McDermott Will & Emery

At Cross Purposes: Recent International Tax Developments in India

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A NOTE REGARDING CONTENT

From time to time in the course of our practice we have encountered and informed clients about the aggressive positions being adopted by the government of India in matters of international taxation. This *White Paper* highlights our understanding of certain key developments in Indian taxation of potential importance to U.S. businesses and other multinational enterprises. Please note that McDermott Will & Emery neither is licensed to practice law in India nor holds itself out as being so licensed. This *White Paper* is solely informational in nature and does not constitute legal or tax advice.

In the latter part of 2009, the Indian tax authorities continued to aggressively pursue the taxation of international transactions with an arguable Indian nexus, if anything, buttressed by the introduction of a draft Direct Taxes Code. The last quarter of 2009 was also replete with court decisions and administrative rulings (including the withdrawal of certain long standing administrative guidance) that potentially affect non-residents doing business and providing services in India. Certain of these developments are discussed below.

THE TAXATION AND JUDICIAL SYSTEMS OF INDIA: AN OVERVIEW

A national hierarchy of courts administers justice in India. The apex court is the Supreme Court of India, followed by the High Court, which sits in each of the states that together compose the Republic of India. The Supreme Court has appellate power over any final judgment of any High Court. In the case of income tax matters, immediately below the High Court lies the Income Tax Appellate Tribunal (ITAT) which also sits in every state. The ITAT hears taxpayer appeals from determinations of the Commissioner of Income Tax who, in turn, hears appeals from determinations made by the assessing office (generally, the equivalent of the audit or exam team in the United States). The ITAT is typically the ultimate adjudicator of fact on income tax matters, as the High Court's jurisdiction is generally confined to questions of law. All income tax matters are generally heard by the national courts. Income taxes are administered by the Central Board of Direct Taxes of India (sometimes referred to as the Indian Revenue Department) which, in turn, is governed by the Ministry of Finance of the Indian central government (the equivalent of the U.S. Treasury Department).

Vodafone, SABMiller and Indian Tax Jurisdiction

One of the most aggressive assessment cases of the year was the ongoing, US$2 billion withholding tax case brought against UK telecom company, Vodafone. In that case, Hutchison Telecommunications sold—but only indirectly sold—its interest in an Indian company, Hutchinson Essar (India) Ltd., which owned certain telecommunications assets located in India, to a Dutch subsidiary of Vodafone. The transfer was accomplished by Hutchinson transferring all of its shares in a Cayman Islands holding company which, in turn, indirectly held stock in Hutchinson Essar through certain Mauritius holding companies. The Indian Revenue Department (IRD), by way of a "show-cause" notice asserted that, since Indian domestic law deems all income accruing or arising through any transfer of a capital asset situated in India as income that accrues or arises in India, it follows that the gain on disposition of shares in a non-resident company, by one non-resident to another, would be taxable in India if it results in an indirect transfer of assets located in India. Therefore, the IRD concluded, Vodafone was obligated to withhold Indian taxes from the amount paid to the seller. Interestingly, this issue might have been avoided if the direct Mauritius parent entities of Hutchinson Essar had sold their shares of Hutchinson Essar (India) to Vodafone, as it appears that Article 13 of the India-Mauritius Tax Treaty would have precluded India from taxing the capital gains realized by the Mauritian sellers. (For its part, Mauritius imposes no tax on capital gains or distributions.)

Although Vodafone sought judicial intervention, the Indian courts have declined on technical grounds to intervene at this stage, and the IRD has informed Vodafone that it has withholding-tax jurisdiction over the transaction. Vodafone has recently filed its response to the IRD's notice, and the outcome of the case will no doubt establish India's position on its jurisdiction to levy tax in cases of indirect transfers of assets located in India.

Similarly, in December 2009 it was reported in the Indian media that the IRD was preparing to serve notice on UK-based brewer SABMiller (Miller), requesting Miller to show cause as to why the Indian tax authorities did not have jurisdiction to tax the company on its 2006 acquisition of Foster's India, the Indian arm of Australian brewer Foster's. In 2006, Miller acquired for cash from Foster's Australia the intellectual property rights, brand and trademarks of Foster's India. The parties indicated at the time that there was no Indian tax liability on the deal because the transfer of assets took place outside India. The IRD argued that the transaction was subject to Indian capital gains tax and that, under Indian law, the buyer is required to withhold capital gains taxes and remit such taxes to the Indian government. The IRD issued a show-cause notice to Miller in March 2009, demanding the company explain why it failed to deduct capital gains taxes at source when it acquired Foster's India. Miller challenged the jurisdiction of the Indian tax authorities in the Bombay High Court. The court dismissed the petition in May 2009, indicating that the company was required to respond to the IRD notice prior to initiating legal proceedings. The court also directed the IRD to determine whether it had jurisdiction to tax the transaction.

Notably, Foster's Australia had filed previously an application with India's Authority for Advance Ruling (AAR), requesting a decision as to whether the sale of the brand, trademark and brewing license of Foster's India to Miller was taxable in India. In May 2008, the AAR held that the *situs* of Foster's India's brand, trademark and goodwill was located in India and that the sale of those assets to Miller was taxable in India under the Indian Income Tax Act 1961 (ITA). However, the sale of the brewing license was held to be not taxable in India. When Foster's Australia appealed the AAR decision to the Indian Supreme Court, the court declined to hear the appeal on grounds that the company had skipped a step in the judicial hierarchy by failing to appeal to the High Court first. The matter is now pending before the Delhi High Court.

THE AUTHORITY FOR ADVANCE RULING (AAR)

The AAR provides advance tax rulings for certain types of taxpayers. These rulings are binding on the Indian taxing authority and the taxpayer, but do not constitute precedent. They are roughly analogous to a Private Letter Ruling issued by the U.S. Internal Revenue Service (IRS), but the procedure for obtaining an advance ruling involves an arbitration-like process. Advance rulings by the AAR are binding only with respect to the specific facts ruled upon. While the rulings are not appealable they can, in certain circumstances, be quashed by invoking the writ jurisdiction of either the High Court or the Supreme Court. The AAR panel consists of a Chairman, who is a retired Judge of the Supreme Court, and two members of the rank of Additional Secretary to the Government of India, one each from the Indian Revenue Service and the Indian Legal Service. Thus the AAR, unlike the IRS, is a semi-independent entity. Application for a ruling from the AAR requires a fee equivalent to US$50 and the filling out of certain forms. The AAR is required to render a pronouncement within six months of receiving a valid application. See http://aar.gov.in for more information.

Draft Direct Taxes Code of 2009

The Draft Direct Taxes Code (DTC) was made public on August 12, 2009, and will come into force on April 1, 2011, if enacted. Pursuant to the proposed DTC, in the event of a conflict between the provisions of the DTC and an existing Indian income tax treaty, the DTC will prevail on the basis of its enactment later in time.

Some of the elements of the DTC affecting international tax are highlighted below.

TAXATION OF NON-RESIDENTS

- Introduces a branch profits tax
- Clarifies that the treatment of income from the transfer, directly or indirectly, of a capital asset situated in India will be deemed to accrue in India (arguably a confirmation of the stance taken by the IRD in the Vodafone case)
- Makes mandatory the requirement of a Tax Residency Certificate for claiming relief under an applicable tax treaty

- Provides for the recovery of tax due from a non-resident from any of the non-resident's assets, even if situated outside India, or from any amount payable by any person to such non-resident

- Introduces provisions that will treat a foreign company as resident in India if, at any time in the financial year, the control and management of its affairs is situated wholly or partly in India (at present, a company must be wholly situated in India to be considered as resident in the country)

With regard to the final item immediately above, a determination of India residency can technically lead to taxation in India on a worldwide income basis. While not entirely clear at this stage, this could mean that a foreign company with significant Indian operations could potentially be considered resident in India, leading to taxation in India of its worldwide income.

SERVICE FEES AND ROYALTIES

- Broadens the scope of "fees for technical services" to include development and transfer of designs, drawings, plans and software, or similar services

- Broadens the scope of "royalties" to include consideration for the use or right to use transmission by satellite, cable, fiber optic, ship or aircraft and live coverage of any event

- Introduces net-basis taxation with respect to royalty income and fees for technical services earned by non-residents through a permanent establishment in India

TRANSFER PRICING

- Introduces an Advance Pricing Agreement mechanism with respect to arm's-length pricing for international transactions (agreements will generally be valid for five consecutive financial years unless there is a change in law or facts)

- Expands the scope of the transfer pricing regulations by broadening the definition of an "associated enterprise" (for example, enterprises having shareholdings with 10 percent (earlier 26 percent) voting power, loans amounting to 26 percent (earlier 51 percent) of total assets, nomination of one-third (earlier one-half) directors, and purchases of two-thirds (earlier 90 percent) raw materials and consumables would each constitute affiliation for purposes of the definition)

- Creates the office of Transfer Pricing Officer (TPO) to ensure that transfer pricing matters are determined by personnel with the requisite expertise (the TPO will select cases for a detailed audit based on risk-management criteria and strategy framed by the Indian tax authorities and will have broad powers to make adjustments to the arm's-length pricing)

- Limits head-office expenditures in the case of non-residents to 0.5 percent of total sales, turnover or gross receipts

GENERAL ANTI-AVOIDANCE RULE

The DTC also introduces a general anti-avoidance rule (GAAR) which can override the provisions of any tax treaty and will be invoked if each of the following three conditions are met:

- The taxpayer has entered into an "arrangement" (this is somewhat analogous to the position taken in recent economic substance cases under U.S. income tax law, under which individual steps in any transaction aimed at securing a tax benefit can be treated as an arrangement and can include any interposition of an entity or transaction where the substance of such entity or transaction differs from the form given to it).

- The main purpose of the arrangement is to obtain a tax benefit.

- The arrangement includes any one or more of the following attributes:

    i) Has been entered into, or carried out, in a manner not normally employed for *bona fide* business purposes

ii) Has created rights and obligations which would not normally be created between persons dealing at arm's length

iii) Results, directly or indirectly, in the misuse or abuse of the provisions of the DTC

iv) Lacks commercial substance, in whole or in part

The highlights of the proposed DTC as compared to certain existing provisions are summarized in Table 1.

Table 1: Comparison of Tax Rates under the Current Indian Income Tax Act 1961 and the Proposed Direct Taxes Code 2009

TAX RATES	CURRENT	PROPOSED
Corporate Income	30%	25%
Minimum Alternative Tax	15% (levied at 15% of adjusted book profits on companies where income tax payable on taxable income is lesser than tax payable on book profits)	2% of gross assets (0.25% of gross assets for banking companies)
Capital Gains	Up to 40% (depending on whether it is short- or long-term capital gains)	30% (no distinction between short- and long-term capital gains)
Foreign Company	40%	25%
Branch Profit	0%	15% (levied on branches of foreign companies, on after-tax total income, resulting in an effective tax rate of 36.25%)
WITHHOLDING TAXES		
Dividends	0% (but 15% DDT; see discussion of DDT below)	0% (but 15% DDT; see discussion of DDT below)
Interest	10% to 40%	20%
Royalty	10% on a gross basis	20% on a gross basis
Service and Management Fees	10% on a gross basis	20% on a gross basis

A dividend subject to the dividend distribution tax (DDT) is exempt from tax in the hands of the recipient. U.S. corporate taxpayers generally take the position that the DDT is creditable pursuant to Section 902 of the U.S. Internal Revenue Code of 1986, as amended (U.S. Tax Code). In addition, Article 25(1) of the U.S.-India Tax Treaty provides that, subject to applicable conditions and limitations, the United States shall allow a U.S. company that qualifies for benefits under the Treaty, and that owns at least 10 percent of the voting stock of a company which is a resident of India and from which the U.S. company receives dividends, a credit for income taxes paid to India by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

Reiterating Validity of the India-Mauritius Tax Treaty

In the midst of the speculation caused by the provisions of the proposed DTC with respect to the continued validity of certain Indian tax treaties, and in what many advocates of foreign investment in India considered a welcome move, the Foreign Investment Promotion Board of India (FIPB), which is the primary governmental agency responsible for facilitating, regulating and monitoring foreign direct investment (FDI) in India, has chided the Indian tax authorities for rejecting FDI proposals channeled through Mauritius on the basis that they are aimed at treaty shopping and tax avoidance.

The India-Mauritius tax treaty does offer very favorable terms for investment channeled through Mauritius (as will be noted from the Vodafone discussion above and the chart below)—in particular, it permits the disposition of such investments from Mauritius without any Indian capital gains taxes. There have been unsuccessful attempts by India to renegotiate the treaty in order to curtail these tax advantages and, as discussed above, the draft Indian Direct Taxes Code proposed in August 2009, if enacted as proposed, will seek to statutorily override certain provisions of all existing Indian tax treaties on a "later in time" basis. However, pending these developments, the FIPB has pointed out that the India-Mauritius Tax Treaty continues to be valid and operational. In fact, the validity of the treaty and the capital gains exemption available under that treaty have been repeatedly upheld by the Indian courts, notably by the Indian Supreme Court in the case of *Union of India v. Azadi Bachao Andolan*, (2003) 263 ITR 763.

A brief overview of withholding tax rates under the India-Mauritius tax treaty as compared to rates under certain tax treaties between India and other countries is provided in Table 2.

Table 2: Comparison of Withholding Tax Rates on Certain Payments under Indian Income Tax Treaties

Gains on Disposition of Assets Located in India								
	Cyprus	**Denmark**	**France**	**Mauritius**	**Netherlands**	**Singapore**	**Sweden**	**United States**
India	0%	0%[1]	0%[1]	0%	0%[2]	0%[3]	0%[4]	Taxable under applicable domestic law
India Withholding Tax on Certain Types of Income								
	Cyprus	**Denmark**	**France**	**Mauritius**	**Netherlands**	**Singapore**	**Sweden**	**United States**
Dividends	15% (10%)[5]	25% (15%)[7]	10%[6]	15% (5%)[5]	10%[6]	15% (10%)[7]	10%[6]	25% (15%)[5]

[1] Provided the shares alienated represent at least 10 percent of the share capital of the Indian company and provided the Indian company's property does not consist directly or indirectly principally of immovable property situated in India.

[2] Gains realized by a 10 percent (or greater) shareholder of an Indian company may be subject to tax in India, if the purchaser is a resident of India. India may also tax gains arising from the alienation of shares representing 25 percent or more of the capital stock of an Indian company, the value of which shares is derived principally from immovable property situated in India (other than immovable property held as inventory). An exemption is provided for gains realized in the course of a corporate organization, reorganization, amalgamation, division or similar transaction, where the buyer or the seller owns at least 10 percent of the other.

[3] This treatment is available only as long as similar beneficial treatment is effective under the India-Mauritius tax treaty.

[4] Provided seller is subject to tax in resident state. If the Indian company's property consists directly or indirectly principally of immovable property situated in India, then the alienation of shares of such company will be taxed in India.

[5] Lower rate applicable where the beneficial owner of the dividends is a company that owns at least 10 percent of the shares of the company paying the dividends.

[6] The protocol to the treaty limits the scope and rate of taxation to that specified in similar articles in treaties signed by India with another country which is a member of the OECD.

[7] Lower rate applicable where the beneficial owner of the dividends is a company that owns at least 25 percent of the shares of the company paying the dividends.

Table 2: Comparison of Withholding Tax Rates on Certain Payments under Indian Income Tax Treaties								
India Withholding Tax on Certain Types of Income								
	Cyprus	**Denmark**	**France**	**Mauritius**	**Netherlands**	**Singapore**	**Sweden**	**United States**
Interest	10%	15% (10%)[8]	10%[6]	Taxable under applicable domestic law	15%[6] (10%)[8]	15% (10%)[9]	10%[6]	15% (10%)[9]
Royalties	15%	20%	10%[6]	15%	10%[6]	10%	10%[6]	10%/15%[10]

***** Currently, no Indian withholding taxes are imposed on "dividend distributions." However, dividends are subject to a dividend distribution tax or DDT as described above of 15% (16.99% after surcharge/other levies) which is paid by the Indian payor company.

Delay in Introduction of Proposed Goods & Services Tax

The Indian government also announced on December 16, 2009, that the introduction of its new goods and services tax (GST) regime, aimed at unifying the rate across the country at both the state and federal levels, will now be delayed. Indications are that, at a minimum, implementation will be delayed until 2011. The original implementation deadline was April 1, 2010. (The Indian fiscal year runs April 1 to March 31.)

Permanent Establishments and Business Connections

CONSTRUCTION CONTRACTS AND PERMANENT ESTABLISHMENTS

In a ruling issued in September 2009, the AAR concluded that an Indian subcontractor performing construction work in India for a German company did not result in a permanent establishment for the German company under the India-Germany tax treaty.[11] The India-Germany tax treaty (similar to the U.S.-India tax treaty) contains provisions addressing the circumstances in which a construction site or project carried on by a foreign company would constitute a permanent establishment and generally provides that construction projects that last longer than a period of six months constitute permanent establishments and thus expose the foreign construction company to tax.

The IRD argued that the Indian subcontractor was undertaking various activities that constituted the core of the contract work entrusted to the German company. All the activities undertaken by the subcontractor were on behalf of the German company and were in connection with the execution of the contract between the German company and its Indian customer. Therefore, the IRD claimed, the Indian subcontractor's workshop and worksite constituted a permanent establishment of the German company.

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[8] Lower rate applicable where interest is paid on any loan granted by a bank.
[9] Provided interest is paid on a loan granted by a bank carrying on a *bona fide* banking business or by a similar financial institution (including an insurance company).
[10] Rates apply to royalties and fees for included services. The applicable rate depends on the category of royalty. The 10 percent rate generally applies to payments for the use of, or the right to use, any industrial, commercial, or scientific equipment and certain fees for included services which are ancillary and subsidiary to the enjoyment of such equipment.
[11] See A.A.R. NO. 790 OF 2008, September 11, 2009.

The AAR found that, under the facts advanced in the ruling, the Indian company was acting in an "independent capacity," and that the German company and Indian subcontractor were similar to two principals dealing at arm's length and that, therefore, the Indian subcontractor's activities did not result in a permanent establishment of the German company in India.

WITHDRAWAL OF GUIDANCE ON A NON-RESIDENT INDIAN BUSINESS CONNECTION

In October 2009, the Indian Central Board of Direct Taxation (CBDT) withdrew Circular 23 of 1969 (Circular 23), which laid down certain limitations on the taxability of non-resident business income in India, on the basis that it was being misused. This circular, which was binding on tax authorities, originally set out the position of the CBDT with respect to the interpretation of the term "business connection" under Section 9 of the ITA and provided guidance with respect to various types of business arrangements non-residents generally have with India, such as non-resident companies selling goods to an Indian subsidiary and non-residents purchasing goods from India.

In general, similar to the United States, Indian residents are taxable on their worldwide income while non-residents are taxable on income that accrues or arises, or is deemed to accrue or arise, in India or which is received in India. Section 9 of the ITA provides that business income of a non-resident is deemed to arise in India if it is attributable to a business connection the non-resident has with India. The approach is conceptually not dissimilar to the U.S. taxation of income that is effectively connected with a U.S. trade or business pursuant to Section 864 of the U.S. Internal Revenue Code. Also not dissimilar to its U.S. analogue, the term "business connection" is not comprehensively defined. The term has been described by the Indian judiciary to mean "a real and intimate connection between a trading activity carried on outside India and trading activity carried on inside India by the non-resident"[12] and encompasses more than the narrower concept of permanent establishment found in many Indian tax treaties.

Circular 23 provided in relevant part that "Section 9 does not seek to bring into the tax net the profits of a non-resident which cannot reasonably be attributed to operations carried out in India." In the case of non-residents acting in India through agents, Circular 23 mitigated the broad ambit of the term "business connection" and the income attributable thereto, by providing that a non-resident doing business in India through an agent would not have any additional income attributable to such business connection if the agent was remunerated on a basis that was fully representative of the value of profit attributable to his service.

This was consistent with the proposition laid down by the Indian Supreme Court that in an international transaction, if the non-resident compensates its permanent establishment (PE) at an arms-length price, no further profits of the non-resident would be attributable to the PE in India.[13]

The impact of the withdrawal of Circular 23 is unclear. While questioning whether any misuse of the circular was occurring, commentators also speculate that the practical effect of the withdrawal will be to embolden IRD examiners to bring greater scrutiny to bear on the activities of non-residents connected to India.

Withholding Taxes on Remittances and Royalties

REMITTANCE FOR IMPORTS POSSIBLY SUBJECT TO WITHHOLDING TAX

In October 2009, the Karnataka High Court held in *CIT v. Samsung Electronics Co. Ltd*,[14] that every person making a payment for import of "shrink wrapped" software must deduct and withhold tax at source. The tax authority argued that the payments for supply of software were analogous to license fees and thus should be treated as a royalty. The taxpayer argued, based on judicial precedent, that instead of acquiring a copyright, it acquired copyrighted articles.

The court observed that in making a payment, the payor must make an application to the assessor's office to determine what percentage of the goods are subject to withholding. In the absence of such a determination, the entire amount would appear to be subject to withholding. The court's rationale stemmed from its analysis of Section 195 of the ITA. Based on its reading of the

[12] *R.D. Aggarwal v. CIT*, (1965) 56 ITR 20.
[13] *DIT (International Taxation), Mumbai v. Morgan Stanley and Co. Inc.*, (2007) 7 SCC 1.
[14] ITA No. 2808 to 2810 of 2005.

provision, the court concluded that the resident payor's liability arises at the moment there is a payment made to a non-resident and thus, if the amount transferred to the non-resident is *per se* income in the hands of the recipient, the payor must withhold. Since it will not be clear to the payor what percentage of the amount will actually be income in the hands of the recipient, the court indicated a ratio that must be withheld with respect to the payments under review, pending approval by the assessor's office as to whether the payor could refrain from withholding.

The court's ruling could have far-reaching implications, perhaps subjecting any payment made for the import of goods or services to withholding. However, soon after the Karnataka High Court's judgment, the Supreme Court of India stayed recovery proceedings in the case in a special leave petition filed before it.

By contrast, under U.S. federal income tax law, the character of a software transaction is governed by regulations that specifically address the matter. Generally, the purchase of a "shrink wrapped" software program will result in tax treatment similar to that of inventory.

COPYRIGHT VERSUS COPYRIGHTED ARTICLE

The issue of transfer of a copyright versus transfer of a copyrighted article, as noted above, was also examined in the case of *AsiaVision Home Entertainment Pvt. Ltd. v. CIT*,[15] where the Mumbai ITAT, in December 2009, ruled that license fees payable to a U.S.-based movie studio for the right to distribute and market its movies on digital and video CDs in India did not constitute taxable royalties.

The taxpayer had entered into an agreement with Columbia Tristar Films, USA (CTF), pursuant to which, as a licensee, it was allowed to commercially distribute motion pictures owned and controlled by CTF through their rental and sale on DVDs and VCDs. The taxpayer paid CTF a license fee based on the number of DVDs and VCDs rented and sold. The license fee was referred to as a royalty in the agreement. In the taxable year under consideration, the taxpayer had paid license fees to CTF pursuant to the agreement and claimed a deduction for such payments, but had not withheld any taxes from such payments. The Indian tax authorities contended that the license fee constituted a royalty under Section 9 of the ITA and, therefore, that the taxpayer was obligated to withhold tax from such payment and that, in the absence of any withholding, the payment was not tax deductible. The taxpayer contended that the payment did not constitute a royalty pursuant to Section 9 and that the character of the payment cannot be determined from the nomenclature of the agreement alone.

Section 9 of the ITA specifies the situations in which the income of a non-resident can be deemed to be accruing in, and thus taxable, in India. Section 9(1)(vi) provides that a royalty paid by a resident to a non-resident will be deemed to accrue in India if the underlying right and property are used for the business of the resident in India. For purposes of this provision, a royalty is defined as a payment for the transfer of all or any rights (including the granting of a license) to any copyright or literary, artistic or scientific work, including films or videotapes for use in connection with television or tapes for use in radio broadcasting. The definition does not include consideration for the sale, distribution or exhibition of cinematographic films. Section 40(a)(i) of the ITA denies a deduction for a royalty paid outside India if the payer has not withheld tax from the royalty payment.

In agreeing with the taxpayer, the ITAT concluded that the license fee was not a royalty because it was not a payment for the rights to use the films in television or radio broadcasting.

It would appear that a similar decision may have been rendered under U.S. tax principles on the same facts, on the basis that the payment being made by the taxpayer to CTF was not for a copyright but for a copyrighted article.

PAYMENTS FOR USE OF SATELLITE TRANSPONDERS HELD TO BE "ROYALTY"

In October 2009, the New Delhi ITAT issued a ruling in favor of the revenue authorities in appeals filed by two non-resident satellite companies: New Skies Satellites N.V. (a Dutch tax resident) and Shin Satellite Public Co. Ltd (a tax resident of Thailand). The tribunal held that payments made to the satellite companies for use of satellite transponders would be characterized as "royalty" income, as they involved the use of a "process," and therefore were liable to tax in India both under the ITA and applicable tax treaties. This decision reversed the decision delivered in the case of *PanAmSat International Systems*

[15] ITA No. 3300/Mum/07 (2010).

(2006), 103TTJ (Delhi) 861 and reinstated the earlier decision in *Asia Satellite Telecommunications Limited (2003),* 78TTJ (Delhi) 489.

The non-resident satellite companies were engaged in the business of providing satellite transponder facilities to telecasting and telecom companies in the Asian region. Indian telecasting/telecom companies had entered into agreements with the satellite companies for obtaining transponder capacity to enable them to up-link and down-link programs to be telecast. The issue that arose for adjudication was with respect to the characterization of the consideration received by the satellite companies under these agreements.

The Indian tax authorities maintained that the consideration paid to the satellite companies was in the nature of royalties under both the ITA and India's tax treaties and, therefore, was taxable in the hands of the satellite companies. The satellite companies argued that the payments did not qualify as royalties and that in the absence of a permanent establishment in India, the income was not taxable in India. In holding in favor of the tax authorities, the tribunal appeared to be of the view that the Indian telecasting and telecom companies (as opposed to the satellite companies) had complete control of the up-links and down-links and, therefore, that these companies in effect operated the satellites using a predetermined and pre-guided process. The consideration the satellite companies received was for exploitation of the process and, therefore, fell within the scope of a royalty under the ITA. Moreover, the tribunal rejected a contention by the satellite companies that a process must be secret in order to constitute a royalty.

The ruling potentially has far-reaching ramifications with respect to non-resident companies providing satellite and telecommunications services in India.

Taxation of Services

TAXATION OF SERVICES INCOME ARISING FROM OIL AND GAS PROSPECTING

In two rulings released in December 2009, the AAR concluded that payments received by non-residents of India for the provision of seismic data and related services to Indian oil and gas companies do not qualify as fees for technical services; rather, they qualify as business income subject to tax on a deemed-income basis.[16] The parties requesting the rulings were non-resident geophysical service companies resident in Poland and the United Arab Emirates, respectively.

Pursuant to Section 44BB of the ITA, subject to certain conditions, income arising to a non-resident supplying services or facilities *in connection with*, or plants and machinery used in, the exploration, extraction and commercial production of mineral oils in India shall either be deemed to be 10 percent of the consideration receivable (whether in India or outside) by the non-resident or, at the option of the non-resident, the actual profits. The profits are taxed at the applicable corporate rate, with the base rate for a foreign company being 40 percent. Therefore, on a deemed-income basis, the effective base tax rate is 4 percent of the gross consideration receivable. Similar provisions also apply, for example, to shipping and the operation of aircraft. This treatment is not available to any payment in the nature of fees for technical services (FTS), which are generally taxable at 10 percent on a gross basis. Pursuant to Section 9(1)(vii) of the ITA, fees for technical services are defined to mean any payment for the supply of managerial, technical or consultancy services, except those related to any construction, assembly, mining or similar project undertaken by the supplier. FTS paid by an Indian resident are deemed to accrue in India unless the services are used by a business conducted outside India.

The Indian tax authority argued that the services at issue were FTS because the taxpayers were not engaged in the business of providing services in prospecting for, extraction of or production of mineral oils, as they were not undertaking a mining or similar project. According to the Indian tax authority, the project was being undertaken by another business enterprise to which the taxpayer was rendering certain technical services.

In disagreeing with the Indian tax authorities, the AAR observed that the provisions governing the computation of income on a deemed basis for certain businesses were special and complete codes in themselves for governing such business carried out by non-residents in India. The AAR noted that the phrase "in connection with" was comprehensive and has both a direct and an

[16] A.A.R. No.813 of 2009.

indirect significance. Accordingly, the AAR concluded that there was a real, intimate and proximate nexus between the services performed by the taxpayer in India and the exploration or extraction of mineral oils by the oil and gas companies for whom the services were being performed. The seismic survey and data acquisition services provided by the applicants were a prelude to and a very critical component of the oil and gas exploration activity, without which it would be impractical for an oil and gas company to carry out the activity of prospecting and exploration. Therefore, the AAR held that these services were caught up in the ambit of Section 44BB.

PAYMENTS FOR CONSULTANCY SERVICES NOT FEE FOR TECHNICAL SERVICES

In a ruling issued on November 30, 2009, the AAR concluded that payments for consultancy services provided by a U.S. university were not FTS and, therefore, not subject to withholding tax obligations.[17]

The taxpayer seeking the ruling was the Federation of Indian Chambers of Commerce and Industries (FICCI), a non-profit company engaged in the promotion and development of commerce and trade. FICCI entered into an agreement with an Indian defense organization to assist the organization in the identification and development of competitive global technologies from its inventory of existing defense-related innovations. The University of Texas (UT) provided assistance to FICCI to complete part of the work, for which it received payment from FICCI. FICCI applied to the AAR for a ruling on whether (1) UT was a resident of the United States within the meaning of the U.S.-India tax treaty, and (2) the payment made by FICCI was liable to tax in India in the hands of UT, thereby requiring FICCI to withhold taxes from such payments.

The IRD questioned UT's qualification as a resident of the United States pursuant to Article 4 of the treaty on the basis that it was not clear if UT was liable to tax in the United States. The issue was resolved by the AAR in favor of UT, upon FICCI submitting a certificate from UT confirming that UT was a resident of the United States for purposes of U.S. taxation and stating that, while UT was exempt from U.S. tax under the U.S. Tax Code, it was subject to tax on its unrelated business taxable income.

The AAR also rejected the IRD contention that the services provided by UT were technical services such that payments for such services were FTS subject to tax pursuant to Section 9(1)(vii) (as described earlier). While remarking that the services may have constituted FTS, the AAR observed that in a situation where a tax treaty applied to an item of income, pursuant to Section 90(2) of the ITA, the provisions of the ITA were superseded to the extent the treaty provisions were more favorable. However, after reviewing Article 12 of the U.S.-India tax treaty, the AAR concluded that the payments in question did not fall within the purview of the Article 12(4) definition of fees for "included services," as UT did not "make available" (as set out in Article 12(4)(b)) to FICCI any technical knowledge, skill or know-how and, thus, the fees for the services provided could not be classified as fees for included services pursuant to the treaty. As a result, services provided by UT to FICCI did not fall within the purview of Article 12 of the treaty. Neither were the payments liable to be taxed as FTS under the domestic law. The fees were also not subject to tax as business profits in view of the fact that UT had no PE in India and the services were not carried out through a PE in India. Therefore, FICCI was not obligated to withhold any tax from the payments to UT.

LEGAL FEES PAYABLE TO FOREIGN FIRM RULED TAXABLE IN INDIA

In contrast, in August 2009, in the case of *TATA Iron and Steel Co. Ltd. v. Dy. DIT*, 2009-TIOL-565-ITAT-MUM, the Mumbai ITAT held that, in the absence of a Double Tax Avoidance Treaty with Hong Kong, payments by TATA, an Indian company, to a law firm based in Hong Kong for legal services connected to a bond issuance, were subject to Indian tax. Therefore, TATA was responsible for withholding tax from the fees it paid to the Hong Kong law firm.

Previously, TATA floated an Issue of Bonds in Europe that were convertible into Global Depositary Receipts. In so doing, TATA engaged the Hong Kong-based law firm, which advised TATA on various laws and procedures outside India that applied to the bond issues. TATA paid for these services, but did not withhold any tax from the fee. In auditing TATA's withholding tax returns, the Indian tax authorities contended that the fees qualify as fees for technical services pursuant to Section 9(1)(vii) of the ITA and, as there was no income tax treaty between India and Hong Kong to override that classification, the mere fact that FTS were paid by an Indian resident was sufficient to deem it as India-source income of the law firm and subject to withholding.

[17] A.A.R. No.811 of 2009.

In agreeing with the position advocated by the Indian tax authorities, the tribunal concluded that legal fees fell within the definition of FTS; if the fees paid by a resident are held to be in the nature of FTS, those fees are deemed to accrue in India and are thus subject to tax regardless of where the services are provided or used.

The court did not address the issue of territorial nexus in relation to FTS. Nexus was addressed in detail by the Supreme Court case of *Ishikawajima Harima Heavy Industries Ltd. v. DIT*, (2007) 288 ITR 408 (SC), which held that the conditions of both (i) rendition and (ii) the utilization of services in India should be satisfied for the services to be classified as FTS. A later case, *Clifford Chance v. DCIT*, 2009 (111) Bom LR 428, further emphasized the necessity of sufficient nexus in India for a service payment by a resident to a non-resident to be taxable in India.

Given this background, the TATA case highlights the ambiguities in the Indian tax law on the subject of the taxability of FTS.

Other Developments

TRANSFER OF SHARES OF INDIAN SUBSIDIARIES IN BANKRUPTCY RESTRUCTURING IS NOT TAXABLE

In a ruling issued in November 2009, the AAR concluded that the transfer of shares in an Indian company as a consequence of the restructuring of its indirect parent company in a bankruptcy proceeding in the United States is not a taxable transfer and thus is not subject to capital gains tax in India.[18]

Dana Corp. (DC), a company incorporated and resident in the United States, held stock in certain U.S. and non-U.S. entities, including shares in three Indian companies. DC initiated bankruptcy proceedings under Chapter 11 of the U.S. Bankruptcy Code. As part of its approved plan of reorganization, Dana Holding Corp. (DHC) and Dana Companies Limited Liability Co. (DC LLC) were established, with DHC holding 100 percent of the interests in DC LLC. In January 2008, pursuant to the plan of reorganization, DC transferred the shares it held in various non-U.S. subsidiaries, including its Indian subsidiaries, to its two U.S. subsidiaries. There was no consideration paid for the transfers. One of the reasons cited for the transfer of the shares in the non-U.S. subsidiaries was the need to achieve business homogeneity in the same or similar products dealt with by the group entities. An independent private equity investor provided fresh equity capital to DHC. DHC issued additional equity shares to settle claims made by various creditors against DC, which made DHC a publicly held company. All properties of DC (including the shares in the two U.S. subsidiaries) were transferred to and vested in DHC. DC merged with and into DC LLC on January 31, 2008.

The AAR's November 2009 ruling implicated an interpretation of Sections 45 and 48 and the transfer pricing provisions of the ITA. Section 45 provides that any profits or gains arising from the transfer of a capital asset are subject to tax as capital gains in the year in which the transfer took place. As discussed above, the transfer of shares in an Indian company (which are capital assets) triggers capital gains tax liability regardless of the resident status of the transferor. Section 48 provides the method for computing taxable capital gains. The full value of the transfer consideration accruing to the transferor, reduced by the cost of the acquisition or improvement of the asset and any expenses incurred wholly and exclusively in connection with the transfer, is a taxable capital gain. The transfer pricing provisions of the ITA provide that any income arising from a related-party transaction must be computed based on an arm's-length price. The Indian tax authority argued that Section 45 applied to a transfer by virtue of operation of law or court order and that the consideration was the extinguishment and/or settlement of the liabilities of DC in the reorganization process. Even if the consideration was not readily determinable, the market value of the shares (at the time of transfer) in the three Indian companies must be counted as "consideration" when computing taxable capital gains.

However, the AAR accepted the position advocated by the taxpayer that the transfer of the shares in the Indian companies involved no consideration and, because the consideration was not determinable, the computational provisions in Section 48 did not come into play; therefore, there was no capital gains tax liability. As there was no tax liability, the AAR concluded that the transfer pricing provisions of the ITA were not applicable, on the basis that such provisions were not taxing provisions but, rather, only provided for the determination of an arm's-length price if a transaction between related parties is taxable.

[18] A.A.R. No.788 of 2008, November 30, 2009.

Conclusion

These developments illustrate the increasing complexity that could be faced by U.S. businesses and multinational enterprises in conducting business connected with India, as well as some of the potential tax problems that may arise for the unwary. Notably, even transactions that appear to occur entirely outside India between non-resident parties can result in action by the Indian tax authorities, as demonstrated by the cases involving Vodafone's indirect acquisition of the assets of Hutchinson and SABMiller's acquisition of the stock of Foster's India.

In addition, while it is not certain that the Draft Direct Taxes Code will be enacted in its current iteration, it does introduce a number of new provisions that are likely to expand the Indian government's power to tax transactions engaged in by non-resident taxpayers. The proposed General Anti-Avoidance Rule could be particularly problematic, as its breadth and vagueness could result in significantly less predictable action by the Indian tax authorities. The withdrawal of Circular 23 only adds to the tax uncertainties faced by foreign investors intent on doing business in India.

That said, India remains a highly dynamic, growing country with a number of unique economic opportunities for the business investor. There are many ways to invest in and to exit the Indian economy and—with proper structuring—such transactions can be both efficient and predictable from a tax perspective.

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