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THE DIRECT TAXES CODE, 2010 – USHERING IN CONTROLLED FOREIGN CORPORATION RULES IN INDIA

Sunil Jain*

ABSTRACT

The author provides a basic understanding of the Controlled Foreign Corporation [Hereinafter, "CFC"] Rules proposed to be introduced in India under the Direct Taxes Code, 2010. CFC Rules seek to tax income earned by a foreign company which is established in a low-tax jurisdiction and is controlled by a company resident in India. CFC Rules also provide for the circumstances and conditions under which income of a CFC will become taxable in India.

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I. INTRODUCTION

The Government has introduced a Bill to consolidate and amend the law relating to direct taxes, i.e., the *Direct Taxes Code, 2010* [Hereinafter, "DTC 2010"], in the Parliament. DTC 2010 takes into account the comments and feedback received in the two rounds of public consultations in August 2009 and June 2010. DTC 2010

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will replace the *Income Tax Act, 1961* upon its enactment. It is expected that DTC, 2010 will come into effect from April 1, 2012.

The original proposals made in August 2009 were widely criticized in relation to the non-resident tax policy that they sought to introduce. The story is not very different in relation to the general response on resident and domestic company tax proposals. However, DTC, 2010 brings substantial relief for non-residents in comparison to the original proposals. Two major items of relief are the restoration of the principle of 'treaty overrides' and the method of determining the tax residence of a foreign company in India.

As a 'source' tax jurisdiction, India taxes a non-resident on income generated in India or arising due to payments made by Indian tax residents. In order to avoid the double taxation of income earned by non-residents in India as well as in the home country, India has concluded tax treaties known as Double Taxation Avoidance Agreements with many countries. Generally, it is understood that in relation to non-residents, whichever is more beneficial among the provisions of the Indian income tax laws and that of the applicable tax treaty will apply. This principle is known as the principle of 'treaty overrides'. However, the original proposals of August 2009 provided that the provisions of the DTC or the provisions of the applicable tax treaty, whichever is 'later-in-time', will apply. As India had already concluded tax treaties with major industrialized countries in the world, it would have meant that the provisions of such treaties would have been superseded by the DTC legislation. Among others, the later-in-time principle challenged the principles of the Vienna Convention on the law of treaties, which encourages treaty partners to respect the provisions of such treaties within the bounds of the national laws of the treaty partners.

DTC, 2010 has restored the principle of treaty overrides. However, in order to deal with the menace of tax avoidance and to create adequate checks and balances, DTC, 2010 has carved out three exceptions to this principle. General Anti-Avoidance Rules [Hereinafter, "GAAR"], levy of branch profits tax and CFC Rules are the three exceptions. CFC Rules have been on the anvil for some time. The original recommendation for introduction of a CFC regime was made by a working group on non-resident taxation, constituted by the Ministry of Finance, in its report issued in January 2003.

II. CFC RULES – SOME BASICS

Presently, income earned by an Indian resident taxpayer from an overseas investee company, in which such resident has made an investment, is taxable on

the basis of its accrual or receipt in India. In case the overseas investee company declares or distributes dividend income, the same is taxable in India, in the hands of the Indian investor company, at 30% (plus applicable surcharge and education cess). *The Finance Act, 2011* has provided a one-time option to bring all such dividend income into India at a special tax rate of 15% (plus applicable surcharge and education cess). However, it is possible to defer or avoid payment of tax by not declaring such dividends or having them received by an intermediary company organized in a low tax or tax-free jurisdiction and not repatriating such dividends to India. CFC Rules address such tax deferral and deal with the tax liability of a resident taxpayer in relation to the income from a company controlled by an Indian resident shareholder and incorporated in a low tax foreign jurisdiction.

CFC Rules are applicable where a resident taxpayer exercises substantial influence, direct or indirect control, or has constructive ownership over a foreign company through related parties. The two basic methods for identification of income of a CFC attributable to a resident shareholder are the 'transactional approach' and the 'jurisdictional/entity approach'. The transactional approach seeks to identify passive income such as dividends, royalties and fees for technical services and considers it as 'tainted' income in view of the favourable tax treatment in the jurisdiction of the CFC. The jurisdictional approach targets the income earned by a CFC in a specified low-tax jurisdiction.

The CFC Rules provide a minimum threshold of income, beyond which the income is attributed to the resident shareholder and subject to tax. Generally, an exemption is provided to a listed entity or one which distributes a substantial percentage of its income. Exemption is also provided in the case of genuine business income or where there is a genuine business 'motive' behind the incorporation of a CFC in a particular jurisdiction. Once the income of a CFC attributable to a resident shareholder is identified, the CFC Rules provide for certain reliefs. The reliefs include exemption for loss-making CFCs, credit for foreign taxes paid and exemption from further taxation of dividends previously deemed to be distributed under the CFC Rules. In certain jurisdictions, a 'participation exemption' is also in place and supplements the CFC regime. The participation exemption regime envisages an exemption from tax of dividends and capital gains from an overseas investment exceeding a prescribed percentage of equity participation in such an overseas company.

Accordingly, at a policy level, the important issues in relation to a CFC regime are the definition of 'control', the identification of the low-taxed jurisdiction, how the income should be taxed, the tainted income of a CFC which is taxable, income

which needs to be exempted from the application of the CFC Rules and the relief provisions necessary to prevent double taxation. Relief includes providing tax credit for the taxes already suffered on the tainted income in the jurisdiction of the CFC.

III. CFC RULES- INDIAN DESIGN

A foreign company will become a CFC in case such a company satisfies all the five tests prescribed. The 'location test' applies when a foreign company is a tax resident of territory with a lower rate of taxation than India. A country in which the tax payable by a foreign company on its income is less than 50% of the effective tax payable on such income in India will be a territory with a 'lower rate of taxation'. Next is the 'listed company test', i.e., a foreign company should not be listed on a stock exchange in its country. In case it is listed, CFC Rules will not be applicable to such a company. The 'control test' applies when a foreign company is controlled by one or more Indian tax residents, individually or collectively with other residents. In case shares carrying at least 50% of the voting power or the capital of the foreign company are held by the Indian residents, or there is an entitlement to secure application of at least 50% of the income or assets of the foreign company for the benefit of Indian residents, the control test will stand satisfied. It is also satisfied if the Indian resident exercises *dominant influence* due to a *special contractual relationship*, or a *decisive influence*. The underlined terms have not been defined and may lead to a lot of subjectivity in the hands of the Commissioner of Income Tax, who will be the repository of adjudicatory powers in relation to the CFC Rules. The 'activity test' applies when a foreign company is not engaged in any active trade or business. The activity test is designed in a negative manner and to avoid exposure to CFC Rules, a foreign company will need to be engaged in active trade or business. A foreign company will be deemed to be engaged in active trade or business if it actively participates in industrial, commercial or financial undertakings through employees, in the economic life of the home country of the CFC and the 'passive income', i.e., income from related parties and other tainted income, is below 50% of the income of the foreign company during the accounting period. Passive income includes dividends, interest, royalties, capital gains etc. The '*de minimis*' or 'income threshold' test applies when the 'specified income' of a foreign company exceeds INR 2.5 million. If all the tests discussed above are satisfied by a foreign company, it will become a CFC and the controlling Indian resident will be liable to pay tax.

If any of the tests is not satisfied, the foreign company will not be a CFC and CFC Rules will not apply.

As regards taxing the income of a company which becomes a CFC, it is proposed that the specified income of a CFC will be attributed to the Indian company controlling such a CFC. The 'attributable income' of the CFC will be taxed, in the hands of the Indian company, at 30% as 'income from residuary sources'. Income will be taxed in India in the financial year in which the accounting period of the CFC ends. It is notable that the 'accounting period' of the CFC will be governed by the laws of the jurisdiction in which such a CFC is established. The accounting period of a CFC will be a period of 12 months which may or may not end on March 31st, as is the case with the Indian financial/business year. Detailed formulae have been proposed for ascertaining the specified income and the attributable income to determine the income of a CFC which is taxable in the hands of the Indian resident controlling such a CFC. It is also proposed that the value of shares in a CFC will be treated as part of its net wealth and will be subject to wealth tax at 1% on 'net wealth' in excess of INR 10 million.

IV. CFC RULES - AN INTERNATIONAL PERSPECTIVE

Internationally, CFC Rules form part of many mature tax jurisdictions across the world, such as Australia, Germany, Japan, UK and USA. The Council of the European Union adopted a non-binding resolution on June 8th, 2010 recommending that member states within the EU adopt common guiding principles while formulating domestic legislations on CFCs. The common thread amongst the major CFC jurisdictions across the world, including major OECD members, is that these are capital exporting countries (outbound investments exceed capital inflows) and follow a 'residence' based method of taxation. Introduction of a CFC regime in these countries was accompanied by or followed the liberalization of foreign investment and exchange control regimes. In contrast, India is a net importer of capital, a favored inbound investment jurisdiction, and its tax policy follows a mixed approach of 'source' and 'residence' based taxation rules. A jurisdiction following the residence based method of taxation seeks to tax income earned by people who are tax residents of such jurisdiction. The fact that an income is generated in such jurisdiction or originates due to payments made by its tax residents is not a guiding factor. In contrast, the source based method seeks to tax an income if such income is generated in a jurisdiction or originated due to payments made by tax residents of such a jurisdiction.

V. CFC RULES AND TAX TREATIES

Importantly, DTC 2010 proposes the introduction of the CFC Rules as an anti-avoidance measure and as an exception to the principle of treaty overrides. In other words, the provisions of the applicable tax treaty, i.e., the tax treaty with

the country in which CFC is established, will make way for the provisions of DTC, 2010 wherever the CFC Rules are applicable. A consultation paper in relation to the proposed legislation argues that anti-avoidance rules are part of the domestic tax laws and not the tax treaties and thus, the limited exception to the principle of treaty overrides due to anti-avoidance measures such as the CFC Rules will not lead to any conflict. Internationally, there is no consensus on the compatibility of the CFC Rules with the tax treaties. Thus, it will be interesting to see how the Indian CFC Rules interface with the Vienna Convention on the Law of Treaties as well as the constraints, international customary law, theme and spirit behind the tax treaties India has already concluded with major economies of the world.

VI. CFC RULES AND FOREIGN INVESTMENT

Outbound investments are regulated under the Overseas Direct Investment Regulations of the Reserve Bank of India [Hereinafter, "ODI Regulations"]. Outbound investments led by fiercely competed global acquisitions accentuate India's status, reputation and image as a business destination and naturally support inbound foreign direct investment. Outbound forays by Indian companies, which are respectfully referred to as 'Indian Multinationals', are in nascent stages and need to mature on the backing of appropriate policy measures. Thus, it is important that the tax policy, including CFC Rules and the ODI Regulations, create an enabling environment for Indian companies with global aspirations.

VII. CONCLUSION AND THE WAY FORWARD

The objective of the CFC Rules is to strike at the deferral of tax liability achieved by avoiding distribution of income. However, the Government needs to take adequate safeguards to design a just and fair CFC regime. It is important to define 'control' in a precise manner, as the control test is the fulcrum of the CFC Rules. Further, it should be considered that no income is inherently passive in nature. Tax credit should also be provided for the foreign taxes paid on income sought to be taxed in India, to avoid double taxation of the same income. Levy of wealth tax on the value of shares in a CFC on an annual basis should also be reviewed. The administration of CFC Rules will be a critical factor in determining its acceptability. The tax department will need to equip itself with all the knowledge and training necessary for implementing a just and equitable CFC regime. The task for the Government is both fascinating as well as challenging. Hopefully, upon its introduction, DTC, 2010 will bring simplicity and certainty parallel with tax buoyancy for the Government, based on an improved compliance, collection and assessment mechanism.