KATALYST
ADVISORS LLP

Katalyst Kaleidoscope

April 2018: Tax and Regulatory Highlights

A. Income-tax Highlights

1. India signs Double Taxation Avoidance Agreement ("DTAA") with Hongkong

- On 19 March 2018, Hong Kong and India signed their first comprehensive DTAA to prevent double taxation and to provide for exchange of information between the contracting states.

- Significant provisions covered in the India – Hongkong DTAA are as follows:

  - Article 10, Article 11, Article 12 and Article 13 - The passive stream income may be taxed in the source state with regard to the resident-based taxation at beneficial rates on gross basis as follows[1]: -
    i. Dividend - @ 5% (not relevant to Indian Companies paying dividend due to the applicability of DDT approximately @20.56%);
    ii. Interest, Royalties and Fees for Technical Services respectively – 10%.

    Further, the benefits of these Articles shall not be available if the main purpose is to take advantage of this Article for the beneficial rate of tax by means of that creation, assignment or performance of services.

  - Article 14 - Source based taxation of Capital gain arising on sale of shares / securities has been provided unless more than 50% the value of shares / securities are directly / indirectly derived from immovable properties situated in the other contracting state.

2. Additional Guidance on the attribution of profits to a Permanent Establishment ("PE")

The Organization for Economic Co-operation and Development has issued additional guidance[2] to Permanent Establishments ("PEs") for the attribution of profits as under:

i. Principles for profit attribution including examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure.

ii. Guidance for PEs created as a result of the changes to preparatory and auxiliary activities i.e. under Article 5(4) of tax treaty

iii. Examples on the attribution of profits to PEs arising from the anti-fragmentation rules[3].

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[1] The beneficial rates are applicable subject to fulfilment of conditions mentioned in the India-Hong Kong DTAA
[2] Additional Guidance on the Attribution of Profits to Permanent Establishment dated March 2018
[3] Rules to prevent the breakup of an operating business into several small business units in order to benefit from the preparatory or auxiliary exemption.

Katalyst Comments:

Although guidelines issued by OECD are referred by the Indian courts and tribunals in some tax cases, these are, at best, guiding principles & persuasive arguments from an Indian tax standpoint. Incidentally, the above additional guidance were captured in the OECD Model Tax Convention 2017 update[4], wherein India had various reservations, including in relation to constitution of a PE through a website and dependent PE.

3. Invitation of suggestions by the Task Force towards drafting the new direct tax law

- The Government of India in its press release dated 21st March, 2018, has announced that, in view of the economic needs of the country, a task force has been constituted to review the existing Income Tax Act, 1961 / to draft a new Direct Tax Law. Further, the public release also requested for suggestions on six broad categories mentioned therein.

Katalyst Comments:
With regard to the categories mentioned in the public release, it seems that inputs have not been requested on fundamental issues on substantive law but only towards procedural aspects under the income tax act. It is hoped, however, that the new tax law would make it easier for the people to do business and restructurings and, is drafted considering the broader good and keeping the larger number of assesses in mind.

4. Tax loss on migration of HNIs from India

- In view of the high number of migration of HNIs from India to other foreign jurisdictions, the CBDT[5] has constituted a Working Group whose responsibility is to recommend policy towards tax risk on such HNIs who may still have strong personal and economic ties with India.

Katalyst Comments:

(i) What may have been more relevant is for the committee to be more broad based to look into the entire gamut of issues related to such migrations of HNIs, including the reasons therefore and its consequences such as loss of intellectual capital etc.

(ii) It is pertinent to note that the concept of Exit tax is levied in countries such as US, Australia, Spain, etc. wherein deemed capital gains tax is levied on persons who cease to be tax residents based on the fair market value of their assets in that country. However, given that capital gains in India is source based, whereas it may not be so for all countries, this may not be the right model for India.

5. Lower capital gains tax rate of 10% on sale of shares by a non-resident[6]

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[4] The 2017 update was approved by the OECD Council on 21st November, 2017
[5] CBDT Office Order dated 3rd April, 2018
[6] A.A.R No. 1375 of 2012 [2018] 91 taxmann.com 133 (AAR - New Delhi)

- The AAR relying on the Hon'ble Delhi High Court decision in case of Cairn UK Holdings Limited[7] held that pursuant to sale of listed equity shares outside the floor of stock exchange by a non-resident, capital gains would be leviable at 10% as per proviso to section 112(1) of the Act thereby neutralizing the foreign exchange fluctuations under the Income Tax Act, 1961.

B. Cross Border Regulations: Outbound & Inbound Mergers

The RBI vide notification dated 20 March, 2018, notified the Foreign Exchange Management (Cross Border Merger) Regulations, 2018[8] ("Cross Border Regulations"). The Cross Border Regulations seems to have considered some of the comments of the stakeholders and seems to be more practical as compared to draft regulations dated 26 April, 2017[9].

A. The relevant points with regard to Inbound Merger under the aforesaid regulations are:

i. In relation to liabilities and guarantees of the foreign company, they shall either conform to the ECB, Trade Credits or other applicable FEMA regulations within a transition period of 2 years, or shall be paid off within the transition period without utilizing any Indian remittances. A similar transition period has been specified for assets of the Foreign Company for sale / disposal of such assets if they do not conform with the FEMA provisions.
(Katalyst Comment – In relation to merger of a foreign subsidiary with its Indian holding company, the FEMA Outbound Regulations need to be complied with, however, no provisions have been provided in the said regulation, therefore, RBI guidance in relation to this open issue is necessary)

ii. As consideration for merger, the Indian Company can issue or transfer any (foreign) security to the shareholders of the foreign merging company subject to adherence of entry routes, sectoral caps, etc. as laid down by the FEMA Inbound Regulations (FEMA Transfer or Issue of Security by a Person Resident Outside India Regulations, 2017).

iii. On the cross-border scheme becoming effective, the offices of the foreign company shall be treated as a foreign branch of the Indian Company.
(Katalyst Comment – Consequently the foreign office could be treated as Permanent Establishment of the Indian Company, and further, basis the FEMA regulations, the activities of the foreign office may be significantly limited / reduced especially if it is in the business of manufacturing)

B. The relevant points with regard to Outbound Merger under the aforesaid regulations are:

i. Liabilities and guarantees of the Indian Company not permitted to be held by the Foreign Company under FEMA shall not be taken over; furthermore, a no-objection certificate is necessary to be obtained from all the Indian vendors to ensure said compliance.

7 Cairn UK Holdings Limited v DIT [2013] 359 ITR 268 (Delhi)
8 Notification No. FEMA.389/2018-RB
9 Foreign Exchange Management (Cross Border Merger) Regulations, 2017

However, in relation to the assets of the Indian Company, a transition period of 2 years for its sale / disposal has been provided if they do not confirm with the FEMA provisions. (Katalyst Comment –Detailed evaluation and restructuring of liabilities of the Indian Company necessary since the Cross Border Regulations do not provide for any transition period for Outbound Merger as has been provided for Inbound Mergers)

ii. The shareholders of the Indian merging company may acquire or hold the securities of the Foreign Company issued as consideration on merger in accordance with the FEMA Outbound Regulations; further, for resident individuals, Liberalized Remittance Scheme to be apply based on the fair market value of the shares issued.
(Katalyst Comment – if the Indian Company has certain foreign shareholders, the FEMA provisions may not apply on issue of shares by the foreign company as consideration)

iii. Further, the office(s) of the Indian Company shall be deemed to an Indian branch of the Foreign Company as per the relevant FEMA regulations.
(Katalyst Comment –Risks akin to Inbound Merger shall apply.)

C. Few common points relevant for both:

Under the Companies Act, 2013, prior approval of the RBI is necessary for undertaking any Outbound Merger / Inbound Merger; in this context, prior approval of the RBI is deemed to be received if a compliance certificate is submitted by the MD of the Indian Company with the NCLT;
(Note: The format of such compliance certificate is yet to prescribed)

Katalyst Comments:

- As per the Income Tax Act, 1961, exemption from capital gains tax has been provided only for Inbound Mergers; conversely, in relation to Outbound mergers, in the absence of any specific provisions for exemptions, the capital gains tax exposure needs to be assessed.
- The expression "a company incorporated in the jurisdiction of such countries as may be notified by the Central Government" may also include a foreign body corporate; therefore, an Outbound or Inbound Merger may involve a foreign LLP subject to the company's / LLP's incorporation in the jurisdiction as specified by the Central Government and on further evaluation of the laws in the respective foreign jurisdiction.

C. Foreign Exchange Regulations

1. The RBI recently notified the Foreign Exchange Regulations, 2018[10] dealing with acquisition and transfer of immovable property in India which replaces the earlier regulations issued by the RBI. The key highlight is as follows:

   - With regard to repatriation of sale proceeds, under the new regulations, repatriation is only possible if the acquisition is fully paid in foreign currency, whereas under the

[10] Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2018, notification no. FEMA.21(R)/2018-RB/GSR 280(E), DATED 26-03-2018

erstwhile regulations, pro-rata repatriation was possible based on the percentage of foreign currency utilized towards any acquisition.

2. The RBI vides its notification dated 26th March, 2018, has amended the FDI policy to align with the amendments sought by the DIPP in January 2018; thereby, making the amendments effective. Para C of our January 2018 Katalyst Kaleidoscope captured the said amendment. Click here to access the same.

Katalyst Comments:

It is worthwhile to note that whilst all the amendments as laid down by the DIPP vide press note 1 of 2018 were notified by the RBI, the specific amendment by DIPP for inclusion of a Competent Authority examining FDI applications under Automatic Route and Government Approval Route from Countries of Concern has not been included by the RBI in the FEMA Regulations, 2018. Therefore, applications from Countries of Concern under Automatic Route will have to approach the DIPP even though not specifically provided under the FEMA framework.

3. In continuation of the fresh FEMA Inbound Regulations[11] notified last year, the RBI has updated the Master Direction for Foreign Investment in India[12] and Master Direction on Reporting under FEMA. An overview of the key changes are as under:

- Impact on Venture Capital Funds (VCF)-
  VCFs which were treated as investment vehicles until now, have been specially excluded from the definition of "investment vehicle"; consequently, investments by VCFs with foreign investment would be subject to downstream investment requirements.

- Investment by Foreign Portfolio Investors ("FPIs") in Non-Convertible Debentures ("NCDs")-
  i. Listed NCDs / bonds –
  FPIs can invest in primary issues of NCDs / bonds only if listing of the same is committed to be done within 15 days of such investment, in failure of which, the FPIs shall immediately dispose of these bonds / NCDs either by way of sale to a third party or to the issuer.

  ii. Unlisted NCDs / bonds -
  FPIs are permitted to invest in unlisted NCDs/ bonds issued by an Indian company subject to a minimum residual maturity of three years and end-use restriction on investment in real estate business, capital market and purchase of land.

- Transfer of listed securities from a resident to a non-resident-
  It has been clarified by the RBI that the relevant date for determining the price applicable to an off-market transfer of listed securities will be the date of transfer of shares from a resident to a non-resident.

[11] Notification No. FEMA20(R)/2017-RB dated 7 November 2017
[12] FED Master Direction No. 11/2017-18 dated 4 January 2018 (updated from time to time)

- Downstream Investment by a Foreign owned and controlled Indian entities (FOCC)-

  The FOCCs are prohibited from making downstream investments by using funds raised in the domestic market, in this context it has clarified that, funds raised by issuing NCDs to non-residents portfolio investors will not be deemed to be raised in the domestic market; accordingly, such funds can be used to make foreign investment.

D. Corporate Law Highlights

Rejection of substantive modification in a Scheme of Arrangement"

- The Bombay High Court[13] recently held that modification of a previously sanctioned scheme to retain one of the business undertakings with the transferor company due to non-availability of tax benefits would lead to modifying the basic fabric of the Scheme which is not allowable under Section 392 of the Companies Act, 1956; therefore, it rejected the request of the applicants to modify the already approved Scheme of Arrangement.

Katalyst Comments:

Since similar powers have been provided to the NCLT under the Companies Act, 2013; therefore, one needs to be cognizant of the effect of the Scheme before the same is sanctioned by the NCLT since it may not be possible to modify thereafter.

E. Securities' Laws Highlights:

1. Exemption from open offer on transfer of shares of the promoter holding companies to promoter managed trust

- SEBI vide its order[14] exempted the open offer requirements as per the Takeover Code[15] on transfer of shares of a promoter holding company to a promoter managed trust, subject to the condition that the trustees and the beneficiaries are members of the promoter family.

Katalyst Comments:

Reference is drawn to the SEBI circular on Takeover Code dated December 22, 2017, wherein SEBI provided certain guidelines for granting of exemption from open offer in cases where shares are to be settled in a trust.

2. Recommendations of the Kotak Committee on Corporate Governance

- SEBI accepted the major recommendations of the Kotak Committee on Corporate Governance in a meeting on March 28, 2017. Few key recommendations are as follows:

[13] Associated Aluminium Industries Limited [LSI-117-HC-2018(BOM)]
[14] In the case of Alembic Limited (WTM/GM/CFD/02/2018-2019) dated April 6, 2018,
[15] SEBI (Substantial Acquisition of Shares and **Takeovers**) Regulations, 2011

a. Composition and Role of the Board of Directors

- Minimum number of 6 Directors to be present
- Inclusion of at least one woman Director.
- Listing expertise / competencies that should be possessed vis-à-vis actually possessed by the board.
- Separation of the Roles of Non-Executive Chairperson & Managing Director / CEO
- Reducing maximum number of Directors to 8 Directors by 1 April 2019 and to 7 Directors by 1 April 2020.

b. Other matters

- Increase the role of audit committee for end use utilization of funds.
- Half yearly disclosure of related party transaction and imposition of strict penalties in case of any contravention;
- Obtain approval of shareholders on a "majority of minority" basis for payment to related parties for royalty / brand usage over 2% of consolidated turnover;
- Adequate disclosure of reasons for resignation of auditors.

F. Other Highlights

1. On 26 March 2018, the Insolvency Law Committee ("Committee") made the following recommendations for amendments to the Insolvency and Bankruptcy Code, 2016 ("IBC"):

- Inclusion of amounts raised by home buyers / allottees under real estate project as "Financial Creditors".

- Financial creditors (being regulated by financial sector regulators) who are issued equity shares in the Corporate Debtor by virtue of conversion or substitution of debts, should not be considered as related party and be allowed in the Committee of Creditors ("CoC").

- Initiation of Corporate Insolvency Resolution Process ("CIRP") by Corporate Applicant by obtaining approval of the shareholders by special resolution or an approval of at least three-fourth of the total number of partners, as the case may be.

- Re-calibrate the voting share threshold for decisions of the CoC under various circumstances.

- Streamline the eligibility to submit a resolution plan under section 29A of the IBC so that only those who contributed to defaults of the Company or are otherwise undesirable are rendered disqualified.

- Amend Sec. 31 of the IBC to provide for maximum time limit of 1 year for obtaining relevant approvals for the resolution plans from relevant regulators or authorities (such as Central and State Government etc.).

- Committee proposed to define 'Corporate Guarantor' in Sec. 60 of IBC thereby linking insolvency / liquidation proceedings with Corporate Debtor

G. Indirect Taxation

1. Kerala Authority of Advance Ruling (AAR)[16] clarified that recovery of food expenses from employees for canteen services provided by company is liable to GST as 'outward supply' in terms of Section 2(83) of CGST Act, 2017.

2. E-Way Bill[17] system for Intra-State movement of goods would be implemented from 15 April, 2018 in Andhra Pradesh, Gujarat, Kerala, Telangana and Uttar Pradesh.

3. Clarification[18] regarding job work related issues under CGST are as follows:
   - Supply of goods by the principal from the place of business/premises of the job worker will be regarded as supply by the principal and not by the job worker.
   - Where the goods are being sent to a job worker, the principal should prepare challan in triplicate, as prescribed in CGST Rules. Two copies of this challan may be sent to the job worker. The job worker should send one copy of the said challan along with the goods while returning them to the principal.
   - Form GST ITC-04 will serve as the 'intimation' envisaged under Section 143 of the CGST Act, 2017.
   - Input Tax Credit (ITC) will be available to the principal, irrespective of whether the inputs or capital goods are received by the principal or directly received at job worker's place of business.

4. The Central Government has clarified[19] that exporters shall file Bond/Letter of Undertaking ('LUT') in Form RFD-11 only on the portal. LUT shall be deemed to accepted as soon as Application Reference Number (ARN) is generated. No document needs to be physically submitted.

5. The Central Government has clarified that 5% GST rate (without ITC) is applicable to supply of food and / or drinks by the Indian Railways or IRCTC or their licensees, in train and on platforms.[20]

6. Clarification on export related issues are as under:[21]

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[16] Refer advance ruling obtained by Caltech Polymers Pvt. Ltd. (TS-110-AAR-2018-NT)
[17] Press release of Finance Ministry
[18] Circular no. 38/12/2018-GST dated March 26, 2018 under CGST
[19] Circular no. 40/14/2018 dated April 6, 2018 under CGST
[20] Order no. 2/2018 dated March 31, 2018 under CGST
[21] circular no. 37/11/2018 dated March 15, 2018

- In case of discrepancy between values of GST invoice and shipping bill/bill of export, refund of lower value should be sanctioned.
- No bank realization certificate or FIRC is required in case of refund for export of goods.

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