Tax Structuring – Recent Developments

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The Indian Scenario

- Economy on the cusp of recovery – potential for double digit growth seen
- Investor sentiment on the upswing
- High expectation of economic reform
- Falling global oil prices and weakening domestic inflation – create room for large scale reform

- Positive developments on the tax front:
  - Increased engagement with taxpayers
  - Focus on avoiding prolonged litigation
  - Improvement in overall taxpayer experience targeted

- GAAR slated to come into force on 1 April 2015

Uncertainty and litigation on key issues continue
The Global Scenario

- Governments facing significant fiscal pressures
- Increased political and public focus on perceived tax avoidance by multinational companies
- Widespread recognition that the international tax regime is inadequate to address current challenges faced by developed and developing countries
- Aggressive drive to reform underway as part of the OECD’s BEPS initiative – India playing a key role in the deliberations
- Increased scrutiny on cross-border transactions and structures in several countries

Tax Structuring – now a challenging, dynamic and multi-faceted exercise
Inbound Structuring – Issues and Developments
Key Considerations - Inbound

- Choice of entity
- Use of Holding Companies
- Cash Extraction
- Foreign Tax Credit Availability
- Exit Strategy
### Choice of Entity: LLP v. Company

<table>
<thead>
<tr>
<th>Income Tax</th>
<th>Private company</th>
<th>LLP</th>
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<tbody>
<tr>
<td></td>
<td>▪ Corporate Tax Rate applicable – 32.45% / 33.99%</td>
<td>▪ Corporate tax rate applicable – 33.99%</td>
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<tr>
<td></td>
<td>▪ DDT @ 19.994 %* on distribution of profit by way of dividend; Dividend exempt in hands of shareholder</td>
<td>▪ DDT &amp; BBT is not applicable; Share of profit is exempt in hands of partner in India</td>
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<tr>
<td></td>
<td>▪ MAT @ 20.96% applicable on Book profits</td>
<td>▪ AMT @ 20.96% on Adjusted Total Income (typically, applies where tax holidays are claimed)</td>
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<td>▪ BBT @ 22.66% applies on share buyback</td>
<td>▪ Deemed Dividend provisions under s. 2(22)(e) not applicable</td>
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<table>
<thead>
<tr>
<th>Foreign Direct Investment (FDI) &amp; Foreign Exchange Management Regulations (FEMA)</th>
<th>Private company</th>
<th>LLP</th>
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<tbody>
<tr>
<td>▪ No FIPB approvals required for FDI at the time of entry or exit as long as activities are covered under the automatic route</td>
<td>▪ FDI permitted only for activities covered under automatic route &amp; subject to prior approval from FIPB</td>
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<tr>
<td>▪ Foreign investment can be done by way of cash consideration, swap of shares, conversion of receivables etc.</td>
<td>▪ Foreign capital participation in LLP – by way of cash contribution only</td>
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<tr>
<td>Governance Framework</td>
<td>Private company</td>
<td>LLP</td>
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<td></td>
<td>▪ Higher statutory reporting requirements</td>
<td>▪ Relatively limited reporting requirements</td>
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<td></td>
<td>▪ CSR spend of 2% of net profits compulsory</td>
<td>▪ LLP not required to comply with CSR obligations</td>
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<td></td>
<td>▪ Requirements for holding minimum number of board meetings</td>
<td>▪ Greater flexibility for conduct of business</td>
</tr>
<tr>
<td></td>
<td>▪ Decisions subject to shareholders / Board approval</td>
<td>▪ Governed by LLP agreement - No requirement for approvals / minimum meetings</td>
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<td>▪ Related party transactions are subject are subject to board / shareholder’s approval and arm’s length pricing</td>
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</table>
Choice of Entity: LLP v. Company

**Key Advantages of LLPs**

- Tax Efficient structure as no MAT, DDT & BBT applicable
- No mandatory CSR spend of 2% of profits.
- Operational flexibility and reduced compliance costs

**Key Considerations**

- New ventures can be housed in an LLP instead of existing corporate entities
- Conversion of existing companies into LLPs possible:
  - Stringent conditions for tax-neutrality- INR 60 Lakhs turnover criteria
  - Arguments for non-taxability based on first principles possible – position litigative

LLPs – a key component of inbound tax structuring
Use of Holding Companies

Direct Investments in India

- Capital gains on sale of shares of Indian company taxable in India
- Treaty benefit available in respect of capital gains available only in to select countries
- Risk of double taxation due to conflicting ‘source’ rules
  i.e. Foreign Investor’s jurisdiction may consider capital gains on sale of Indian Co. shares as ‘domestic’ sourced income not eligible to foreign tax credits (e.g. US)
Use of Holding Companies

Use of intermediate holding companies

- Risk of double taxation can be mitigated through Holding companies situated in countries with favourable treaty provisions (e.g. Mauritius, Singapore, Netherlands etc.)

- Claim for treaty benefits in India under increased scrutiny – need for careful structuring

- Claim to be backed up by:
  a) Substance in jurisdiction of Hold Co.
  b) Commercial rationale for use of Hold Co.
  c) Availability of Tax Residency Certificates
  d) Compliance with LOB Article (if any)

Boilerplate structures involving holding companies – no longer advisable
Use of Holding Companies

Use of multi-tier structures – additional considerations

- Retrospective amendments to s. 9(1)(i) – Foreign Investor Co., HoldCo 1 and HoldCo 2 shares deemed to be situated in India if they derive value substantially from assets located in India
- Meaning of ‘substantially’ under Section 9(1)(i) not certain – Delhi HC’s criteria > 50%
- No pro-rata taxation or exemption for listed foreign co shares, group restructuring under current law
- Taxability in India of dividends paid by Hold Co. 2 and Hold Co. 1 – an area of concern
- No clarity on applicability of treaty benefits in case of sale of shares of HoldCo 1 or HoldCo 2
Cash Extraction

**Tax Implications**

- **Dividends**
  - Dividend Distribution Tax @ 19.994 payable on dividends declared, distributed or paid by domestic companies

- **Buyback of Shares**
  - Buyback Tax @ 22.66% on ‘distributed income’ payable by domestic companies on buyback of unlisted shares

- **Interest**
  - Interest payments liable to withholding @ 10%
  - Concessional tax @ 5% on interest available in certain cases

- **Royalties**
  - 25% rate on royalties / FTS under domestic law – lower rates may be available under treaties

**Significant tax costs associated with cash extraction – proper planning needed**
Other Considerations

- Foreign Tax Credit availability in home jurisdiction on income-streams from India to be evaluated

- For e.g. creditability of DDT and Buyback tax could pose contentious as:
  - DDT / Buyback tax is levied on the company and not on the shareholder
  - DDT / Buyback tax is not paid on behalf of shareholders
  - Underlying tax credits may not be always available

- Non-availability of credits could significantly affect tax costs and overall financial projection

- Applicability of MAT to capital gains earned by foreign companies in favourable treaty jurisdictions - a litigative issue

- Conflicting decisions of AAR on the above:
  - Timken Co. In re (326 ITR 193)
  - Castleton In re (348 ITR 537) (SLP pending before the SC)

Need for clarificatory amendments
Outbound Structuring – Issues and Developments
Outbound Investments – Regulatory Aspects

• **Under the Automatic Route**, an Indian Party does not require any prior approval from the RBI for setting up a JV/WOS abroad

• **The criteria for direct investment under the Automatic Route** are as under:

<table>
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<tr>
<th>Investments up to 400% of Net worth</th>
<th>Valuation requirements to be complied with respect to the value of investments</th>
<th>All transactions relating to a JV/WOS routed through one branch of an AD bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indian Party not on RBI’s caution list / under investigation by enforcement agency</td>
<td>Submission of APR in respect of all overseas investments</td>
<td>Indian subsidiary is required to report its investments in form ODI to the AD bank</td>
</tr>
</tbody>
</table>

• **Certain additional conditions** to be fulfilled in case investment by an Indian Party engaged in Financial Services Sector

• **Investment in foreign companies engaged in real estate, trading in TDRs and banking business requires** prior approval of RBI
Key Considerations - Outbound

- Need for SPVs
- Holding Company Regimes
- Participation exemption / thin cap rules
- IPR Regime
- Withholding tax provisions
Use of SPVs – Some Benefits

- Flexibility in borrowing
- JV Private Equity Funding
- Bilateral Agreements
- Tax Efficiency
- Ease in Exit
- Overseas Listing
- Flexibility in corporate structuring
- Ring fencing of Risk
Key Considerations

Participation Exemption

• Exemption in SPV’s jurisdiction for dividend income and capital gains from downstream investments upon fulfilment of certain conditions
• Conditions typically pertain to shareholding pattern, jurisdiction of parent entity and percentage of holding

IPR Regime

• Specific incentives, deductions and exemptions available in some jurisdictions in relation to IPR holdings
• Patent Box regime (i.e. concessional rate for royalty incomes from certain IPRs) and deduction for cinematographic films given in UK
• Accelerated Deduction allowed on R&D spends in Singapore and Switzerland

Withholding tax provisions

• WHT exemptions on dividends / royalties / interest (e.g. under EU directives)
Key Considerations

Favourable Holding Company Regimes

- Lower income-tax rates for holding companies under specific holding company regimes (e.g. UK, Singapore)
- Existence of CFC provisions
- Good Treaty Network

Thin capitalization rules

- Companies said to be thinly capitalised when its capital is made up of a much greater proportion of debt equity
- Tax efficient cash repatriation possible by claiming tax deduction for interest on debt
BEPS – an overview
On 19 July 2013 the OECD released an Action Plan on Base Erosion and Profit Shifting (BEPS) which was presented to the meeting of G20 Finance Ministers in Moscow.

The purpose of the Action Plan is “to prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from activities that generate it.”

The report indicates that “no or low taxation is not per se a cause for concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.”

The Action Plan covers 15 specific Actions which are broadly to be achieved within a two year time frame (i.e. by the end of 2015).
Focus on key items
• Transfer pricing, hybrids, interest deductions, treaty abuse and the digital economy

Wide ranging actions, for example:
• Changes to the Model Tax Convention (e.g. in relation to hybrids, treaty abuse)
• Recommendations regarding the design of domestic law (e.g. CFC rules, interest deductions)
• Changes to the TP guidelines (e.g. in relation to ensuring TP outcomes are in line with value creation)

A number of the actions are linked, for example:
• The actions on CFCs, interest deductions, and hybrids will be closely linked

BEPS outcomes to have a significant impact on cross-border structures
BEPS – An Overview

June 2012
Project announced / started

February 2013
Document released ‘Addressing Base Erosion and Profit Shifting’

July 2013
Release of Action Plan with 15 separate actions/work streams

September 2014
Project Completion of approximately 1/3 of Action Plan

2016 onwards
Monitoring, additional / ongoing actions

Coherence
- **Action Item 2**: Hybrid mismatch arrangement
- **Action Item 3**: Controlled Foreign Company rules (CFC)
- **Action Item 4**: Interest deductions
- **Action Item 5**: Harmful Tax practices

Substance
- **Action Item 6**: Preventing tax treaty abuse
- **Action Item 7**: Avoidance of permanent establishment status
- **Action Item 8**: Transfer Pricing aspects of intangibles
- **Action Item 9**: Transfer Pricing/risk and capital
- **Action Item 10**: Transfer pricing/high risk transactions

Transparency
- **Action Item 11**: Methodologies and data analysis
- **Action Item 12**: Disclosure rules
- **Action Item 13**: Transfer pricing documentation
- **Action Item 14**: Dispute resolution

Action Item 1: Digital Economy
Action Item 15: Multilateral Instrument
BEPS – Key Risk areas and Actions

**Key Risk areas**
- Digital economy
- Hybrids
- Treaty abuse
- Dependence on specific PE exceptions
- Significant interest deductions
- Intangibles, and which group company has an interest
- Contractual allocation of risk and capital versus Key enterprise risks /Significant People Functions
- Does TP policy overall make economic sense?

**Actions**
- Operational structures – does income reflect economic activity? Particular focus should be placed on the use and exploitation of intangibles
- Transfer pricing policy A renewed focus on APAs?
- Robust documentation and evidences to be maintained – especially qua conduct of parties
- International financing and organisational structures – are they sustainable in light of the BEPS recommendations?
- Consider potential impact on planning arrangements currently being contemplated
The interim report titled ‘Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance’ released by OECD on 16 September 2014 reflects consensus on the importance of having appropriate “substantial activity” requirements in preferential regimes and on the need for increased transparency.

- The ‘substantial activity’ factor: whether a regime “encourages purely tax-driven operations or arrangements”

- Are taxpayers deriving benefits from the regime while engaging in operations that are purely tax-driven and involve no substantial activities.

- Regimes that meets the “no or low effective tax rates” test will be considered harmful if there is no substantial activity in the country granting the regime.

- Determining the location of substantial activity - a subjective determination

New substance requirements formulated in various jurisdiction - companies required to adhere to specific substance requirements for satisfying the substance test
Substance and India

- Long standing bias towards ‘form’ increasingly under challenge
- General Anti-Avoidance Rule enacted – proposed to be made effect from 1 April 2015
- Anti-abuse principles increasingly invoked by the tax authorities and Courts
- Key principles emerging from the landmark SC decision in the Vodafone case:
  - Tax planning within the framework of law is permissible unless it is a sham or colorable device
  - Onus on the tax authority that the transaction is sham
  - True nature to be ascertained by ‘looking at’ the legal arrangement actually entered into and carried out

Era of conventional tax planning over – need for a more sophisticated approach
Key Takeaways
Key Takeaways

• BEPS – a game changer in the coming years

• Need to focus on domestic anti-abuse tax legislations in various jurisdictions

• Transparency and Exchange of Information – here to stay

• Fast changing global tax regimes

• Need for longevity and flexibility in cross-border structures

• Tax and Morality debate – likely to continue