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India/Tax Practice

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India Budget 2013: Key Changes Affecting International Investors

On February 28, 2013, India's Finance Minister presented the country's budget for the fiscal year beginning April 1, 2013 (Budget). The Budget includes several proposals that affect international investors investing in India, including the following which are significant:

- The General Anti Avoidance Rule (GAAR) proposed last year is to come into effect from the financial year beginning April 1, 2015, in line with the recommendations of an expert committee constituted by the Prime Minister on GAAR (the Shome Committee). However, certain other proposals recommended by the Shome Committee that were favorable to international investors have not been accepted.
- Foreign investment in an Indian company of less than 10% is to be deemed to be under the foreign institutional investor (FII) route and foreign investment above this limit is to be deemed to be under the foreign direct investment (FDI) route.
- Tax rates applicable to business income of foreign companies above certain thresholds and on royalties and fees for technical services paid to a non-resident have been increased.
- Tax is to be imposed on Indian companies buying back unlisted shares.

The Budget also proposed that a tax residency certificate (TRC) will be necessary but not sufficient for a non-resident entity to claim a tax treaty benefit. However, this attracted adverse investor reaction and the Ministry of Finance issued a press release on March 1, 2013 clarifying that a TRC would be accepted as evidence of residency "and the Income Tax Authorities in India will not go behind the TRC and question [the] resident status". Changes to the proposed Finance Bill to reflect this clarification are awaited.

In addition, although widely expected, the Budget did not amend certain controversial provisions of the Indian tax law that were introduced last year relating to taxation of income from certain indirect transfers of shares of an Indian company. Such transactions continue to be taxable in India (including on a retrospective basis) (see our earlier alert of April 2012).

The Budget proposals are expected to be enacted by the Indian Parliament by June 2013.

GAAR

The GAAR provisions are to come into effect from April 1, 2016 and will be applicable to transactions undertaken in the financial year commencing April 1, 2015 and in the following years.

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In addition, the "impermissible avoidance arrangements" to which GAAR will apply have been narrowed to arrangements whose "main purpose" (and not merely "one of the main purposes") is to obtain a tax benefit (see our earlier alert of April 2012).

The Shome Committee's recommendation to grandfather existing investments so that upon an exit GAAR would not be applied to deny any benefits, and the recommendation not to use GAAR to question the residency of a non-resident entity (if the non-resident entity provided a TRC) have not been accepted.

The guidelines and conditions for implementation of GAAR are, however, yet to be finalized.

Application of the FDI/FII Regime

The Budget proposes to apply the FDI or FII regime depending on whether the level of foreign investment is less than 10% (such investments being classified as FII investments) or in excess of such limit (such investments being classified as FDI investments). However, the details of this proposal are to be considered and formulated by an expert committee to be appointed by the Ministry of Finance. The full implications of this change, including whether it applies only to investments in listed companies or all companies, are not yet clear.

Increase in certain tax rates

- **Corporate tax rates on foreign companies**
  If the income of a foreign company from India exceeds INR 100 million, the effective tax rate on such income is proposed to be increased from 42.02% to 43.26% (inclusive of surcharge and cess).
- **Royalties and technical service fees**
  The tax rate on royalties and fees for technical services paid to a non-resident is proposed to be increased from 10% to 25% (plus surcharge and cess) but this should not affect any lower tax rates under applicable double tax avoidance agreements.

Tax on buy-back of unlisted shares

A new tax with an effective tax rate of 22.66% (inclusive of surcharge and cess) is proposed to be levied on an Indian company buying back its unlisted shares. This tax will be levied on the difference between the consideration paid for buy-back and the sum received at the time of issuance of the relevant shares. As in the case of dividends, the income received by a shareholder from the issuer company on account of a share buy-back will not be taxed in India.

Prior to this proposal, while the income of a shareholder tendering shares in the buy-back was subject to capital gains tax in India, such income could be exempt from capital gains tax under an applicable tax treaty.

Implications of the Budget

If the Budget proposals are enacted into law in their current form, then foreign investors in India will face increased tax costs and uncertainty in their activities relating to India.

In addition to the proposals summarised above, there are a number of other significant proposals included in the Budget and parties should consult their advisors to fully understand these changes and their implications.

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