Annual International Bar Association Conference 2023

Recent Developments in International Taxation, India

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1. <u>**Taxing infusion of share capital made by foreign investors**</u>

Under Indian income tax law, if a closely held company issues shares to an Indian tax resident, at a premium, for a consideration above the fair market value ("**FMV**") of such shares, the difference between such consideration received by the issuing company and the FMV is taxed in the hands of the issuing company as its ordinary income. The policy intent for this tax rule was to prevent generation and circulation of unaccounted money through share premiums received from resident investors in a closely held company.

As a result, closely held companies had to maintain valuation reports when they raised capital at a substantial premium. Such valuation reports were often contested by the Indian tax office that adversely impacted India's start-up ecosystem. Therefore, over the years, certain limited exceptions were introduced including for eligible start-ups and venture capital funds from such tax rule.

Under Union Budget 2023, the Indian Government has extended such tax rule even to shares issuances made by closely held companies to non-residents. Several representations were filed with the Indian Government since the extension of such tax rule to share issuances to foreign investors would impact foreign capital inflows and ease of doing business in India. Moreover, such tax rule conflicted with Indian regulatory law, which requires the non-resident investor to invest in Indian shares at a price equal to or above the FMV.

Consequently, the Government has granted certain exemptions from such tax rule based on source of funds of the non-resident investor. Broadly, exemption has been granted to any investments made by a foreign government and foreign government related investors, banks or regulated entities involved in the insurance business and investors registered as Category-I foreign portfolio investors with the Indian securities regulator, who are resident in specified jurisdictions. Notably, the list of such specified jurisdictions does not include Mauritius, Singapore and Netherlands from where investments are often routed into India.

Additionally, certain other relaxations have also been provided such as inclusion of additional valuation methodologies for determination of the FMV and safe harbour rules.

2. <u>**Withholding tax on royalties and fees for technical services**</u>

Pursuant to Union Budget, 2023, India has increased its withholding tax rate on royalties and fees for technical services under its domestic tax law from 10 per cent (plus surcharge and cess) to 20 per cent (plus surcharge and cess). The withholding tax rate under India's tax treaties ranges from 10 per cent to 15 per cent on such payments. Therefore, such an increased tax rate is likely to impact repatriation to countries where the tax treaty rate is higher than 10 per cent on royalties and fees for technical services (such as the US).

Moreover, foreign enterprises will need to test their eligibility to tax treaty benefits in the context of such payment streams based on considerations of tax residence, commercial substance, principal purposes test, limitation of benefits clause, etc.

3. **Appeals on transfer pricing matters**

Under Indian income tax law, an appeal can only be filed against a decision of the Indian Income Tax Appeal Tribunal ("**ITAT**") before the High Court on matters that present a substantial question of law. In 2018, an Indian High Court [in the case of ***PCIT v. Softbrands (India) P Ltd, (2018) 406 ITR Karnataka)***] had ruled that the determination of arm's length price, which involves comparability analysis and application of filters, is a question of fact. Since the ITAT is the last fact-finding authority under Indian income tax law, no appeal can lie to the High Court on matters relating to determination of arm's length price unless the appellant pleads and demonstrates perversity in the decision of the ITAT.

Consequently, several appeals made to the High Courts on matters relating to the determination of the arm's length price were rejected based on this proposition of law.

Recently, the Indian Supreme Court in the case of ***SAP Labs India Private Limited v ITO [2023] 149 taxmann.com 327 (SC)***, has overturned such decision of the High Court. The Indian Supreme Court has held that there cannot be an absolute proposition of law that in all cases where the ITAT has determined the arm's length price, such determination is final and cannot be scrutinized by the High Courts. High Courts can consider and determine if such arm's length price has been determined in accordance with the transfer pricing guidelines set out under Indian income tax law. The High Courts can also examine the question of comparability of two companies or selection of filters to see if this has been done judiciously based on relevant material or evidence on record.

The Supreme Court's decision has been widely discussed by the Indian tax practitioner community. It is hoped that this decision does not result in a full-fledged scrutiny of ITAT orders relating to the determination of arm's length price, which in turn will impact the timelines of transfer pricing litigation in India. Post the Supreme Court's decision, it is important that parties' arguments in a transfer pricing dispute on the arm's length price are juxtaposed against Indian transfer pricing guidelines that have a bearing such issues.

4. **Tax ruling on tax residence certificate being sufficent proof for entitlement to tax treaty benefits**

Under Indian income tax statute, a non-resident claiming treaty benefits must necessarily furnish a tax residence certificate from the tax authorities of its country of residence to be eligible for tax treaty benefits. A key issue that has debated by the Indian courts is whether such tax residence certificate is sufficient proof for entitlement to tax treaty benefits or can the Indian tax authorities go beyond such tax residency certificate to validate the taxpayer's tax treaty claim.

In a recent ruling in the case of ***Blackstone Capital Partners (Singapore) VI FDI Three Pte Ltd. [TS-41-HC-2023(DEL)]***, the Delhi High Court held that the taxpayer was entitled to the capital gains tax exemption under the India-Singapore tax treaty, considering that the taxpayer was able to furnish a tax residence certificate issued by the Singapore tax authorities. The court held that the Indian tax authorities cannot go behind the tax residence certificate issued

by the taxpayer's jurisdiction. Moreover, the court held that the tests of beneficial ownership applied to interest, dividends, and royalties but not to capital gains income. This is an important decision considering that the Indian Government has assured foreign investors in the past that tax residence certificates would qualify as sufficient proofs of tax residency for substantiating tax treaty claims. However, in practice, Indian tax authorities often look to deny tax treaty benefits based on arguments of commercial substance and beneficial ownership, despite taxpayers furnishing such tax residence certificates.

5. Taxation of Real Estate Investment Trusts and Infrastructure Investment Trusts ("Business Trusts")

Business Trusts that are set up under Indian laws have tax pass through status in India. With a few exceptions, any income realized by a Business Trust from underlying investment in the operating entities is taxed in the hands of the investors who hold units in the Business Trust.

Accordingly, Business Trusts typically fund underlying operating entities by way of debt. The amounts received by the Business Trust from the operating entities when such debt is repaid, are distributed onwards by the Business Trust to its investors. Pursuant to pass-through taxation, no tax was paid by the investors or the Business Trusts on such distribution amounts since such amounts were classified as a 'repayment of capital'.

Indian income tax laws have been recently amended to provide that any amount paid by Business Trust to the investor as 'repayment of capital' will be reduced from the cost of acquisition of the unit held by such investor in the Business Trust, each time such payment is made by the Business Trust to the investor. However, once such cost of acquisition of the unit is recovered by the relevant investor, any amount received by such investor from the Business Trust as 'repayment of capital' will be taxed as 'ordinary income' in the hands of the investor (and not capital gains). This was a key change for foreign investors considering that the tax rate on such ordinary income for foreign investors can go up to 43.68 per cent. Moreover, typically, under Indian tax treaties there are no benefits available in respect of such income.

6. Withholding taxes on online gaming companies

The Indian Government has introduced a new provision for withholding taxes on winnings from online gaming. With effect from April 1, 2023, online gaming platforms are required to withhold tax at the rate of 30 per cent on the aggregate net winnings earned by a user (calculated in accordance with tax rules). Such tax is required to be withheld at the time of withdrawals and at the end of the tax year on the net winnings that have not been withdrawn. Such withholding tax obligation may also impact foreign online gaming platforms that engage with Indian users.