliated companies get benefit of tax consolidation or similar treatment?

There is no concept of corporate tax consolidation or group relief in India. Further, associated companies cannot be treated as a single taxable entity or be entitled to set-off profits and losses amongst each other.

## 4. Can an assessee carry forward losses to offset against future income?

- Business losses (not being losses from speculation business) can be carried forward for a period of eight years to be set-off against future business profits. However, unabsorbed depreciation can be carried forward indefinitely.
- Speculation business losses can be carried forward for a period of four years to be set-off against future speculation business profits only.
- Capital losses and losses from house property can be carried forward for a period of eight years to be set-off against future capital gains and future house property income respectively.

## 5. Are there any conditions to be fulfilled to be eligible to continue to carry forward and set-off losses?

The Act, *inter alia*, contemplates situations where certain conditions have to be satisfied so as to continue the carry forward of losses:

- Companies seeking to carry forward and set-off the losses are required to file their income tax returns within the prescribed due date;
- Losses incurred by a closely held company will be allowed to be carried forward and set-off in a subsequent year, unless there is a significant change in shareholding of the company. The beneficial shareholding of the company to the extent of 51% should continue i.e. in the year in which the loss was incurred and in the year of carry forward and set off, in which case the closely held company will be entitled to carry forward and set-off losses.

# V. Compliance Obligations

## 1. What are the tax related compliance obligations to be undertaken by a company at the time of its incorporation?

*(a) PAN*

Once a company has been incorporated, it is required to obtain a PAN, essentially a tax identification number allotted by the Indian tax authorities.

With effect from April 1, 2010, the Act requires that any person entitled to receive any sum liable to withholding tax in India, is required to furnish his PAN to the payer. If the PAN is not furnished, then the payer is required to deduct tax at the rates specified in the relevant provisions of the Act or the rates in force or 20%, whichever is higher.

*(b) TAN*

If a company is required to withhold tax on payments, it has to obtain a TAN (another identification number) to be quoted, *inter alia*, on all withholding tax receipts, certificates and statements filed by companies.

It is important to note that failure to quote or provide a correct PAN and TAN (where so required) attracts a penalty.

## 2. What are the ongoing compliance obligations for Indian companies and consequences of non-compliance?

*(a) Audit of books of account*

A company undertaking business and having sales, gross receipts or turnover of more than INR 10 million in a tax year, is required to get its books of account audited by a practicing chartered accountant.

*(b) Transfer pricing report*

The transfer pricing regulations require maintenance of prescribed documentation on a contemporaneous basis by the person to whom the transfer pricing provisions are applicable. A transfer pricing report from an independent chartered accountant, providing the details of the transactions with the AE and the ALP, also has to be filed with the Indian tax authorities within the prescribed time limit.

While the transfer pricing documentation is required to be prepared irrespective of the quantum of international transactions, documentation is mandatory where value of transactions exceed INR 10 Million.

*(c)* ***Filing of annual tax returns***

It is mandatory for every company to furnish its annual tax return, irrespective of its amount of income (or loss).

*(d)* ***Withholding tax compliance***

In order to facilitate the timely collection of tax, the Act prescribes that every company shall, at the time of making specified payments, deduct tax from such payments and deposit it with the Indian Government within the prescribed time.

The payer is then required to provide a withholding tax certificate to the payee based on which the payee can claim credit for such tax withheld while filing its annual tax returns. Further, the payer is also required to file electronic withholding tax returns with the Indian tax authorities.

*(e)* ***Consequences of non-compliance***

Violation of any of the obligations specified above could lead to penal consequences including monetary fines, penalties and even imprisonment in certain cases.

## 3. What are the different types of payments on which tax is required to be withheld?

An illustrative list of payments for which tax is required to be withheld in India are as follows:

- Salaries;
- Interest on securities;

- Remuneration, fees or commission, not in the nature of salary paid to a director of a company;
- Interest other than interest on securities;
- Payments to resident contractors, sub-contractors;
- Commission/brokerage payments;
- Royalty and fees for professional/technical services; and
- Any sum chargeable to tax, that is payable to a non-¬resident (including capital gains).

## 4. What is the manner in which taxes are to be discharged to the Indian tax authorities in India?

Taxes, other than taxes withheld are paid in any of the following forms:

*(a) Advance tax*

The Act provides that where tax payable by a company is greater than INR 10,000, the same shall be payable in

| Due date | % of tax payable* |
|---|---|
| June 15 | 15 |
| September 15 | 45 |
| December 15 | 75 |
| March 15 | 100 |

* Each instalment is to be reduced by the amounts of advance tax paid in earlier an instalment(s) and taxes withheld.

*(b) Self-assessment tax*

In case the tax withheld by payers and the advance tax payments fall short of the total tax liability, then the assessee-company is required to discharge its remaining tax liability by self-assessment.

## 5. How do Indian tax authorities audit companies in India?

Under the Act, the Indian tax authorities can initiate tax assessment proceedings with the issue of a notice requiring the assessee to produce details/evidence to support its claim in the tax return. In certain situations, the tax officer concerned may also order a special audit of the books of the assessee. Thereafter, post taking into account any representation(s) made and the relevant details submitted by the assessee, an assessment of the total income of the assessee, along with the tax payable by such an assessee is prepared by the tax officer. The tax payable, if any, is payable within 30 days of the issue of the demand notice, failing which the assessee would be treated as an 'assessee in default' and there may be interest and penal liabilities that arise subsequently.

## 6. What are the remedies available to a corporate entity against the tax demanded by the Indian tax authorities?

If the tax officer raises a notice of demand with which the company disagrees, then the company may file an appeal against the tax officer's assessment within the prescribed time.

The company may file a petition for a stay of demand, until the time its appeal is heard by the higher authorities. In cases of severe hardship, the company may also request for an extension of time to pay the demand or request for payment of the tax demand in instalments.

## 7. What are the different ways of dispute resolution with the Indian tax authorities available in India?

### Normal Dispute Resolution

*(a) Appeal before the CIT(A)*

Where the company is aggrieved by the tax assessment order prepared by the tax officer, the company may lodge an appeal to the CIT(A). The CIT(A) is the first level of adjudication in tax matters and an appeal will have to be filed within 30 days from the date of receipt of the assessment order from the tax officer.

(b) *Appeal before the ITAT*

The ITAT is the last fact-finding tax appellate authority and its various benches are constituted across the country.

The company may appeal against the order of the CIT(A) to the ITAT within 60 days from the date of receipt of the CIT(A)'s order.

(c) *Appeal before the HC*

The Indian judicial system is composed of twenty four HC having jurisdiction over a state, a union territory or a group of states and union territories.

Appeals pertaining to orders of the CIT(A) can be made to the HC within 120 days of the ITAT order, in matters involving a question of law.

(d) *Appeal before the SC*

The SC is the apex judicial authority in India. If the assessee is aggrieved by the HC's order, an appeal may be lodged with the SC within 90 days of the HC order.

**DRP**

In disputes involving foreign companies and transfer pricing matters, the assessee may file an objection with the DRP, against the draft assessment order issued by the tax officer. The filing of an objection with the DRP is purely at the discretion of the assessee. The key advantage however is that the DRP is under statutory obligation to issue directions to the tax officer within nine months and such directions are binding on the tax officer.

Appeals against the DRP order can be filed directly with the ITAT. Subsequent appeals, if required, can be made with the HC and SC.

## 8. What are the other options available to the assessee to challenge the actions initiated by the Indian tax authorities?

*(a) Writ Petitions*

The HC and SC are also vested with writ jurisdiction. The assessee may, when alternative remedies of dispute resolution have been exhausted, invoke the writ jurisdiction of the HC concerned. It seeks to direct a person or officer to whom the writ is issued, to do or refrain from doing some specific act. Issue of a writ is purely discretionary and a writ will not be issued to supersede the authority and jurisdiction conferred to the Indian tax authorities. Where an alternative efficacious remedy by way of appeal or revision exists, the HC will normally refuse to exercise writ jurisdiction.

*(b) Settlement Commission*

Settlement Commission is a quasi-judicial body before which the assessees can apply and disclose the additional income that has not been disclosed to the Indian tax authorities, provided the tax on an undisclosed amount exceeds the specified amount. The Settlement Commission, *inter alia*, has the power to grant immunity from penalty and prosecution. The assessee has to pay the full amount of tax and interest on the additional income disclosed before filing the application.

The Settlement Commission decides upon the admissibility of the application and in case of admitted applications, carries out the process of settlement in a time bound manner by giving opportunity to both parties. At present the benefit of the settlement mechanism can be availed by an assessee only once in their lifetime.

## 9. Is MAP available under the Indian tax law?

Yes, MAP is available. Under a MAP, the Indian tax authorities and the Competent Authorities of the concerned DTAA country negotiate until they reach an agreement acceptable to both the authorities. To facilitate the MAP, the GOI has specified rules which state that any resident assessee who is aggrieved by the actions of a foreign tax authority can apply to the prescribed Competent Authority in India to seek relief under a MAP.

To further facilitate the MAP, India has entered into MOUs with the Competent Authorities of USA, UK, and Denmark. The main advantage of these MOUs is that Indian tax authorities may suspend tax collection in India (provided appropriate bank guarantees are provided) during the pendency of a MAP negotiation involving transactions with associated enterprises in USA, UK or Denmark.

Another aspect to be considered is the time frame involved in the MAP. To address this, the MOUs with USA and UK provide a maximum period of two years to bring the MAP to a close.

## 10. What are the dispute mitigation mechanisms available to an assessee?

*(a) AAR*

An advance ruling can be sought by a non-resident or a resident, in order to determine the tax treatment of a non-resident with whom a transaction has been undertaken or is proposed to be undertaken. Such an advance ruling, which is issued by an independent body called the AAR, is ordinarily binding on the applicant as well as the Indian tax authorities. An advance ruling is only binding on the parties to whom it applies, although it does have a persuasive value for other transactions. The Finance Act, 2014 extended this facility to resident taxpayers in respect of its tax liability arising out of one or more transactions which have been undertaken or are proposed to be undertaken, valuing INR 1000 million or more in total.

*(b) APA*

The Act has provisions relating to APA mechanism, which allows the assessee to enter into an agreement with the Indian tax authorities on an appropriate transfer pricing methodology for a set of international transactions over a fixed future time period.

The salient features of the provisions are as follows:

- APAs will specify the determination of the ALP or the manner in which the price is to be determined. The ALP shall be determined on the basis of prescribed methods or any other non prescribed method;
- APA is valid for a maximum of five consecutive years unless there is a change in the provisions of law or the facts having a bearing on the transaction; and
- APA will be binding on the assessee and the Indian tax authorities in respect of the concerned international transaction.

*(c) Safe harbour rules*

To mitigate the transfer pricing disputes in relation to arm's length price, the Act has provided for Safe harbour rules. 'Safe harbour' means circumstances in which the Indian tax authorities shall accept the transfer price declared by the taxpayer. Certain specified eligible transactions in specified sectors have been identified, wherein the safe harbour ratios have been prescribed. The specified sectors are IT and ITeS services and knowledge process outsourcing services (KPO) with insignificant risks, intra group loan to WOS, explicit corporate guarantee to WOS, contract R&D related wholly or partly to software development or pharmaceuticals, and manufacture and export of auto components.

# VI. Corporate deductions and incentives

## 1. Are there any tax incentives for setting up new businesses in India?

There are various tax incentive schemes available for setting up new businesses in India. Some business activities are entitled to tax holidays from income-tax (on the fulfilment of certain conditions), including:

- Developing and operating infrastructure facilities;
- Generating/transmitting/distributing power;
- Developing an SEZ;
- Setting up a unit in an SEZ for undertaking permitted activities;
- Processing, preserving and packaging fruits or vegetables, meat and meat products, poultry, marine or dairy products or the integrated business of handling, storing and transporting food grains;
- Setting up and operating a cold chain facility, warehousing facility for agricultural produce, laying and operating a cross country natural gas or crude or petroleum oil pipeline network;
- Setting up undertakings in the north-eastern states for manufacturing specified articles; and
- Collecting and processing or treating bio-degradable waste for generating power or producing bio-fertilizers;

## 2. What are the benefits available to SEZs and units established in SEZs?

A SEZ is a specifically delineated, duty free area (notified as such by the Ministry of Commerce under the SEZ Act, 2005), which is considered to be outside the customs territory of India for the purposes of carrying out certain authorized activities.

The developer of an SEZ is entitled to a deduction of 100% of the profits and gains derived from the business of developing an SEZ, for any ten consecutive years out of a period of fifteen years, beginning with the year in which the SEZ was notified by the Indian Central Government.

Entrepreneurs establishing units in SEZs are eligible to claim a tax holiday for a period of fifteen years (in a phased manner) for:

- 100% of the profits and gains derived from the export of goods/services provided by the unit, for five consecutive years commencing from when the Unit begins the production/provision of services;
- 50% of such profits and gains for a further five years; and
- Thereafter, for the next five consecutive years, so much of the amount (not exceeding 50% of the profits) as is debited to the profit and loss account of the tax year in respect of which the deduction is to be allowed and credited to a reserve account (called the 'SEZ Re-investment Reserve Account') which is utilized for certain specified business purposes.

## 3. Is any special incentive available on expenditure incurred on scientific research?

The following incentives are available under the Act:

*(e) Capital and revenue expenditure*

- 100% deduction of all revenue and capital expenditure (excluding land acquisition) incurred by the assessee on scientific research related to the business of the assessee (including where the research is carried on by another person for and on behalf of the assessee);

*(f) Contributions to approved institutions*

- 125% deduction of the sum paid to (a) a scientific research association, or (b) to approved universities, colleges or other institutions to be used for social science or statistical research; (c) an Indian company with its main object of carrying on scientific research and development and also satisfying certain additional conditions;

- 175% of the sum paid to (a) National Laboratory, (b) Indian Institute of Technology; (c) University; (d) specified person to be used for scientific research under an approved programme.

*(g) Expenditure on in-house R&D*

- Companies engaged in certain businesses, like biotechnology, drug manufacture, electronic equipment, computers and telecommunication equipment are entitled to a deduction of 200% of the expenditure incurred on in-house R&D (except expenditure incurred on acquisition of land). The R&D facility is required to be approved by a prescribed authority and the deduction is available until March 31, 2017.

The company is also required to enter into an agreement with such a prescribed authority for co-operation in relation to the R&D facility and for the audit of accounts.

## 4. Is any special incentive available for setting up manufacturing business in backward areas?

Where an assessee sets up an undertaking or enterprise for manufacture or production of any article or thing after April 1, 2015 in any notified backward areas of Telangana, Andhra Pradesh, Bihar or West Bengal, and acquires and installs any new plant & machinery for this purpose, then an additional deduction of 50% of actual cost of such a new asset will be available in the year in which the asset is installed. This is applicable form April 1, 2015 to March 31, 2020.

# VII. M&A Taxation

## 1. What are the tax advantages of following a court based restructuring route?

Several forms of business restructuring (including mergers, demergers and spin-offs or slump sale) or capital restructuring (reduction of capital), can be achieved by approaching the relevant HC under Sections 391-394 and Sections 100-104 of the Companies Act, 1956 respectively.

The following are the main advantages of adopting the route of a court based business restructuring (i.e., scheme of arrangement, amalgamation or demerger):

- The transaction does not give rise to any income tax on capital gains on the transferor company or its shareholders, provided the conditions specified in the respective sections are met. Also, in the case of an amalgamation/ demerger, the period of holding (required to determine whether the shares sold are a long term or a short term capital asset) will be computed by including the period for which that shareholder held shares of the amalgamating/demerged company prior to the scheme;
- The amalgamated/resulting company may carry forward the unabsorbed depreciation of the amalgamating/demerged company for an indefinite period. The amalgamated/resulting company may also amortize the expenses of the amalgamation/demerger over five years from the date of amalgamation /demerger; and
- Tax holidays or other tax benefits available to the amalgamating/demerged company as of the date of amalgamation/demerger will be available to the amalgamated/resulting company, if the stipulated conditions are satisfied.

## 2. What are the transaction costs that would typically arise on a business transfer and an asset sale?

The primary difference between a business transfer and an asset sale is that in the former, the purchaser acquires the entire business undertaking consisting of assets, liabilities, employees, and goodwill on a 'going concern basis', whilst in the latter, the purchaser can acquire specific assets. A business transfer is generally carried out through a slump sale. A slump sale typically involves a lump-sum consideration without values being assigned to individual assets and liabilities (except for determination of value of assets or liabilities for stamp duty/registration fees or other similar purpose), whilst in an asset sale, the price of each asset would be identifiable.

The gains arising from a business transfer which falls within the definition of a 'slump sale' under the Act are taxed as long term or short term capital gains, depending on the period for which the seller held the undertaking as a whole prior to disposition, irrespective of the period for which each constituent asset was held. Gains from the disposal of an undertaking held for more than 36 months are taxed @ 23.07% as long term capital gains, if held for less than 36 months, the gains are taxed @ 34.61%, as short term capital gains. On the other hand, in the case of an asset sale, income tax is to be paid by the seller depending upon the nature of assets (i.e. depreciable or non-depreciable).

## 3. What are the tax implications on a reduction of share capital?

A company can decrease its issued share capital, either by buying back its shares from shareholders or by reducing its share capital. Both procedures are governed by the Companies Act, 2013 and apply equally to listed and unlisted companies.

- Buyback of shares is governed by Section 68 of the Companies Act, 2013. The taxability on buyback of shares is different for a listed and an unlisted company undertaking the buyback.

- In case of buyback by a listed company, payment made by the company on buyback of its shares is subject to income tax in the hands of the shareholders on the amount of capital gains (unless specifically exempt if STT has been paid).
- In case of buyback by an unlisted company, the unlisted company is liable to pay additional income-tax @ 23.07% on distribution of income (i.e. consideration paid to shareholder less amount received by the company at the time of issue of shares) through buyback of its shares. Distributed income is exempt from tax in the hands of the shareholders.

- Share capital may be reduced subject to (a) confirmation by the concerned HC; (b) the company being authorized to do so by its constitutional documents; and (c) the shareholders passing a special resolution to that effect.

Under the Act, any distribution made by a company on the reduction of its capital to the extent to which the company possesses accumulated profits (whether capitalized or not), constitutes 'deemed dividend' and the company is required to pay DDT on such accumulated profits. Any payment exceeding such accumulated profits will be subject to tax as capital gains in the hands of the shareholders.

## 4. What are the tax implications of a transfer of shares in a foreign company by a foreign seller to a foreign buyer, where the foreign company directly or indirectly owns shares in an Indian company?

The Act provides that any income arising, directly or indirectly, through the transfer of a capital asset situated in India shall be deemed to accrue or arise in India. Further, it also provides that an asset or capital asset, being any share or interest in a company or entity incorporated outside India, shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.

Therefore, transfer of shares in a foreign company by a foreign seller, where the value of shares of the foreign company derives, directly or indirectly, its value substantially from the assets of the Indian company, would be caught in the Indian tax net. These provisions do not override the provisions of DTAA which India has entered into with various countries. Hence, if the foreign seller is in a favourable tax jurisdiction (like Singapore for example), then capital gains on such an indirect transfer will not be chargeable to tax in view of the respective DTAA between India and the country of the foreign seller.

However, the provisions were not clear as, *inter alia*, few important terms like 'substantially' and 'value', were not defined under the Act, thereby giving room for varying interpretations. The Finance Act, 2015 has, with respect to the aforesaid indirect transfer provisions, made the following clarifications –

- **Meaning of substantial:** The share or interest of the foreign entity shall be deemed to derive its value substantially from the assets located in India, <u>if the value of such Indian assets exceeds INR 100 million, and represents at least 50% of the value of all the assets owned by the foreign entity.</u>
- **Meaning of value:** The value of an asset shall be the <u>fair market value</u> as on the specified date, of such an asset without reduction of liabilities, if any, in respect of the asset. The fair market value will be determined in accordance with the rules to be prescribed.
- **Calculation of capital gains:** In case all the assets of the foreign entity are not located in India, only such part of the income, as is reasonably attributable to the Indian assets, shall be subject to capital gains tax in India.

Further, the Finance Act, 2015 has also provided for exemption from applicability of indirect transfer provisions to small shareholders of a foreign entity by stating that the indirect transfer provisions shall not apply in a case where the transferor of share or interest in a foreign entity, along with his associated enterprises, neither holds the right of control or management nor holds voting power or share capital or interest exceeding 5% of the total voting power or total share capital in the foreign entity, holding the Indian assets directly. In case the foreign entity indirectly holds the Indian assets, the exemption would apply provided the intermediate entities do not entitle the transferor company to the same right.

Unfortunately, the exact computation mechanism for determining capital gains has still not been provided under the law and therefore, the quantification of the tax liability is yet under wraps. It must be noted that the Act now requires an Indian entity to furnish information relating to off shore transactions of foreign companies to the Indian tax authorities where the foreign company derives substantial value from assets located in India. In case of non-compliance, a penalty which is equal to 2% of the value of the transaction is levied. This penalty would be applicable only when the Indian entity has failed to furnish information and the transaction resulted in direct or indirect transfer of right of management or control in relation to the Indian concern. In all other circumstances, a penalty of INR 0.5 million would be levied in case of a default.

# VIII. International Taxation

## 1. What are the double taxation relief regulations in India?

The Act recognizes the need to provide relief from double taxation and empowers the Indian Central Government to enter into agreements with foreign countries, not only to grant double taxation relief but also to promote mutual economic relations, trade, and investment. The Act also provides that any specified association in India may enter into an agreement with any specified association in certain foreign territories and the Indian Central Government may adopt and implement such agreements. As per the Act, the provisions of the Act or the DTAA entered into between India and the country of tax residence of the assessee, whichever are more beneficial, shall be applicable.

India has entered into DTAAs with more than 82 countries including USA, UK, Japan, France, and Germany.

The tax withholding rates prescribed under some of the DTAAs are as given below- (as compared to or minimum of 26% for mandatory offers).

| Country | Rate of Tax (%) | | | |
|---|---|---|---|---|
| | Dividend | Interest | Royalty | Fees for technical services |
| Australia | 15 | 15 | 10/15 | 10/15 |
| China | 10 | 10 | 10 | 10 |
| Cyprus | 30[7] | 30[8] | 30[9] | 30[10] |
| Germany | 10 | 10 | 10 | 10 |
| France | 10 | 10 | 10 | 10 |
| Mauritius | 5 / 15 | Domestic tax rates | 15 | - |
| Netherlands | 10 | 10 | 10 | 10 |
| Singapore | 10 / 15 | 10 / 15 | 10 | 10 |

7 Cyprus has been declared a Non-Cooperative Jurisdiction by India and hence all payments made to Cyprus investors are now subject to withholding tax in India at 30% vide Notification No. 86/2013 dated November 1, 2013.

8 Supra at 7

9 Supra at 7

10 Supra at 7

| Country | Rate of Tax (%) | | | |
|---|---|---|---|---|
| | Dividend | Interest | Royalty | Fees for technical services |
| United Arab Emirates | 10 | 5 / 12.5 | 10 | - |
| UK | 15 | 10 / 15 | 10/ 15 | 10 /15 |
| USA | 15 / 25 | 10 / 15 | 10 / 15 | 10 / 15 |

The non-resident would be entitled to DTAA benefits only if it obtains a tax residency certificate from their Government authorities and provides the prescribed documentation to the Indian tax authorities.

## 2. What are the regulations related to transfer pricing in India in relation to International Taxation?

The Act provides for detailed transfer pricing regulations in intra-group cross- border transactions between the associated enterprises. Under the Act, any international transactions entered into between the associated enterprises have to be at ALP. The ALP shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the CBDT may prescribe, namely:

(a) Comparable uncontrolled price method

(b) Resale price method

(c) Cost plus method

(d) Profit split method

(e) Transactional net margin method

(f) Any other method

The transfer pricing regulations require maintenance of documentation and certification by the person who has entered into international transaction(s). Additionally, a report from a chartered accountant (transfer pricing report) confirming that the dealings with the associated enterprise were at ALP and the profit has been appropriately reported by the associated enterprise, has to be filed with the Indian tax authorities within the specified time limit. Further, under the Act, there are severe consequences for not complying with the Indian transfer pricing regulations.

## 3. Whether the transfer pricing provisions also apply to domestic transactions?

Yes, the Indian transfer pricing provisions are applicable to specified domestic transactions between resident assessees/units of the assessees, where the aggregate value of such transactions exceeds INR 50 million. The specified domestic transactions include:

- payments made to prescribed related parties; and
- inter-unit transfer of goods or services between two undertakings, wherein one of the undertakings are enjoying tax holiday.

Any income or allowance for any expenditure in relation to specified domestic transactions is to be computed having regard to ALP. Assessees transacting such specified domestic transactions need to maintain contemporaneous documentation. A transfer pricing report from a chartered accountant, providing the dealings with the associated enterprise and the ALP, has to be filed with the Indian tax authorities within the prescribed time limit.

## 4. Whether India has a mechanism to determine the taxability or otherwise of a transaction in advance?

Yes, India does have a mechanism for determining the taxability or otherwise of a transaction in advance especially for non-resident assessees, to facilitate proper planning and avoid any future disputes. The assessee may opt for mechanisms like advance rulings or advance pricing agreements. Please refer to discussion at *Dispute mitigation mechanisms* listed earlier.

## 5. Which are the DTAAs entered into by India that provides beneficial tax treatment for capital gains on sale of shares of Indian companies?

Under certain DTAAs entered into by India, the right to tax the 'capital gains' arising from alienation of shares is with the country of which the alienator is a resident and accordingly, India does not have the right to tax the capital gains. Some of the relevant DTAAs are as follows-

- Indo-Mauritius DTAA[11]
- Indo-Singapore DTAA[12]

[11] Under renegotiation
[12] Limitation of benefits (LOB) clause applicable under this DTAA

# IX. Glossary

| | |
|---|---|
| AAR | Authority for Advance Ruling |
| ALP | Arm's Length Price |
| AMT | Alternate Minimum Tax |
| AE | Associated Enterprises |
| AOP | Association of Persons |
| AO | Assessing Officer |
| APA | Advance Pricing Agreements |
| BOI | Body of Individuals |
| CBDT | Central Board of Direct Taxes |
| CFC | Controlled Foreign Companies |
| CIT(A) | Commissioner of Income Tax (Appeals) |
| CSR | Corporate Social Responsibility |
| DDT | Dividend Distribution Tax |
| DRP | Dispute Resolution Panel |
| DTAA | Double Taxation Avoidance Agreement |
| ESOP | Employee Stock Option Plan |
| FCCB | Foreign Currency Convertible Bonds |
| FMV | Fair Market Value |
| GAAR | General Anti-Avoidance Rule |
| GDR | Global Depository Receipts |
| GOI | Government of India |
| HC | High Court |
| HUF | Hindu Undivided Family |
| INR | Indian Rupees |
| Act | Income Tax Act, 1961 |
| ITAT | Income Tax Appellate Tribunal |
| LLP | Limited Liability Partnership |
| M&A | Mergers and Acquisitions |
| MAP | Mutual Agreement Procedure |
| MAT | Minimum Alternate Tax |
| MOU | Memorandum of Understanding |

| | |
|---|---|
| PAN | Permanent Account Number |
| PE | Permanent Establishment |
| R&D | Research and Development |
| SC | Supreme Court of India |
| SEZ | Special Economic Zone |
| STT | Securities Transaction Tax |
| TAN | Tax Deduction and Collection Account Number |
| TDS | Tax Deducted at Source |
| UK | United Kingdom |
| USA | United States of America |
| UTI | Unit Trust of India |
| WOS | Wholly owned subsidiary |

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