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Client Alert

India/Tax Practice

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Proposed Tax Changes in India may have a significant impact on International Investors

On March 16, 2012, India's Finance Minister presented the country's budget for the fiscal year beginning April 1, 2012, which included proposed legislation that seeks to reverse the decision of (India's) Supreme Court in the *Vodafone case* and makes several other significant amendments to (India's) Income Tax Act, 1961 ("**IT Act**"). Many of the proposed amendments take effect retroactively from April 1, 1962.

(India's) Supreme Court ruled in the *Vodafone case* that income arising from the transfer of shares of a company incorporated outside India by a seller resident outside India to a buyer resident outside India is not taxable in India (even if such transfer has the effect of indirectly transferring shares of an Indian company).

The proposed amendments to the IT Act however seek to impose, with retroactive effect from April 1, 1962, Indian income tax on income arising from a transfer of shares or interests in an entity incorporated outside India if such shares or interests derive value substantially from assets in India. The proposed amendments also seek to reverse virtually all of the other principles established in the *Vodafone case*. To see our alert on the *Vodafone case*, please click here.

The budget, together with such amendments to the IT Act that the Government of India may choose to proceed with, are likely to be approved by the Indian Parliament no later than mid-June, 2012.

Summarized below are certain other key proposed amendments that will affect international investors and cross-border business transactions in a significant way if brought into effect in their present form:

Withholding Requirement

The proposed amendments would require any person or entity resident outside India (irrespective of whether they have a residence, place of business, business connection or any other presence in India) to withhold Indian income tax when making payments to other persons or entities resident outside India, to the extent Indian income tax applies to such transaction. This requirement is to take effect retroactively from April 1, 1962.

General Anti-Avoidance Rule (GAAR)

Transactions undertaken through "impermissible avoidance arrangements" would be reviewed, readjusted and potentially taxed in India. "Impermissible avoidance arrangements" are transaction structures whose main purpose (or any element of which) is designed to reduce, avoid or defer tax and which satisfy any one of

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the following tests: (i) are not for bona fide business purposes; (ii) create rights or obligations not ordinarily created between persons dealing at arm's length; (iii) result directly or indirectly in misuse or abuse of tax laws; or (iv) lack commercial substance.

The onus is on the taxpayer to establish that its transaction structure is not an impermissible avoidance arrangement. If an arrangement is held to be an impermissible avoidance arrangement, Indian tax authorities may deny tax treaty benefits and look through such arrangement by disregarding any corporate structures in determining tax liability.

Guidelines and conditions for implementation of GAAR are yet to be announced. GAAR is proposed to come into effect from April 1, 2013, but is expected to cover the financial year commencing April 1, 2012 and subsequent years.

Implications of the Proposed Changes

While investors and industry associations are making significant efforts to obtain a roll-back of some of the proposed amendments, it is not clear if the Government of India will reconsider its position or proceed to enact these amendments in their present form. If the proposed amendments are approved in their current form, then parties should be mindful of the following:

(i) Income derived from the indirect transfer of interests in an Indian company by transferring shares of a company resident outside India would be subject to Indian taxes. Past transactions structured in this manner could be reopened by Indian tax authorities and tax liability imposed.

(ii) Commonly used investments structures (such as routing investments into India through entities resident in jurisdictions such as Mauritius to take advantage of favorable tax treaties with India, which structures had been recently validated by the Supreme Court of India in the *Vodafone case*) would no longer be effective unless such entities have substance and such structures have a clear commercial rationale. This would apply to both foreign direct investments and portfolio investments by foreign institutional investors.

(iii) All payments to non-residents that could be subject to Indian income tax would have to be made only after withholding the relevant Indian income tax amount.

There is considerable uncertainty currently regarding these issues and we await further clarifications from the Government of India on the final scope of these proposed changes.

Meanwhile, parties should examine their existing transaction structures and their past and current transactions that could be vulnerable to challenge by the Indian tax authorities and should consider what steps can be taken now to mitigate any adverse consequences. In addition, there are a number of other material amendments proposed to the IT Act and parties should consult their advisors to fully understand these changes and their implications.

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