International Taxation
Recent Developments in India

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1. INTRODUCTION

Through this paper, we are providing a broad macro-outlook on the tax challenges which select activity will face having regard to the identified parameters of Income tax provision/rules. This note will enhance your understanding of the economic activity which shall be an indicator of the likely tax disputes/controversy which MNEs will have to manage.

Budget 2024 would offer one such opportunity for Government in this regard. In the post BEPS environment, MNEs would welcome unambiguous, transparent & clear tax rules and policy from the government. Such positive steps by the Government will further support its ambitious and inclusive growth-oriented schemes like Make in India, Digital India, etc.

In India, the international tax system also changed rapidly as a result of coordinated action by OECD and unilateral measures designed by individual countries, intended to tackle concerns over base erosion and profit shifting (BEPS) and perceived international tax avoidance techniques of high -profile multinationals. This note provides selected Action Plans as mentioned below for quick reference.

Also, the Government of India had amended few treaties with the intent to avoid treaty abuse and tax evasion. The developments during recent years were in the backdrop of efforts made by India in order to keep transparency and have an exchange of information with other jurisdictions.

OECD introduced 'Action Plan 15 – Development of MLI (Multilateral Instrument) to implement the tax treaty related BEPS measures' to bring changes to the existing treaties in such a way that over 1950 tax treaties across the world between more than100 nations have changed so far.

During the year 2016 and 2017, the erstwhile double taxation avoidance treaties entered into by the Governmentof India with Singapore, Cyprus and Mauritius were re-negotiated. Thereafter, the Government of India notified the amended India-Singapore tax treaty in March 2017 pursuant to which tax on capital gain on sale of shares was subject to tax in India for any gain arising from sale of shares acquired on or after 1st April, 2017, subject to the transition provisions provided in the said treaty.

The India-Mauritius tax treaty was modified in 2017, after 33 years since it had come into force. The modifications were similar to those proposed in the India-Singapore treaty, wherein the gain earned by a resident of Mauritius on transfer of shares of an Indian Company acquired post 1st April, 2017 would be subject to tax in India, subject to the transition provisions.

Since then, after Implementing BEPS Action plan, there has been various challenges after the digitalization of economies. To overcome those challenges OECD/G20 BEPS project released Statement on a Two-Pillar Solution in July 2021 with more 132 countries and jurisdiction including India joined this reform in international tax rules to ensure that multinational enterprises pay fair tax wherever they operate.

Apart from above, General Anti Avoidance Rules ("GAAR"), an anti-tax avoidance legislation, is effective from 1st April, 2017. GAAR can be invoked by the Indian revenue authorities in case a transaction or an arrangement is undertaken with the main purpose of obtaining a tax benefit. However, prior to invoking GAAR, the tax authorities have to obtain a prior approval of the Approving Panel, comprising of 3 members.

2. MLI - Amendment to Tax Treaties

India had deposited an instrument of ratification to OECD on 25th June, 2019 along with its final positions for the CTAs. As such the MLI modified many of the existing tax treaties signed by India. Around 28 DTAAs out of the existing 93 signed by India, were amended since FY 2020-2021 and until date.

To understand the impact of MLI on DTAA, one could refer Synthesized Text (CTA) on the Indian Income Tax website.

Treaty benefit (in case of treaties which have amended pursuant to MLI) can be claimed subject to fulfilment of minimum standards prescribed in the MLI framework. One of minimum standards is that treaty benefit can be denied, having regard to all relevant facts and circumstances, if it is reasonable to conclude that obtaining treaty benefit was one of the principal purposes of an arrangement or a transaction that directly or indirectly resulted in a tax benefit. This is referred to as the Principal Purpose Test (PPT).

Some highlights of the two treaties are explained below:

(i) Amendment to India-Mauritius tax treaty

- Article 13 was amended to give India the right to charge tax on Capital Gain on transfer of Indian Share acquired on or after 1st April, 2017.
- A two-year transition period upto 31st March, 2019 was provided during which the tax rate was 50% of the prevailing tax rates, subject to satisfaction of the Limitation of Benefit (LOB) Clause.
- After 31st March, 2019 tax will be charged at full domestic tax rates.
- The shares acquired before 1st April, 2017 are exempt from above amendment.
- Capital gain on derivates and fixed income securities will continue to be exempted even after 1st April, 2019.
- The above amendment effectively nullified the benefit earlier taken by investors from third jurisdictions by using Mauritius as an intermediate jurisdiction for making investments in India.
- **Interest on Debt Instruments:** Article 11 was amended such that the interest arising in India and paid to a Mauritius resident will be taxed at 7.5% in India and as per amended Article 12A Fees for Technical Service (FTS) paid from India would be taxed at 10% in India if the beneficial owner of FTS is a resident of Mauritius.
- As per section 56 of the Income Tax Act, 1961 shares acquired for a consideration lower than the fair value is liable to tax as Income from Other Sources in the hands of the recipient. However, earlier given that other income clause in Article 22 of India- Mauritius DTAA was too restrictive, the said income was not taxable in India. But as per amendment in Article 22, it will be taxed under Other Income in the country of Source.
- Moreover, while both India and Mauritius are signatories of MLI, Mauritius has not included its DTAA with India within the scope of its MLI compliance. As a result, anti-abuse provisions such as PPT are not applicable to India-Mauritius DTAA.

- **On 7 March 2024**, India and Mauritius signed a Protocol amending the India-Mauritius tax treaty. The key amendments include:
    1) The Preamble to the India-Mauritius tax treaty is replaced to state that the intention of the tax treaty is to avoid double taxation without creating opportunities of non-taxation or reduced taxation through tax evasion/tax avoidance.
    2) A new Article 27B has been included to satisfy the principal purpose test condition (in line with the MLI) for availing the beneficial provisions of India-Mauritius tax treaty.
    3) The Protocol requires India and Mauritius to notify one another regarding completion of the procedures required by their respective laws to implement the provisions of the Protocol. Once the notification has been issued by both the countries, the Protocol will enter into force on the date of later of the two notifications.
    4) The provisions of the Protocol shall have effect from the date of entry into force of the Protocol — without regard to the date on which taxes are levied or the taxable years to which the taxes relate.
    However, the Indian Tax Department had issued a clarification on the social media as under:

    "Some concerns have been raised on the India Mauritius DTAA amended recently. In this context, it is clarified that the concerns /queries are premature at the moment since the Protocol is yet to be ratified and notified u/s 90 of the Income-tax Act, 1961. As and when the Protocol comes into force, queries, if any, will be addressed, wherever necessary."

(ii) Amendment to India-Singapore Treaties

- Amendment gives India the right to charge tax on Capital Gain on transfer of Indian Share acquired on or after 1st April, 2017.
- Where such capital gains arise during the transition period from 1st April, 2017 to 31st March, 2019, the tax rate will be limited to 50% of the domestic tax rate of India. However, the benefit of 50% reduction in tax rate during the transition period shall be subject to the Limitation of Benefits Article.
  After 31st March, 2019 tax will be charged at full domestic tax rates.
  The alienator must refer to Article 24A of the treaty to determine the applicability of principle purpose test.
- However, the shares acquired before 1st April, 2017 are exempt from above amendment.

3. Base Erosion Profit Shifting (BEPS) & BEPS 2.0

BEPS is the terminology used for the tax avoidance strategy used by multinational companies, wherein profits are shifted from jurisdictions that have high taxes (such as United States and many Western European countries) to jurisdictions that have low (or no) taxes (so-called tax havens).

- **BEPS Action Plan 1,** the OECD had amongst the others, considered Equalization Levy as one of the modes of taxing the digital transactions to deal with tax challenged emerging from the digital economy.

This led to the introduction of Equalization Levy (EL) of 6% on online advertisements as a part of the Indian Finance Act, 2016 (section 165) and now on e-commerce transactions at 2% by Finance Act, 2020 (for specified circumstances (section 165A):

"Equalization levy" means tax leviable on consideration received or receivable for any specified service, for e-commerce supply or services and on specified circumstances.

"Specified Service" means online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement and to include any other service as may be notified by the central government.

"Specified Service receiver"

i. Resident persons (or)
ii. any person using a IP address situated in India (or)
iii. Non-resident in specific circumstances

"E -commerce supply or services" means online sale of goods owned by the e-commerce operator; or online provision of services provided by the e-commerce operator; or online sale of goods or provision of services or both, facilitated by the e-commerce operator; or any combination of activities listed above.

"Specified circumstances" means sale of advertisement, which targets a customer, who is resident in India or a customer who accesses the advertisement though internet protocol address located in India; and) sale of data, collected from a person who is resident in India or from a person who uses internet protocol address located in India

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"Online" means a facility or service or right or benefit or access that is obtained through the internet or any other form of digital or telecommunication network.

Charge of Equalization Levy

i. The applicable rate of tax is 6% of the gross consideration to be received or receivable under Section 165.

ii. The applicable rate of tax is 2% of the gross consideration to be received or receivable under Section 165A.

Equalization levy not to be charged where:

A. <u>For advertising or digital ads (section 165):</u>

- The aggregate amount of consideration for specified service received or receivable in a previous year by the non-resident from a person resident in India and carrying on business or profession, or from a non-resident having a permanent establishment in India, does not exceed Rs 1 lakh during the financial year.

- Where the payment for the specified service by the person resident in India, or the permanent establishment in India is not for the purposes of carrying out business or profession.

- The NR providing the specified service has a permanent establishment in India and the specified service is effectively connected with such permanent establishment

*B. **For specified circumstances defined above (section 165):***

- Where the e-commerce operator making or providing or facilitating e-commerce supply or services has a permanent establishment in India and such e-commerce supply or services is effectively connected with such permanent establishment;

- Where the equalization levy is leviable under section 165

- Where turnover of the e-commerce operator from the online of supply of goods/services to the specified persons does not exceed Rs. 2 crores during the financial year. (Section 165A)

The equalization levy so deducted/collected during the calendar month to be deposited with the Central Government by 7th of the immediately following calendar month, except for quarter 4 where the service

However, due to the progress being made on OECD Pillar 1 (explained below) negotiations on taking foreign earnings by digital service providers. The change came into effect from 1st August, 2024 via the 2024 Finance Bill, equalization levy of 2% as explained above is now scrapped in India.

Hence, 2% equalization levy shall not apply to any consideration received or receivable by an e-commerce operator from e-commerce supply or services made or provided or facilitated by it on or after the 1st day of August, 2024.

- **BEPS Action Plan 4**: To combat the cross border shifting of profits through excessive payments and to protect the tax base; OECD designed rules to prevent base erosion through the use of interest expense. based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA).

Government of India via Finance Act, 2017 had introduced a new section 94B in the Income Tax Act, 1961 to overcome loss of revenue by way of thin capitalization.

Under thin capitalization, interest expenses claimed as tax deductible by an entity, paid to its associated enterprises shall be restricted to 30% of its earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid or payable to associated enterprise, whichever is less.
In order to target only large interest payments, it is proposed to provide for a threshold of interest expenditure

of Rs. 1 crore exceeding which the provision would be applicable. Further Finance Act, 2020 provided that interest limitation would not apply to interest paid in respect of a debt issued by a lender which is a Permanent Establishment (PE) of a non-resident, being a person engaged in the business of banking, in India.

- **BEPS Action Plan 5** Harmful Tax Practices: India had introduced a concessional regime for taxation of royalty income from patents @ 10% gross income, in respect of a patent developed and registered in India by a person resident in India (with effect from 1.4.2016). *(Refer Patent Box Regime below).*

- **BEPS Action Plan 6** seeks to preventive treaty abuse through treaty shopping by setting out certain minimumstandards. Treaty shopping typically involves the attempt by a person to indirectly access the benefits of a taxagreement between two jurisdictions without being a resident of one of those jurisdictions.

India had introduced a general anti-avoidance rule as part of domestic tax law (with effect from 1.4.2017). *(Refer GAAR - General Anti Avoidance Agreement provisions as follows).*

GAAR as applicable from 1st April, 2017 confers broad powers on the tax authorities to deny tax benefits (including tax benefits applicable under tax treaties), if the tax benefits arise from arrangements that are 'impermissible avoidance arrangements.'

- **BEPS Action Plan 13**, the three-tiered transfer pricing documentation *and Country-by-Country Reporting* structure introduced. *It* provides a template for multinational enterprises (MNEs) to report annually and for each tax jurisdiction in which they do business the information set out therein. This report is called the Country-by- Country (CbC) Report. This is to enable the countries to enable transfer pricing assessment on transactions between linked companies.
  - a master file containing standardized information relevant for all multinational enterprises (MNE) group members;
  - a local file referring specifically to material transactions of the local taxpayer; and

A Country-by-Country (Cubic) report containing certain information relating to the global allocation ofthe MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group. The threshold for applicability of CbC reporting has been specified as consolidated group revenue of INR 66 billion in the preceding financial year.

BEPS 2.0

In July 2021 OECD/G20 Base Erosion and Profit Shifting Project released Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy. Till December 2022 more than 130 countries and jurisdictions including India joined a new two-pillar plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate.

The First Pillar

The OECD agreement's first pillar allows jurisdictions where large MNCs' products and services are used to tax their resulting profits, even if these companies have no presence in the country. This applies particularly to Intellectual Property(IP) and digital services.

Pillar One will ensure a fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable multinational enterprises. It will re-allocate some taxing rights over MNEs from their home countries to the markets where they have business activities and earn profits, regardless of whether firms have a physical presence there.

Specifically, multinational enterprises with global sales above EUR 20 billion and profitability above 10% - that can be considered as the winners of globalization - will be covered by the new rules, with 25% of profit above the 10% threshold to be reallocated to market jurisdictions.

The Second Pillar

The OECD's second pillar imposes a global corporate minimum tax of 15% on large MNCs' low-taxed foreign income. This global corporate minimum tax applies only to companies with annual revenues above €750 million in 2 of the last 4 years.

This pillar also introduced The Global Anti-Base Erosion Rules (GloBE) are a key component of this plan and ensure large multinational enterprise pay a minimum level of tax on the income arising in each of the jurisdictions where they operate. The GloBE Rules provide for a co-ordinated system of taxation that imposes a top-up tax on profits arising in a jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the minimum rate

Special rules for applying the 15% tax take into account the relationships between parent MNCs and their constituent entities. Parent MNCs whose subsidiaries have low-taxed foreign income must pay a "top-up" tax to increase the tax rate with respect to such income to 15%.

Deductions will be denied for parent payments to low-tax, foreign subsidiaries unless tax at a rate of 15% otherwise applies with respect to the subsidiaries' income. Source jurisdictions are also allowed to impose limited source taxation on certain related-party payments, which are taxed below the minimum rate.

As of July 9, 2021, India and 132 other countries supported this proposal. With the October 8 agreement, the signatories grew to include Estonia, Hungary, and Ireland—establishing support from all OECD, EU, and G20 member countries. As of May 2022, 137 countries signed on to the plan.

What is Global Minimum Corporate Tax?

A global corporate minimum tax is a proposal to impose a minimum rate of taxation on corporate income in most countries of the world by international agreement. The framework aims to discourage nations from tax competition through lower tax rates that result in corporate profit shifting and tax base erosion.

On Oct 8, 2021, 136+ countries and jurisdictions agreed to a proposal from the Organization for Economic Co-operation and Development. It was set to take effect in 2023, but has since delayed to 2024. In 2024 and onwards,

more than 60 countries will hold elections, including major economies such as the US, the UK and India. The outcomes of these elections will likely have impacts beyond their borders and shape international relations for years to com

A global corporate minimum tax would apply a standard minimum tax rate to a defined corporate income base worldwide. The OECD developed a proposal featuring a corporate minimum tax of 15% on foreign profits of large multinationals.

4. Automatic Exchange of Financial Information

- On 3rd June 2015, India Multilateral Competent Authority Agreement (MCAA) on Automatic Exchange ofFinancial Account Information (AEOI) Under Common Reporting Standard (CRS).
- Section 285BA was amended and Rules 114F & 114H and Form 61B was inserted to enable implementation of reporting requirement under FATCA & CRS.
- Guidance note on implementation of FATCA & CRS issued in December 2015.
- From 2017 onward, 123 countries will start exchanging information automatically by 2025. Also, to avoid menace of Black Money a Joint Declaration was signed between India and Switzerland in November, 2016 for implementation of Automatic Exchange of Information.
- The above has enabled India to receive financial information of accounts held by Indian residents in Switzerland for 2018 and subsequent years on an automatic basis.
- If any person is resident of more than 1 country, and such person is a registered tax payer. And only if the person has informed the bank that he is resident of more than 1 country in KYC, than it is possible that the financial detail will be passed to all the country where the person is resident.
- Standard format has been prepared for exchange of information: -
  Name, address, TINs, Date and place of birth of each Reportable Person, Account No., Name and identifying number of Reporting FI, Account Balance, Any Depository account, any custodial account, any other account not mentioned above.

5. The Foreign Account Tax Compliant Act (FATCA)

- In July 2015 India-USA signed an Inter-Government Agreement (IGA) to implement FATCA.
- Under the IGA, the USA will provide certain information to India which includes:
- The name, address and Indian TIN of any person that is resident of India and holds a reportable financial account in USA
- Account Number
- Gross amount of interest, US source dividends or other income paid or credited
- On the similar lines India will also provide the information to USA.
- The main difference between AEOI and FATCA is that in the AEOI there is no Financial Limit so everytransaction is reportable. Under FATCA there is a financial Limit.

6. UK's Diverted Tax Profit (DTP)

- UK diverted profits tax are applicable from 1st April 2015.
- Tax will be charged at a rate of 31% on diverted profit relating to UK activity.
- The rate increased from 25% from April 2023, in line with the increase to the rate of corporation tax to 25%. DPT is charged at a rate of 55% on ring-fence diverted profits and notional ring-fence profits in the oil sector.
- The charge will arise if either of two rules apply – avoidance of a UK Permanent Establishment (PE) and involvement of entities or transactions lacking economic substance OR main purpose of trading goods or services in UK is to avoid UK tax.
- For eg: Profits are taken out of the UK subsidiary by way of huge allowable expenditure to an associated enterprise in the tax haven.

7. Patent Box Regime

- Finance Act 2016 introduced the patent box regime in India.
- Gross amount of royalty from patents developed and registered in India will be taxed at 10% u/s 115BBF.
- Such rate is optionally available to Patentee resident in India.
- The total income of eligible taxpayer must include income by way of royalty in respect of patent developed and registered in India and at least 75% of the expenditure is incurred in India by eligible taxpayer for invention
- No other expenditure is allowed under the tax provisions if concessional tax rate under section 115BBF is availed.
- No carry forward of set off & losses will be allowed

8. Controlled Foreign Corporation (CFC)

- CFC are foreign companies earning passive income which is controlled directly or indirectly by a resident in India. The income which is not distributed to the shareholders and taxes on such income are deferred is deemed to have been distributed.
- Such income shall be considered to be dividend received by the Indian resident from foreign company.
- A CFC can be a POEM (mentioned below) incase whether or not it is engaged in active business in India. To meet active business test, it's passive (non-business) income should not be more than 50% & it should meet certain parameters in terms of employees, assets and payroll expenditure.

9. PoEM - Place of Effective Management

The Finance Act, 2015 amended the provision of section 6(3) which provides the rule for determination of residential status of a foreign company. The effect of this amendment is that a company would be resident in India in any previous year if it is an Indian company or its PoEM in that year is in India. The PoEM was defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as

a whole are in substance made.

Implementation of PoEM based residence rule has given rise to various issues on applicability of current provisions of the Act to the foreign company.

In January, 2017; The Central Board of Direct Taxes (CBDT) has issued a Circular laying down the final guidelines for determination of the Place of Effective Management (PoEM) of a company. The final guidelines take forward the concept laid down in the draft guidelines for PoEM determination based on the bifurcation of companies engaged in active business outside India and other companies.

PoEM guidelines shall not apply to companies having a turnover/gross receipt of Rs. 50 Cr or less in a financial year.

10. Changes in Income Tax rates for Fees for Technical Services (FTS) and Royalty

The Finance Act, 2023 has increased rates of tax on FTS and Royalty from earlier 10% to 20% (plus surcharge (if any) and cess) which will be applicable from Financial Year 2023-24. The effective tax rate would be 21.84% assuming highest surcharge and cess is applied to the non-resident. Section 115A of the Income Tax Act, 1961 exempts a non-resident from filing his return of income in India as long as his income comprises of income from FTS, royalty, dividends or interest and tax has been withheld at the rates prescribed in the Finance Act.

But, with effect from 1st April, 2023, in case the non-resident (NR) is able to produce a tax residency certificate of the home country, the NR will have to compulsory obtain a PAN and file the tax return in India since the treaty rate would be much lower than the amended withholding tax rate of 20% under the Income Tax Act, 1961.

11. What can we do for you?

- Identify key tax issues at the time of structuring of the transaction.
- Provide guidance for approach to potential tax controversies.
- Advice Indian Companies implement international growth strategies, business models.
- Bring to clients leading expertise on all tax issues critical to Indian companies with overseas operations or those planning global initiatives.
- Develop and implement methodologies that are analytically sound, flexible and fully compliant with the transfer pricing regulations.

Important Note:

This communication is intended to provide a general introduction and guidance on the subject matter and should not be regarded as a basis for taking decisions on specific matters. In such instances, separate advice should be taken.