Inbound Investments in India – Post BEPS – planning & challenges (for GAAR, POEM/CFC & Transfer Pricing)

International Fiscal Association

18th June, 2016, Mumbai

Case Studies

1 Evaluating impact of grandfathering

2a Use of CCD as a funding choice

2b Participation exemption and use of CCD - BEPS & GAAR Impact

3 Regional Head Quarter Company – Impact post BEPS & GAAR

India Attractiveness

- In this cloudy global horizon, India is a bright spot. Recent policy reforms and improved business confidence have provided a boosted to economic activity. Using India’s new GDP series, the IMF expects growth to pick up to 7.2 percent this fiscal year and accelerate further to 7.5 percent next year”

  - MD speech: Seizing India’s Moment, IMF, 16 March 2015

- India makes up 1.8% of US Foreign Equity holdings as on December 2015 as against 1.6% of China
- India’s economic growth is expected to rise to 7.6% in 2016-17

Make in India initiative

Start up India initiative

Number one FDI destination
India has emerged as the number one FDI destination in the world during the 2015. With FDI capital inflows of US$63b, India has outpaced China and all other economies, moving up to the premier position

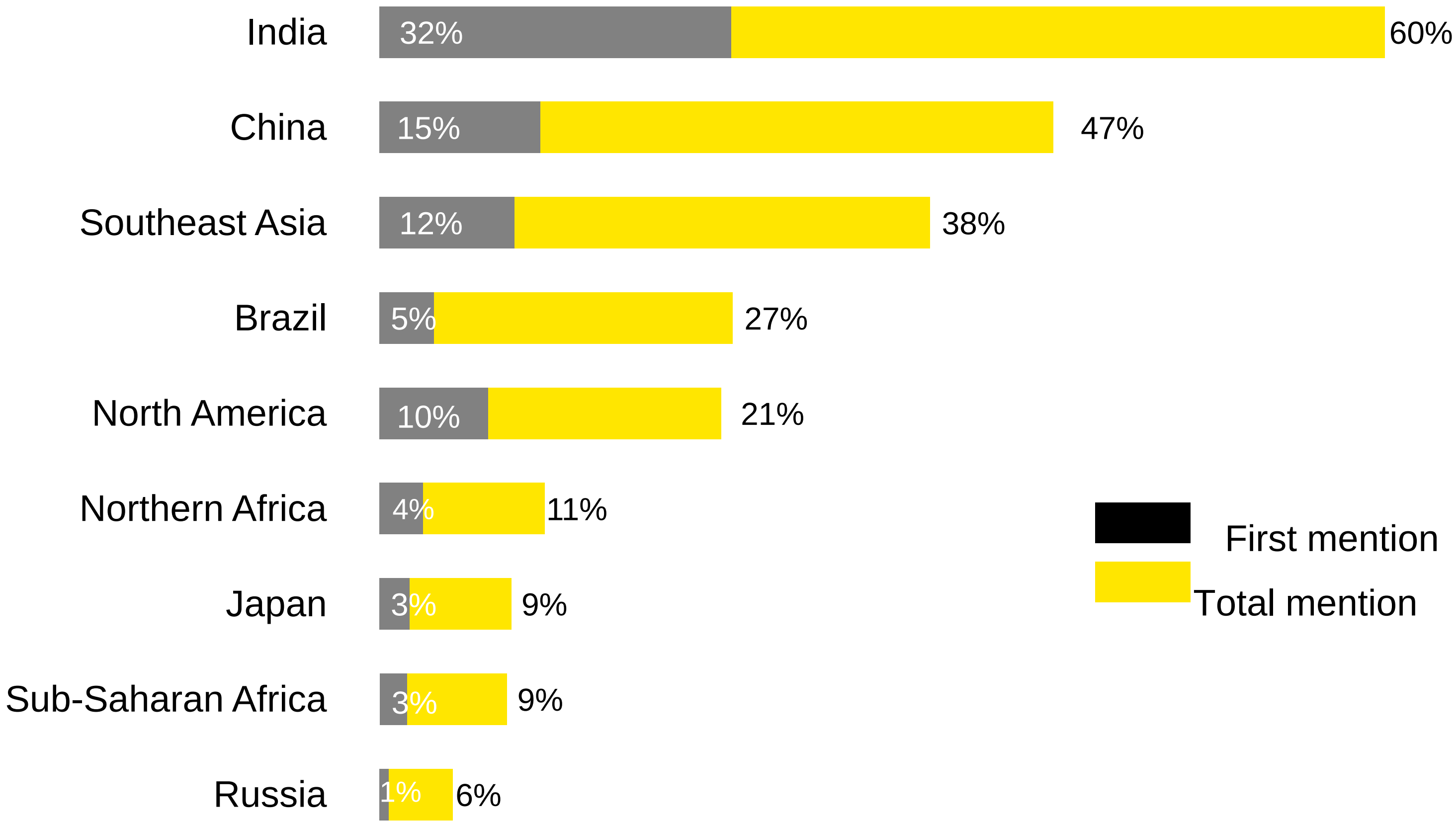
₹ **Ease of doing business in India**

Digital India is a US$17.7b government initiative, which aims to create an electronically connected economy, attract investment in electronics manufacturing and support trade

Focus on urbanization through creation of smart cities

India Attractiveness

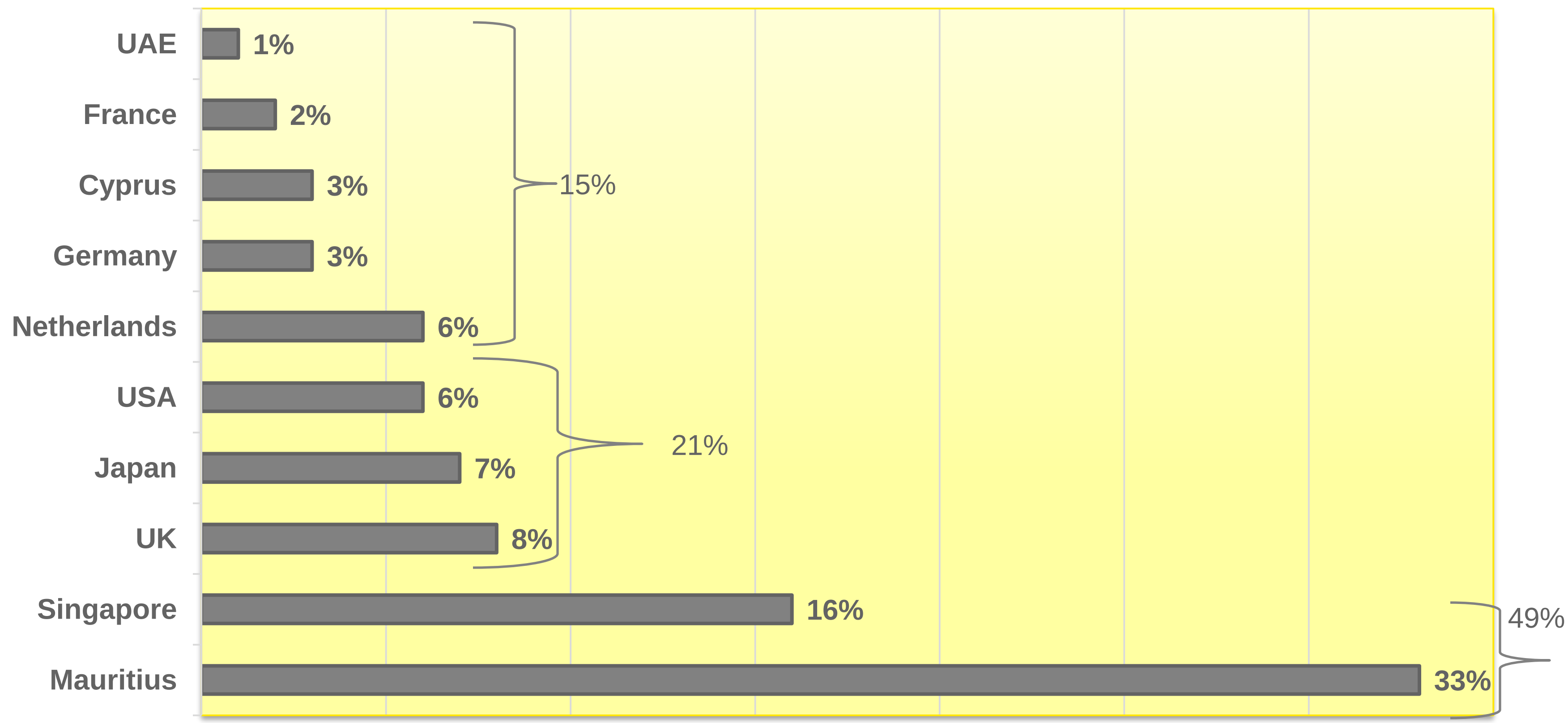
Attractive markets for investment in the next 3 years*



**Source: EY's 2015 India attractiveness survey (total respondents: 505)*

Cumulative Inflows of FDI in India

Percentage of Total FDI Inflow in India in US $ from April 2000 till March 2016* (Top 10 ~ 85%)



*http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_JanuaryFebruaryMarch2016.pdf

Case study 1 : Evaluating impact of grandfathering

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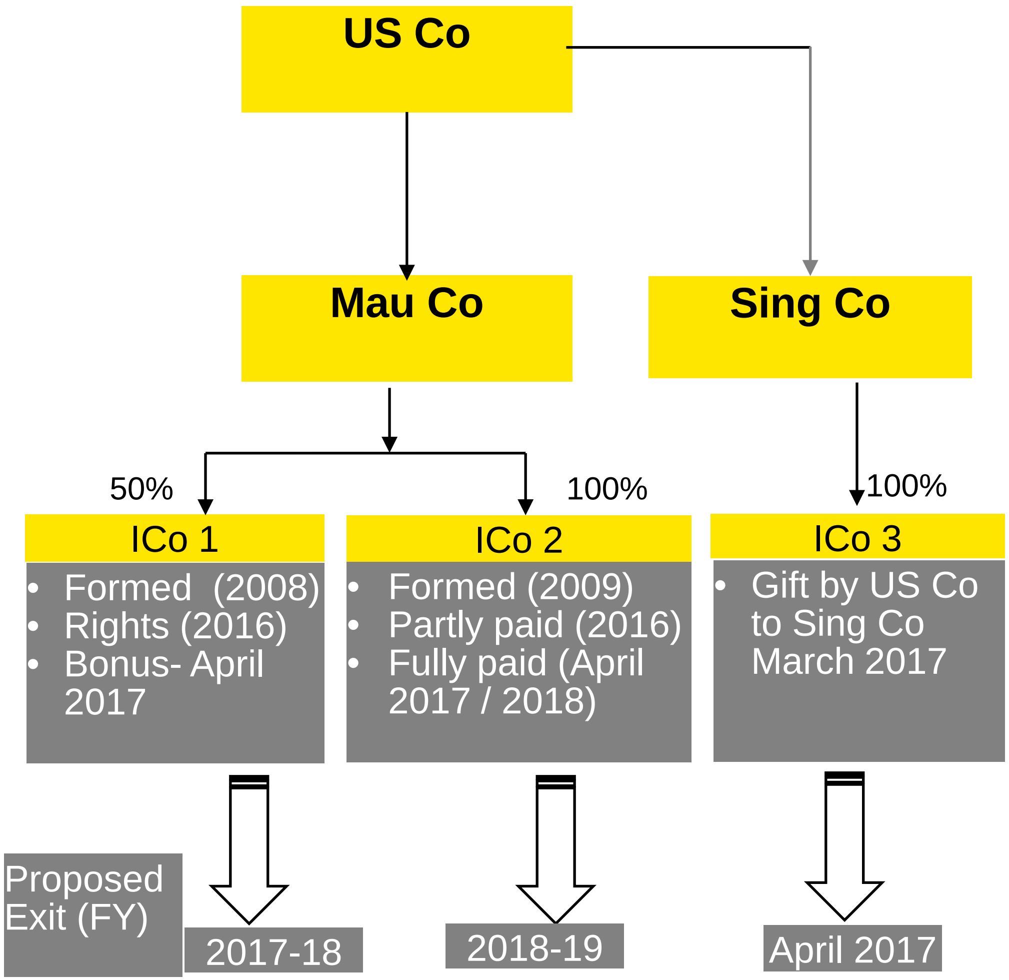

- US Head-quartered Group has holding entities in Mauritius and Singapore
- Mau Co and Sing Co hold 3 operating Indian entities
- Mau Co and Sing Co hold TRC/COR certificate and each is eligible for respective treaty benefit
- The Group has plans of phased exit

Case study 1 : Evaluating impact of grandfathering

- GAAR not to apply in respect of 'income from transfer' of 'investments made before 31 March 2017*
- As per Draft I-M Protocol, residence based taxation continues with regard to shares acquired before 31 March 2017
  - I-S Protocol of 2005, residence based taxation '***so long as I-M Treaty***' provides that "'***any' gains from alienation of resident company shares shall be taxable only in the country of residence***"
- Questions for consideration:
  - Which of the entities, arrangements or investments will be grandfathered as per Rules / protocol?
  - Does grandfathering mandate acceptance of legal form?
  - What meaning would one assign to "acquired" / "investments"?
  - Does denial of grandfathering automatically result in applicability of GAAR or denial of treaty benefit?

** Basis clarification in Explanatory memorandum – though Rule 10U(1)(d) refers to 30 August 2010*

Case Study 2A – Use of CCD as a funding choice

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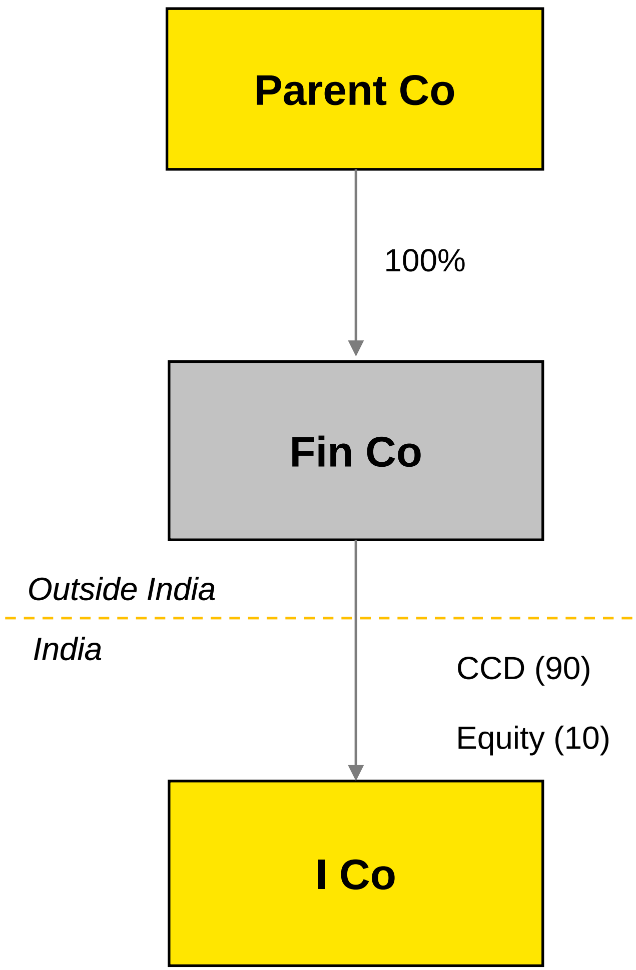
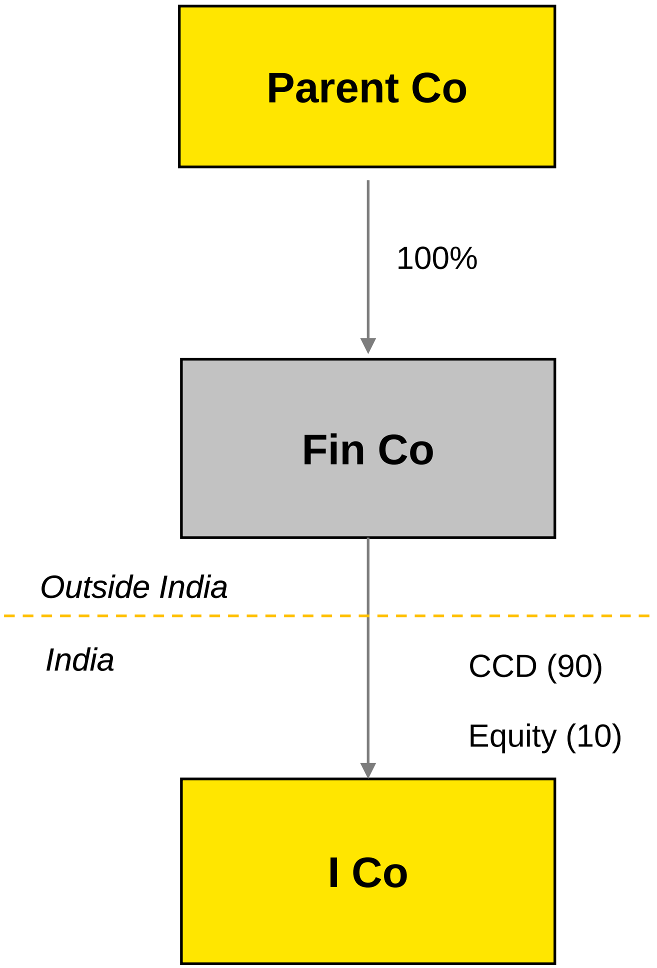


- Parent Co holds 100% of Fin Co
- ICo is 100% subsidiary of Fin Co
- ICo's Capital structure:
  - Equity 10; CCD 90
- CCD terms of issue are FEMA and ALP compliant
- Features of CCD:
  - May or may not be a secured/preferred debt
  - Fixed maturity period – though, may have early conversion option at behest of I Co / Fin Co
  - Repayment in the event of contingency or liquidation or inability of ICo to convert
  - Likely to be senior to all forms of capital or unsecured creditor
  - Interest may be fixed and/or may be topped up linked to profitability

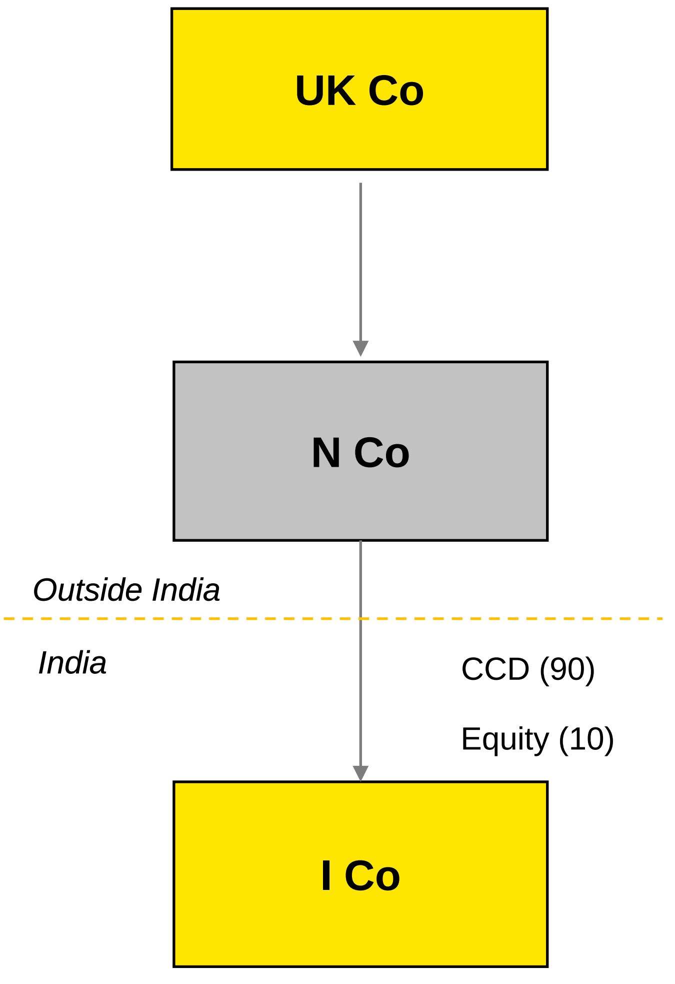
Case Study 2A – Use of CCD as a funding choice



- Is CCD different compared to NCD?
- Can debt be re-characterized as equity under GAAR?
- Does GAAR impact choice of funding the enterprise?
- Borrowing from a party incorporated in a low tax jurisdiction (Example 5 of Shome committee report on GAAR & Example 7 of Draft CBDT guidelines on GAAR)
  - Debt v Equity is a business decision to be left to commercial judgment – GAAR will not be attracted
  - Thin capitalization provisions absent in India
- Does it make a difference if CCDs are in existence prior to 31 March 2017?
- BEPS Action 4 and 6 impact to be evaluated

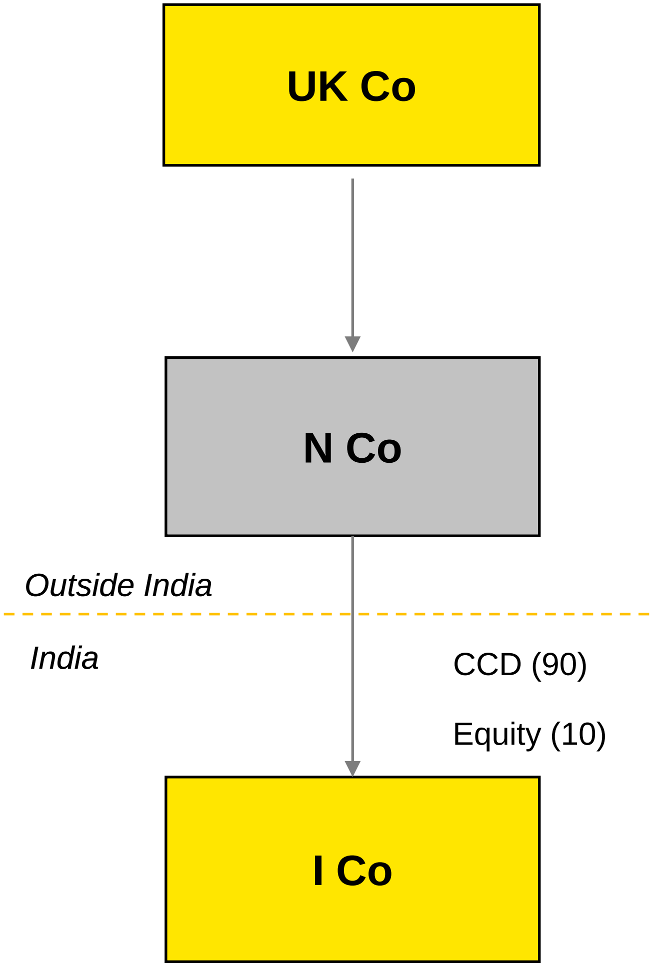
Case Study 2B – Participation exemption and use of CCD - *BEPS and GAAR Impact*

Case Study 2B – Participation exemption and use of CCD



- UK Co holds 100% of N Co
- N Co finances I Co by way of CCD
- Features of CCD which may permit N Co to claim participation exemption in Netherlands
  - Not a secured debt
  - Interest is profit contingent i.e. no interest is payable if there are no profits. Also, there is no carry forward of unpaid interest
  - Compulsion to conversion on bankruptcy or liquidation
  - Long term duration – say, > 50 years
  - Debt is senior only to equity shareholders

Case Study 2B – Participation exemption and use of CCD - *BEPS Impact*



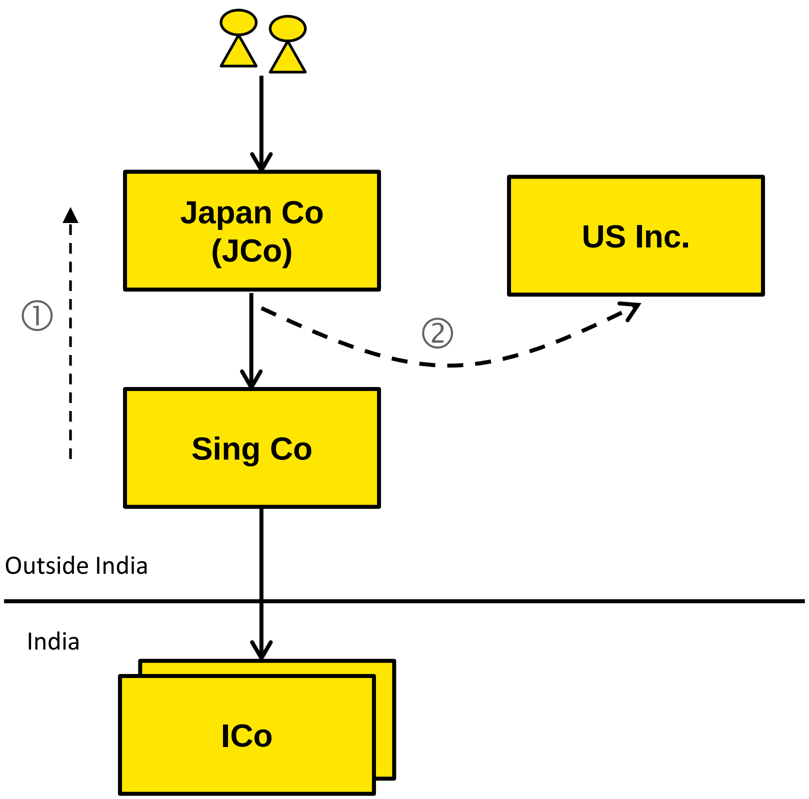
- ICo claims Interest deduction but N Co eligible to claim participation exemption
- If BEPS Action 2 is implemented
  - Primary Rule: Deduction of interest to ICo may be denied
  - Defensive Rule: Such interest may be included as income in Netherlands applying defensive rule
  - Existing structures also likely to be impacted as grandfathering not available
- BEPS Action 3 – CFC Pick up at UK Co level may not trigger Action 2
- BEPS Action 4 – Interest deduction proposed on formulary basis

Case Study 2B – Participation exemption and use of CCD – *GAAR Impact*

- Re-characterizing debt as equity - S. 98(1)(a) read with S. 98(2)(i)
  - Can Interest deduction be denied to I Co by treating it as dividend?
  - DDT implications in the hands of I Co?

Case Study 3 – Regional HQ – Impact post BEPS & GAAR

Facts of the case



① Dividend payment
② Transfer of shares of Sing Co

- J Co, an operating company, is incorporated in and is a tax resident of Japan
- J Co was promoted by Japanese individuals in the year 2000
- J Co set up 100% subsidiary in Singapore (Sing Co) in the year 200X to act as RHQ for its Asia Pac business presence
- Over years, Sing Co evaluated presence in various jurisdiction but could successfully make investments in certain Indian entities
- As of today, Sing Co investments are represented by shares in Indian subsidiaries which have appreciated significantly

Facts of the case

- Promoters of J Co desire to exit and has found US PE fund as a prospective buyer
- For commercial reasons and considering its future plans, buyer is keen to acquire shares of Sing Co from J Co
- J Co and Sing Co valid TRC
- The parties are advised:
  - To revalue assets of Sing Co and pay dividend to J Co from revaluation reserves of Sing Co
  - US Co to infuse CCD in Sing Co to permit declaration of dividend by Sing Co
  - Buyer to acquire shares of Sing Co after declaration of dividend

Presumptions:
- All steps are law compliant
- Investments in Sing Co and I Cos are not grandfathered

Tax implications (Pre GAAR / BEPS)

- Declaration of dividend by Sing Co is not subject to tax in India (Circular 4 of 2015)
- Dividend paid by Sing Co to J Co also protected by ‘other income’ article of I-J treaty / Article 10(6) of I-S treaty
- Transfer of shares of Sing Co by J Co is treaty protected by (Article13(5) of I-J Treaty)
  - Treaty of I-J is that of 1990 and unlike UN Model, does not permit indirect transfer taxation even if immoveable property in India contributes principally to the value of F Co

Tax implications if BEPS measures are implemented

- BEPS Action 6 can lead to introduction of strict LOB + PPT test
- J Co may meet LOB test: Sing Co may likely fail LOB test
- PPT test question: is it reasonable to conclude that one of the principal purposes of arrangement or transaction is to obtain treaty benefit ?
- If treaty benefit is denied, taxation will be in the hands of the person earning the income

Impact of GAAR

- Is there an impermissible avoidance arrangement (IAA) in the structure?
- If yes, what is the arrangement?
  - Was formation of Sing Co an arrangement?
  - Is period of time for which Sing Co existed relevant for determining ‘main purpose’ test?
- Is any tainted element test fulfilled? Particularly, does arrangement involve location or place of residence of Sing Co which is without substantial commercial purpose?

Consequences if GAAR is invoked

- GAAR consequences to be restricted only to that part of the arrangement which is declared IAA (Rule 10UA)
- No clarity about applicability of GAAR when SAAR applies or LOB conditions are fulfilled.
- Assume formation of Sing Co is declared as IAA

Identified IAA	Consequence
Treating IAA as not entered into or carried out	Taxing J Co as if it transfers shares of I Co
Disregarding Sing Co as and accommodating party and/or treating J Co and Sing Co to be one and the same	----------do----------
Considering or looking through the arrangement by disregarding the corporate structure	----------do----------
Treating the place of residence of Sing Co to be in Japan by concluding that Sing Co's location of residence in Singapore is without any substantial commercial purpose	Taxing Sing Co as if it is a company incorporated in Japan and hence effective denial of the treaty benefit

Consequences of GAAR if dividend declaration from J Co is ignored

- Declaration of dividend out of revaluation reserve: Is it IAA as apart from main purpose being tax benefit
  - Is entered into or carried out in a manner which is not ordinarily employed for bonafide purposes?
  - It lacks commercial substance as it does not impact business risk or net cash flow of the parties to the sale transaction?
- Consequences if dividend declaration is considered IAA
  - Disregard, combine or re-characterize the step as part of sale transaction?
  - Re-allocate receipt as that of a sale transaction

Purchaser's (US Co's) perspective and GAAR

- Can Buyer Co be considered as a party to GAAR prone arrangement?
- Is there any tax benefit derived by Buyer Co?
- Can Buyer Co be considered as assessee in default or representative assessee upon invocation of GAAR?
- Is AAR Ruling a sufficient remedy?
- Reporting obligations under S. 285A on transfer of SPV shares
  - ICo required to report transfer of Mau Co shares; onerous obligation?
  - Whether lack of information a possible defence?

Shome Committee Recommendation

- Tax deductor will be allowed to remit funds without inquiry into GAAR if he furnishes undertaking to pay tax at a later date if GAAR provisions are invoked

Thank You

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