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IMPACT OF THE INDIAN FINANCE BILL 2012 ON FOREIGN INVESTMENT IN INDIA

On March 16, 2012, the Finance Minister of India presented the Finance Bill 2012. The Finance Bill contains a number of measures that, if enacted, would have significant impact on foreign investment in India, particularly from a tax perspective.

RETROACTIVE TAXING OF OFFSHORE TRANSFERS

One of the most controversial aspects of the Finance Bill is a proposal to impose a retroactive tax on the indirect transfer of capital assets. Until now, when corporate control passed because of a transfer of shares, income was deemed to accrue in India only if the sale of shares constituted a transfer of a capital asset situated in India. In January 2012, the Indian Supreme Court confirmed this rule in *Vodafone International B.V. vs. Union of India*. There, the Court ruled that a controlling interest in an Indian company is not a separate capital asset and, therefore, the sale of a controlling interest in an offshore holding company was not a transfer of the holding company's underlying capital assets in India. The Finance Bill proposes to overrule *Vodafone* by clarifying the Indian Income Tax Act's ("Tax Act") definitions of "capital assets," "transfer," and "through." As changed, the Tax Act would deem any capital gains arising from the transfer of shares or interest in an offshore company as a taxable transfer within India if the shares or interest derived, directly or indirectly, its value "substantially" from the assets located in India. Moreover, because the Finance Bill purports to simply "clarify" the meaning of terms that have been used by the Tax Act all along since the Tax Act took effect on April 1, 1962, this new rule would operate retroactively, reaching back to all transactions that have occurred in the past 50 years.

These proposed changes would effectively extend the scope of India's source of income rules without any regard to tax optimization structures. Such retroactive clarifications in the law will generate tax uncertainty for foreign investors with plans to invest

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into India, as well as those who have previously made investments. The retroactive tax amendments have been strongly criticized by the Indian and international business community alike. The Finance Bill 2012 will become the Finance Act 2012 after being approved by both houses of the Indian Parliament and receiving the assent of the Indian President. The Indian Minister of Parliamentary Affairs has recently announced that the Indian parliament is likely to consider the Finance Bill 2012 on May 7, 2012.

GENERAL ANTI-AVOIDANCE RULES

The Finance Bill also attempts to codify the principle of "substance over form" with new General Anti-Avoidance Rules ("GAAR") scheduled to take effect on April 1, 2012, once notified by the Indian government. The GAAR would give Indian tax authorities new and sweeping powers to declare that a business transaction is an impermissible arrangement for tax avoidance. Among other things, this could deny businesses customary tax benefits, including benefits under India's tax treaties with other countries.

The proposed GAAR would permit the Indian tax authorities to characterize a transaction as an impermissible tax avoidance arrangement if one of its main purposes was to obtain a tax benefit and it (i) creates rights and obligations not normally created between parties dealing at arm's length; (ii) results, directly or indirectly, in the misuse or abuse of provisions of the Tax Act; (iii) is deemed to lack commercial substance; or (iv) was entered into or carried out in a manner normally not employed for *bona fide* purposes.

An arrangement is deemed to lack substance if, as a whole, it is inconsistent with the form of its individual steps, or if it involves round-trip financing, an accommodating party, elements that offset each other, or disguises certain material elements of the transaction.

The proposed GAAR erects a rebuttable presumption that an arrangement's main purpose is to obtain tax benefit and places upon the taxpayer the burden of proof to show the absence of a motive of tax avoidance. In addition, the GAAR uses broad language (such as "misuse or abuse of provisions of the Tax Act" and "entered into or carried out in a manner, normally not employed for bona fide purpose") that will make its actual scope unclear. Under the Finance Bill, the Central Board of Direct Taxes ("CBDT") will prescribe guidelines for the GAAR's implementation, which may provide some insight on how widely or narrowly the GAAR will be construed. The CBDT is expected to submit draft guidelines to the Ministry of Finance by May 2012.

Already, the proposed GAAR seems to have had an effect upon Indian taxation. On March 22, 2012, the Authority for Advance Ruling ("AAR")[1] upheld a tax demand on Otis Elevators in India and denied capital gains tax benefits provided by the India–Mauritius tax treaty. In this case, Otis India bought shares from Otis Mauritius through a share buyback scheme that resulted in capital gains tax for Otis Mauritius. Under the India–Mauritius tax treaty, this should not have been taxable in India. Nevertheless, the AAR upheld the Indian Income Tax Department's submission that this structure was designed to avoid tax in India and that the share buyback transaction was a "colorable device." The *Otis* ruling follows the principle of "substance over form" found in the proposed GAAR, even though it makes no direct reference to it. In any event, *Otis* gives an insight to the thinking of the AAR and the intentions of the Indian Income Tax Department.

WITHHOLDING TAX OBLIGATIONS FOR NONRESIDENTS

Another retroactive provision in the Finance Bill is the imposition of withholding tax obligations on nonresidents. The amended tax provision would require all persons (both resident and nonresident) who have made a payment to a nonresident person to withhold taxes if that payment would be subject to tax in India. This obligation would apply regardless of whether a nonresident payer has a residence, place of business, business connection, or any other presence in India and, like other provisions of the Finance Bill, would apply retroactively to April 1, 1962.

1 The Authority for Advance Ruling is a quasi-judicial body incorporated under the (Indian) Income Tax Act 1961 that is primarily charged with the responsibility of deciding the income tax liability of a nonresident in cross-border deals. The AAR pronounces rulings on the applications submitted in the prescribed form under the tax legislation, and such rulings are binding both on the applicant and the Indian income tax authority.

CONCLUSION

The Finance Bill and provision of the GAAR threaten to have serious effects upon companies that have invested in India or have plans to do so. Unfortunately, they have adversely affected the outlook and confidence of foreign investors in India at a time when India is actively seeking increased levels of foreign direct investment. It remains to be seen how the Indian tax authorities will implement these provisions. However, it is clear that the amendments will be challenged in the Indian courts. Recently, Vodafone served notice to the Indian government under the India-Netherlands Bilateral Investment Treaty challenging the proposed retroactive tax amendments to the Tax Act. Until these legal issues are resolved, it would be prudent to discuss with your tax and legal advisors any potential impact that the Finance Bill's retroactive amendments or the GAAR may have on any existing or future investments in India.

Jones Day does not practice Indian law and the contents of this Commentary *do not constitute an opinion on or advice on Indian law.*

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