TAXATION IN INDIA AND THE U.S.: STAGES IN THE LIFE OF A U.S. OWNED INDIAN COMPANY

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INTRODUCTION

When a U.S. corporation expands its operations to India through formation of an Indian subsidiary, tax issues will need to be addressed at the various stages of the investment. This article discusses the Indian and U.S. tax consequences at each stage, beginning with formation and continuing through ultimate disposition.[1]

BACKGROUND

The basic facts are as follows:

- Mr. A is a U.S. citizen who runs a successful manufacturing business in the U.S. ("U.S.Co").
- He proposes expanding operations to India to take advantage of lower operating costs and a skilled workforce.
- U.S.Co forms a newly incorporated company in India ("IndiCo"). IndiCo is a private limited company which will be engaged in the business of manufacturing electric appliances in India.
- Under the U.S. default entity classification rules, IndiCo will be treated as an association taxed as a corporation for U.S. tax purposes.

STAGE 1: INVESTMENT INTO INDIA

Indian Tax Aspects When Making Investments Into India

While an investment of funds into India in return for the issuance of shares will likely not result in any income tax obligations in India, there are several factors that must be considered before entering the Indian market, such as the instrument issued to U.S.Co. in consideration for the investment and the value of investment.

Choice of Instrument

One of the key decisions for any investment is the type of instrument, or instruments, that will be issued by IndiCo, such as common shares, preference shares, convertible debt, and any other form of security. The decision is guided by various factors such as the long-term intention of the investor, the regulatory framework in India, and Indian tax rules.

[1] This article reflects rules in effect as of the date of publication. Major changes to U.S. tax law have been proposed by the Biden Administration. Those changes may have profound effect on much of the discussion contained herein.

One option available to IndiCo is the issuance of a debt instrument. From the point of view of the company receiving the investment, the deductible nature of interest payments may make the issuance of debts attractive for tax purposes. This presumes that no limitations exist on the ability of IndiCo to claim a deduction for the entire amount paid or that IndiCo would report profits, but for the interest expense claimed as a deduction. From the investor's viewpoint, interest income will be taxable and, where the investor is a U.S. taxpayer, interest income is recognized as it accrues, even if no payment is received or the payor reports a loss without taking the interest into account.

Normally, interest expense that is reported in IndiCo's books of accounts is deductible for Indian tax purposes, provided (i) appropriate taxes have been withheld and paid over in India, (ii) the issuance of debt does not run afoul of the thin capitalization rules under the Indian Income Tax Act, 1961 ("I.T. Act"), and (iii) the decision of issue debt does not run afoul of the General Anti-Avoidance Rule ("G.A.A.R."). Under Indian thin capitalization rules, interest deductions are capped at 30% of adjusted profits. Under G.A.A.R., the tax benefit of an arrangement may be denied if it arises from an impermissible avoidance arrangement.

In comparison to the issuance of a debt instrument, IndiCo may issue equity in the form of shares of common shares or preferred shares. Dividends can be freely repatriated under the current exchange control regulations. Under the Indian law, dividends can be declared only out of current and accumulated profits, subject to certain conditions. Under the current provisions, dividend payout is not deductible for the payor and is taxable in the hands of the shareholders. The statutory tax rate is 20%, and both a surcharge and cess[2] may be imposed on a nonresident investor. The tax rate may be reduced under the applicable income tax-treaty.

Choice of Acquisition – Direct or Indirect Subsidiary

Investment in India can be made either directly or via an intermediate holding company ("I.H.C."). Investment from an I.H.C. provides the following benefits:

- It protects the parent company from liability.
- If the I.H.C. is formed in an intermediary jurisdiction and subject to tax laws in the investor's country of residence, it may allow funds to be accumulated at the I.H.C. level free of tax in the country of residence of the investor and may be used to make future investments abroad.
- It provides an asset base at I.H.C. level to facilitate the raising of external funds for future investment.
- In the past, it eased an exit from the sale of IndiCo by means of a sale of sale of shares of an I.H.C.

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[2] Surcharge is payable as a percentage of the income-tax payable. Currently, a foreign company with income in excess of INR 100 million is liable to pay surcharge at the rate of 5% on tax while foreign companies whose total income does not exceed INR 100 million (approximately $1.36 million as of September 10, 2021) but is greater than INR 10 million (approximately $136,000 as of September 10, 2021) are liable to pay surcharge at the rate of 2% on tax. Additionally, Health and Education Cess of 4% is levied on the aggregate of income-tax and surcharge.

While the investor may have its own preference as to the location of the I.H.C., Singapore, Mauritius, and the Netherlands have been preferred jurisdictions in the past, due to the combination of attractive tax frameworks for holding companies and favorable tax treaties with India. Indian tax authorities view such sales as abusive and the Government has adopted an indirect transfer provision in the I.T. Act. Popularly known as the Vodafone tax, it provides that shares of, or interests in, a foreign entity is deemed to be situated in India where such foreign entity derives substantial benefit from India – computed in a prescribed manner. More than 50% of value must be derived from India for the tax to be imposed.[3]

“Today, limitation on benefits provisions are in Indian tax treaties with the U.S., Mauritius, and Singapore.”

Having strong commercial substance in the I.H.C.’s jurisdiction is essential in planning that is designed to reduce the exposure to the Vodaphone tax. Whether this is practical is an open question because, by definition, an I.H.C. may have been designed to be a special purpose vehicle to hold the investment in IndiCo. Building in functions for the I.H.C. may be a non-starter unless they are limited to managing only one investment, that being the investment in IndiCo.[4]

Today, limitation on benefits (“L.O.B.”) provisions are in Indian tax treaties with the U.S., Mauritius, and Singapore. India has also approved the ratification of multilateral instrument (“M.L.I.”) to implement tax treaty-related measures. Where approved by partner jurisdictions, India’s existing tax treaties could require a showing that obtaining a tax benefit was not one of the primary purposes for channeling an investment through a particular country.

Fair Value Requirement

Any investment in India is required to be tested to determine whether the value of the asset acquired – such as face amount of debt bearing specific interest or the value of shares issued – meets a fair value requirement. The Indian income-tax law lays down a computation mechanism for such fair value requirement. An investor is required to obtain a valuation report from a Chartered Accountant or Category-I Merchant Banker at the time of investment. Any investment that has a value below the value of the instrument issued is treated as taxable income for the investor. Ordinary income tax rates apply. The rules for valuation of equity shares consider the fair value of underlying assets, such as shares and securities, stamp duty value in case of immovable property, and book value for the other assets.

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[3] In 2012, the Indian government enacted legislation allowing the tax authorities to impose tax retroactively on gains derived from an indirect sale of an Indian company. (The law was enacted several years after the transactions, but was made effective several years prior to enactment in response to adverse decisions in Indian courts.) The provision was challenged by Vodafone and Cairn Energy in arbitration under a bilateral investment treaty. Both companies won and the matters are currently on appeal. Recently, the Indian government has withdrawn the retroactive applicability of this law providing a relief to foreign investors.

[4] An exception may exist for a Singapore corporation as the relevant income tax treaty deems a Singapore company to have substance ifs annual expenditure on operations in Singapore is at least S$200,000.

U.S. Tax Aspects When Investing Into India

Contribution of Appreciated Property May Result in Gain Recognition to the U.S. Shareholder

Generally, the U.S. does not recognize any gain or loss if property is exchanged solely for stock of a corporation which is controlled by the transferor immediately after the exchange.[5] A person is said to control a corporation if the person owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. However, the above nonrecognition provision does not apply in case of a transfer of appreciated property by a U.S. person to a foreign corporation, even if all conditions of code §351 are otherwise satisfied. The foreign corporation is denied corporate status. Consequently, nonrecognition of gain is denied because the benefit of Code §351 applies only to transfers to a corporation in return for the issuance of shares.[6] Because the transferee foreign corporation is not considered to be a corporation, the U.S. transferor must recognize gain on the appreciation in the contributed property. Certain exceptions apply to the recognition rule. The provision does not extend to losses. Such losses are not recognized if the transferee is a foreign corporation and all the conditions of Code §351 are met.

Default Entity Classification Rules

U.S. tax law contains default entity classification rules according to which a foreign entity is treated as a corporation by default, if all members have limited liability.[7] If the entity has two or more members and at least one member has unlimited liability, the default status is that of a partnership. The entity will be disregarded if it has a single owner that does not have limited liability.[8]

If an entity is an eligible entity because it is not listed in I.R.S. regulations as a *per se* corporation, an election may be made by the entity to choose a classification different from the default classification. The election is commonly referred to as a "Check-the-Box" election. It is made by filing Form 8832, *Entity Classification Election*. It may be noted that the default classification rules and check the box election are relevant only for U.S. tax purposes and it will not affect the tax treatment in the foreign country in which it is organized.

All entities making an election, must have a U.S. tax identification number. This applies to foreign entities as well as U.S. entities. Form SS-4, *Application for Employer Identification Number*, is used to obtain a U.S. tax identification number.

In the facts above, the Indian entity will be incorporated as a private company limited by liability and therefore it will default to a corporate status since its only shareholder, U.S.Co, has limited liability with respect to its debts. No check the election is made by U.S.Co.

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[5] Code §351(a).

[6] Code §367(a).

[7] Limited liability means no liability for the debts of the entity.

[8] Treas. Reg. §301.7701-3(b)(2).

STAGE 2: TAXATION OF PROFITS OF INDICO

Indian Income Tax Consequences on the Operations of IndiCo

Under Indian tax law, the business profits earned by a domestic company is taxed on a net basis, after deduction of permissible expenses. The corporate tax rate ranges from 15% to 30%, plus applicable surcharge and cess, depending on several factors including, (i) nature of the company's business, (ii) the date of incorporation, (iii) the volume of turnover, and (iv) specified incentives and deductions claimed by the company.

In certain scenarios, IndiCo may be subject to tax on its adjusted accounting profits ("Book Profit"), if tax computed under normal profits is less than 15% of Book Profit. The term used for tax in this set of circumstances is Minimum Alternate Tax. ("M.A.T."). Such excess tax paid under M.A.T. over and above normal tax liability is allowed as a credit against IndiCo's normal tax liability for later years up to a maximum of 15 years under current law.

Income of IndiCo subject to U.S. Tax Under Two Separate Tax Regimes

U.S. tax law provides for the potential application of two anti-tax deferral regime in the context of a controlled foreign corporation ("C.F.C."). One is commonly known as Subpart F, which addresses income of a C.F.C. from intercompany transactions that are viewed to be abusive under U.S. tax law or income that is merely a passive of funds by a C.F.C. The other is Global Intangible Low-Taxed Income ("G.I.L.T.I.") that governs the operating income of the C.F.C. not otherwise subject to U.S. tax.

A C.F.C. is a foreign corporation in which "U.S. Shareholders" directly or indirectly own shares representing (i) more than 50% of the total combined voting power of all classes of stock entitled to vote or (ii) more than 50% of the total value of all issued and outstanding shares of stock.[9] A U.S. Shareholder is a U.S. person[10] who directly or indirectly owns shares representing (a) 10% or more of the total combined voting power of all classes of stock entitled to vote or (b) 10% or more of the total value of all issued and outstanding shares of stock.[11]

IndiCo is a wholly owned subsidiary of U.S.Co. Consequently, U.S.Co is a U.S. Shareholder of IndiCo and IndiCo is a C.F.C.

Transactions Viewed to be Abusive

A U.S. Shareholder of a foreign corporation generally is not subject to tax on the income of the corporation until the shareholder receives a distribution from the corporation. However, under Subpart F, certain types of income earned by a C.F.C. are currently included in the income of its U.S. Shareholders even if the C.F.C. does not distribute the income to its shareholders in that year.

One such type of income is Foreign Base Company Sales Income ("F.B.C. Sales Income"). For an item of income to be characterized as F.B.C. Sales Income, it

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9 Code §957(a).

10 A U.S. person includes, *inter alia*, a U.S. citizen, a lawful permanent resident of the U.S., an individual who meets the substantial presence test of determining residency, a U.S. corporation, and U.S. partnership.

11 Code §985(b).

must be derived by a C.F.C. from a purchase or sale of personal property involving a related party in which the goods are both manufactured and sold for use or consumption outside the C.F.C.'s country of organization. Such related party transactions are deemed to be tax motivated if the intermediary company is based in a low tax jurisdiction. If the intermediary company is subject to tax at an effective rate of 90% of the U.S. tax rate in effect for the year, the income arising from the purchase and sale of goods is not treated as F.B.C. Sales Income. Similarly, if the property is manufactured or sold for use or consumption in the C.F.C.'s country of organization, it cannot be F.B.C. Sales Income.

In determining whether an arrangement is abusive, U.S. law addresses transactions carried on through branches. The branch rule prevents a U.S. Shareholder from using a branch in lieu of a separate C.F.C. to shift sales income from a high-tax foreign country to a low-tax foreign country. Absent the branch rules, a C.F.C. and its branch would be treated as a single entity for U.S. tax purposes. However, when a C.F.C. carries on selling, purchasing or manufacturing activities by or through a branch outside its country of incorporation and the use of the branch has substantially the same tax effect as if the branch were a separate C.F.C., the branch and the remainder of the C.F.C. will be treated as separate corporations in determining whether the C.F.C. has F.B.C.S. Income from the sale of property. Generally, the branch and the remainder of the C.F.C. will be treated as separate corporations if the actual effective rate of tax of the branch is less than 90% of, and at least 5 percentage points below, the hypothetical effective rate of tax of the rest of the company.

A second type of income derived by a C.F.C. that results in immediate U.S. tax for a U.S. Shareholder is Foreign Base Company Services Income ("F.B.C. Services Income"). The rules for F.B.C. Services Income are intended to deny deferral when a U.S. Shareholder uses a C.F.C. to inappropriately shift services income from the U.S. to foreign jurisdictions or from a high-tax country to a low-tax country.

F.B.C. Services Income may take the form of compensation, commissions, fees, and other forms of payment for services. To be F.B.C. Services Income of a C.F.C., the income must be derived by a C.F.C. in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services outside the C.F.C.'s country of organization for or on behalf of any related person.

Generally, services are considered to be performed where the persons doing the work are physically located when they perform the activities that generate the services income. The determination will depend on the facts and circumstances of each case. F.B.C. Services Income does not include income from services performed within the C.F.C.'s country of organization. However, in many cases, services are performed both within and outside the C.F.C.'s country of organization. In these circumstances, an apportionment is required to determine the amount of the income that is considered to be F.B.C. Services Income.

Typically, the total gross income of a C.F.C. that is derived in connection with services performed for or on behalf of a related person must be apportioned on the basis of time spent by employees of the C.F.C. performing the services within the C.F.C.'s country of organization and the time spent outside that country. In making the allocation, relative weight must be given to the value of the various functions performed by persons in fulfillment of the services contract or arrangement.

Passive Income Taxed as Subpart F Income

Items of passive income, such as interest, dividends, investment gains, royalties, and rents generated by a C.F.C. in a manner that is unrelated to the active conduct of a banking, licensing, or leasing company are considered to be items of Foreign Personal Holding Company Income. As with income from abusive transactions, Foreign Personal Holding Company Income of a C.F.C. will be subject to U.S. tax when and as generated by the C.F.C. Detailed rules have been adopted to distinguish when the above mentioned income and gains are derived in the active conduct of a trade of business by a C.F.C.

Taxation of a U.S. Shareholder

A corporate U.S. Shareholder is subject to a 21% tax on the Subpart F Income inclusion and is allowed an indirect credit for the foreign income taxes paid by the C.F.C. with regard to the income taxed under Subpart F.[12] An individual U.S. Shareholder, on the other hand, is subject to tax at ordinary rates of up to 37% and an indirect credit of the taxes paid by the C.F.C. on Subpart F Income in its country of incorporation is not allowed. However, the taxes paid by the C.F.C. reduce the earnings from the Subpart F Income and function as a deduction for the individual.

In the present fact pattern, IndiCo is an operating company and therefore predominantly earns income from its business operations. However, let's assume it earns interest income on the excess working capital invested in liquid investments in India. Per se, the interest income – which is not operating in nature – is Foreign Personal Holding Company Income, which is a type of Subpart F Income. Therefore the interest income will be taxed in the hands of U.S. Shareholders as Subpart F Income on current basis in the absence of an exception.

Two primary exceptions that are relevant to the present fact pattern are discussed below:

- *De minimis rule*[13] – If the aggregate of Subpart F Income is less than the lower of 5% of gross income or $1 million, none of the C.F.C.'s income is treated as Subpart F Income.[14]
- *High tax exception* – An item of income taxed at more than 90% of the highest U.S. corporate rate (*i.e.* 21% X 90% = 18.9%) in the country of incorporation is not Subpart F Income.[15]

IndiCo is incorporated in India which has a minimum corporate tax rate of 25% which is more than 18.9%. Assuming the computation of income and the timing or income recognition are materially the same for tax purposes in the U.S. and India, the interest income will not be treated as Subpart F Income under the High Tax Exception.[16] Alternatively, the interest income may also escape the Subpart F regime under the

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[12] Code §960(a).

[13] Full inclusion rule, on the other hand, treats the entire gross income of a C.F.C. as Subpart F Income if more than 70% of the gross income constitutes Subpart F Income.

[14] Code §954(b)(3)(A).

[15] Code §954(b)(4).

[16] However, see the discussion on G.I.L.T.I. Income excluded from Subpart F under the High Tax Exception is nonetheless treated as G.I.L.T.I. income.

De Minimis Rule if the interest income together with other Subpart F Income is less than the lower of 5% of gross income of IndiCo or $1 million.

Operating Income Taxed as Global Intangible Low-Taxed Income (G.I.L.T.I.)

The 2017 Tax Cuts and Jobs Act introduced a new tax regime called G.I.L.T.I. that is applicable to U.S. Shareholders of a C.F.C. Although, labeled as a tax on intangible income, the G.I.L.T.I. tax is, in effect, a tax imposed on U.S. Shareholders of a C.F.C. on their share of any income earned by the C.F.C. that is not otherwise subject to U.S. tax in one form or another.

The G.I.L.T.I. regime follows an elimination method to tax the income of a C.F.C. In broad terms, the computation begins with the gross income of the C.F.C. for the current year. Next, the gross income is reduced by current income that is already subject to U.S. tax under other provisions of the Code, such as (i) Subpart F Income, (ii) income that is effectively connected with a U.S. trade or business carried on by the C.F.C., (iii) income that is excluded from Subpart F under the high-tax exception, and (iv) dividend income received from related C.F.C.'s formed in the same country as the C.F.C. receiving the dividend. The residual income of the C.F.C. is subject to a series of adjustment and is taxed at an effective tax rate of 10.5%[17] when the shareholder is itself a corporation. A corporate shareholder is entitled to an indirect credit, but the credit is limited to 80% of the foreign income tax paid on the net G.I.L.T.I. taxable income of the C.F.C. An Individual shareholder is subject to ordinary tax rates of up to 37% without any benefit of indirect foreign taxes paid by the C.F.C.

"The residual income of the C.F.C. is subject to a series of adjustment and is taxed at an effective tax rate of 10.5% when the shareholder is itself a corporation."

Taxation of Subpart F Income and G.I.L.T.I. income have several similarities. Similar to the Subpart F provisions, the income subject to the G.I.L.T.I. provisions is taxed in the hands of U.S. Shareholders in the year earned even if the C.F.C. does not distribute the income to its shareholders on a current basis. In other words, unless an exception applies, the entire income of a C.F.C. is fully taxed in the U.S. on a current basis under the following categories:

- Subpart F Income
- G.I.L.T.I. Income
- Effectively connected income

Like Subpart F, the G.I.L.T.I. regime is also subject to a high tax exception (the "G.I.L.T.I. High Tax Exception"), which, if available and elected, excludes G.I.L.T.I. income from current tax rules. The G.I.L.T.I. High Tax Exception is available if the income is taxed in the country of incorporation at an effective rate that is 90% or more of the U.S. corporate tax rate (*i.e.* 21% X 90% = 18.9%). Income that is excluded from Subpart F under the Subpart F De Minimis Exception discussed above is subject to the G.I.L.T.I. tax regime.[18]

In the present fact pattern, IndiCo is an operating company engaged in the business of manufacturing electric appliances in India. Therefore, subject to the application of the G.I.L.T.I. High Tax Exception, the income of IndiCo that is not otherwise subject

[17] The income tax rate on G.I.L.T.I. is set increase to 13.125% effective Jan 1, 2026.

[18] Treas. Reg. §1.951A-2(c)(4)(iii).

to U.S. tax under other provisions of the Code will be subject to the G.I.L.T.I. Tax. As discussed above, India has a minimum corporate tax rate of 25% which is higher than 18.9%. Therefore, if the G.I.L.T.I. High Tax Exception is elected,[19] the G.I.L.T.I. income will not be subject to G.I.L.T.I. tax in the U.S., if the computation of income and the timing or income recognition are materially the same for tax purposes in the U.S. and India.

STAGE 3: REPATRIATION OF PROFITS BY INDICO

Indian Tax and Other Aspects When Repatriating Funds to the U.S.

At this stage, the investor looks to repatriate funds from the target entity to its home jurisdiction on an annual basis. However, repatriation of funds may trigger a tax in India. An investor must consider the following factors for repatriation of target profits from India.

Mode of Repatriation

Each mode of repatriation has its own pros and cons, and an investor must be mindful when selecting the method of repatriation. Typically, funds are repatriated to investors by way of dividends, interest, royalties, fees for technical services ("F.T.S."), or a return of capital ("Buy-Back").

While payments of interest, royalties, and F.T.S. may provide benefit in the form of tax deduction for the Indian target, they are subject to certain caps under the Indian transfer pricing law, must have commercial justification, and meet an arm's length test. In addition, interest payments are not deductible if the subsidiary making the payment is thinly capitalized. The deduction for interest paid to related parties cannot reduce net profit before interest income and expense by more than 30%.

Indian Withholding Tax Requirement

Under Indian tax law, any payment to a nonresident is subject to withholding tax. Under the I.T. Act, interest payments are subject to withholding tax imposed at rate ranging from 5% to 40% depending on factors such as currency of borrowing, nature of instrument, and type of investor. The tax is increased by the applicable surcharge and cess. In comparison, dividends are subject to flat withholding rate of 20% plus applicable surcharge and cess, and royalties, and payments of F.T.S. are subject to flat withholding rate of 10%, plus applicable surcharge and cess.

The above rates of withholding may be reduced under an applicable income tax treaty. Under the India-U.S. Income Tax Treaty, the rates of withholding taxes are reduced as follows:

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[19] The G.I.L.T.I. High Tax Exception applies only if the U.S. Shareholder of a C.F.C. elects the application of the exception. The election is made by the majority shareholder and is made at a corporate level which implies that the election is applicable on minority shareholders, as well. The election is made by attaching a statement to the shareholder's U.S. Federal income tax return informing the I.R.S. of the election.

- For dividends, the rates are 15% where the shareholder is a U.S. corporation that holds shares representing at least 10% of the voting power in the target. In other cases, the tax rate is 25%.
- For interest payments, the rates are 10%, if the lender is a financial institution, and 15% in all other cases.
- For royalties and payments of F.T.S., the treaty rate is 15%, but the rate under domestic law is 10% plus applicable surcharge and cess.

To claim benefits under a tax treaty, an investor must be the beneficial owner of the income. This is determined under a fact-based exercise and requires detailed evaluation of various factors. It becomes more critical in case of I.H.C. structures.

Transfer Pricing Aspects

According to the Indian transfer pricing regulations, any income arising from an international transaction carried on between two or more associated enterprises ("A.E.'s") is computed under the principle of an arm's length price ("A.L.P."). Generally speaking, parties are treated as A.E.'s if one has the power to exert control over the other. In the context of a corporate structure, enterprises would be considered to be associated if any person or enterprise directly or indirectly holds shares carrying 26% or more of the voting power in each of the enterprises.[20] Thus, any transaction between an Indian target and its foreign sole shareholder must be carried out on an arm's length basis in order to be deductible. The I.T. Act prescribes specific methods for determining the A.L.P.

The Indian transfer pricing law also includes provisions relating to secondary adjustments, which provides that if the primary adjustment is not remitted to India within the prescribed time, the unremitted amount is deemed to be a form or loan or advance made to the foreign A.E. and deemed interest accrues on the deemed advance.

In addition, robust documentation in support of transfer prices must be maintained. The law provides for the filing of transfer pricing certification reports (Form 3CEB is an example). Any expenditure incurred in excess of an A.L.P. is not tax deductible. Similarly, where A.L.P. in a transaction with a foreign A.E. produces a loss for an Indian customer, the A.L.P. deemed to be zero.

Finally, like the I.R.S. in the U.S., the tax authorities in India have a robust mechanism in place for obtaining Advance Pricing Agreements to provide tax certainty in relation to transfer pricing matters.

U.S. Taxation of Distributions From a C.F.C.

As discussed above, Subpart F Income and G.I.L.T.I. are subject to U.S. tax in the hands of a U.S. Shareholder in the year in which a C.F.C. generates income. Absent the following rule, this previously taxed income ("P.T.I.") could be taxed again in the hands of the U.S. Shareholder at the time of an actual distribution. Code §959(a) prevents such double taxation by excluding the distributions of P.T.I. from gross income upon actual distribution.

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[20] Section 92 of the I.T. Act.

Owing to multiple types of P.T.I. (*e.g.*, Subpart F, G.I.L.T.I., and Transition Tax), the Code provides for a specific order in which distributions are deemed to be made out of the earnings and profits ("E&P") of a C.F.C. Generally, the distributions are made under the Last-Inn First-Out method, which implies that the distributions are first made from E&P of the current year and then from the E&P of the immediately preceding year, and so forth until fully exhausted. Moreover, E&P of each year is further divided into the following categories and a distribution is sourced in the following order:

- Previously taxed earnings and profits ("P.T.E.P.") attributable to investments in U.S. property.[21]
- P.T.E.P. attributable to Subpart F Income, G.I.L.T.I. income, and Transition Tax.[22]
- General current and accumulated E&P ("non-P.T.E.P."). This category includes income not subject to tax in the U.S. on account of, *inter alia*, making a high tax exception election to the G.I.L.T.I. income or Subpart F Income, etc.

Distributions that are deemed to be made from the first two categories are not subject to U.S. tax because the income was subject to U.S. tax previously in the hands of a U.S. Shareholder in the year in which the C.F.C. earned the income. Nonetheless, a distribution of P.T.I. may be subject to withholding at source since distributions typically will be treated as dividend to the C.F.C.'s shareholder in the source country.

U.S. taxation of distributions deemed to be made from Category 3 (non-P.T.E.P.) depends on the corporate status of the shareholder. A corporate U.S. Shareholder of a C.F.C. is entitled to a 100% deduction of the foreign-source portion of any dividend received from that C.F.C. ("100% D.R.D.").[23] The foreign-source portion of a dividend generally is the portion of the dividend that is attributable to the non-P.T.E.P. (*i.e.*, distributions deemed to be made from Category 3) of the C.F.C. In other words, a distribution from a C.F.C. that is deemed to be made from non –P.T.E.P is fully exempt by reason of the 100% D.R.D. in the hands of a corporate U.S. Shareholder. Further, the corporate shareholder is not allowed a credit for any foreign taxes paid or accrued with respect to the dividend to which the 100% D.R.D. applies.[24]

A corporation must satisfy the following requirements to qualify for the 100% D.R.D.:

- The corporate shareholder must meet the definition of a U.S. Shareholder, as discussed above.
- The corporate shareholder must have held the stock with respect to which the dividend is made for more than 365 days during the 731-day period beginning 365 days before the date on which the stock is given ex-dividend status.[25]

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[21] Code §959(c)(1).- Investment in U.S. property is not the main focus of this article and therefore has not been discussed here.

[22] Code §959(c)(2).

[23] Code §245A(a).

[24] Code §245A(d)(1).

[25] Code §§246(c)(1)(A), 246(c)(5)(A).

- The foreign corporation must be a specified foreign corporation and the corporate shareholder must be a U.S. Shareholder with respect to that foreign corporation at all times during the period of 365 days.[26]
- The U.S. Shareholder has not diminished its risk of loss through various option arrangements.[27]

An individual shareholder receiving distributions from Category 3 E&P of a C.F.C. is treated as receiving taxable dividends that are subject to preferential tax rate of up to 20% when the dividend is a qualified dividend. For a C.F.C., the dividend would be qualified if the U.S. has an income tax treaty in place with the country of incorporation.[28] In the absence of a treaty, the distribution is taxed at ordinary rates of up to 37%. The individual recipient is allowed to claim a foreign tax credit for foreign taxes withheld from the dividend by the source country. The credit is subject to various limitations of U.S. tax law. Additionally, the Net Investment Income Tax ("N.I.I.T.") of 3.8% is imposed on individuals who receive the dividend directly or through tax transparent entities provided certain income thresholds are exceeded. The N.I.I.T. cannot be reduced by the foreign tax credit for withholding taxes imposed by a foreign country.

In the present fact pattern, U.S. taxation of distributions will depend on several factors, including

- whether IndiCo generates Subpart F Income;
- if so, whether De Minimis Rule or the Subpart F High Tax Exception is applicable; and
- whether the G.I.L.T.I. High Tax Exception is elected.

If the income of IndiCo is not taxed on a current basis (either under Subpart F or G.I.L.T.I. regime), the actual distributions that have not been taxed previously will be deemed to have been distributed from Category 3 E&P (non-P.T.E.P.). Those dividends will enjoy the 100% D.R.D., if applicable, as a result of which the profits of IndiCo will be fully exempt from tax. On the other hand, if the income of IndiCo is treated as Subpart F Income or G.I.L.T.I. Income, U.S.Co will be taxed in the U.S. on a current basis at the rate of 21% or 10.5%, respectively. A subsequent actual distribution to U.S.Co will not be subject to tax in the U.S. to the extent it is treated as a distribution of P.T.I. by virtue of Code §959.

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[26] Code §246(c)(5)(B).

[27] Code §246(c)(4).

[28] Code §1(h)(11)(C)(II).

STAGE 4: EXIT FROM INDIA

Indian Tax and Other Aspects on Exiting India

Mode of Exit

An exit can take the form of a simple share transfer, a slump sale,[29] or the liquidation of IndiCo. Under Indian tax law, capital gains earned by a nonresident investor from transfer of assets based in India, including shares of an Indian company, are taxed at a rate ranging from 10% to 40% (plus surcharge and cess), depending on the period for which such assets were held prior to transfer and the type of asset transferred. The tax treatment of the gain realized by a foreign investor may be modified under an applicable income tax treaty. However, tax treaties that have been entered with the U.S. and the U.K. do not provide any relief from Indian capital gains tax.

Valuation Requirement

In respect of certain assets, the Indian income tax law has specific valuation norms and prescribed valuation mechanisms under which the acquisition of assets for less than inadequate consideration could result in tax implications for the acquirer. Recently, such provisions have also been made applicable to slump sale transactions.

From the seller's perspective, the valuation aspect is critical as there are statutory provisions in India's domestic tax law (Section 50CA) that tax the seller on deemed consideration in certain cases.

Thus, sufficient care should be taken to ensure that the valuation aspect of a transaction is handled appropriately, so that there are no adverse income-tax implications for either of the parties.

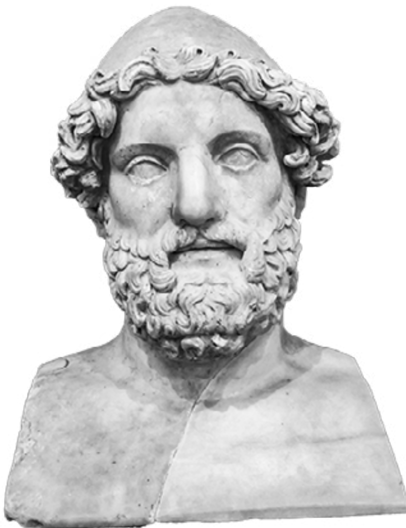
Successor Liability Risk

Under the Indian income-tax law, there is a risk that upon acquisition of a business, the buyer, as a successor, would inherit the tax liabilities, if any, of the seller. This risk is triggered in cases where the transferor cannot be found or where any tax liability is not recoverable from the transferor, for example, on account of inadequacy of assets.

When the provision is triggered, the buyer may be held liable for the tax liabilities of the transferor for a specific period, typically the financial year in which the transfer of the business takes place and the immediately preceding financial year. Thus, a purchaser must confirm the seller's ability to meet its tax liability.

Clearance From Income-Tax Authorities

In the case of pending tax proceeding against the transferor, the Indian tax authorities have the power to declare a transfer of certain specified assets as void, where such transfer takes place without a prior approval of the jurisdictional tax officer. In this regard, the Indian income-tax law provides a mechanism for obtaining a tax clearance certificate for the transfer of business assets. In secondary transfers



[29] In India, a slump sale is the transfer of an undertaking as a whole for a lumpsum consideration without considering values of individual assets or liabilities contained within the undertaking. That said, for the purpose of merely determining stamp duty or other similar taxes, individual values may be of relevance.

of business assets, this can become a point of negotiation between the parties because tax clearance certificates can be a time-consuming process. Hence, this aspect should be discussed early in deal negotiation to assess whether mere contractual covenants would suffice.

Tax Indemnities

Merger and acquisition transactions have been steadily growing in India and some of the most highly negotiated provisions are those relating to indemnities in case of breach of representations and warranties. In a secondary transfer, the purchaser takes over the target company together with all its related liabilities, including contingent liabilities. Hence, the purchaser normally requires more extensive indemnities than in the case of an asset acquisition. From a seller's perspective, globally there has been a rapid growth in the use of representations and warranties insurance ("R.W.I.") in relation to these transactions in order to avoid the out-of-pocket costs arising from an unforeseen liability. This has become a popular alternative to an indemnity under an S.P.A. or where indemnity is capped.

"When significant sums are involved, it is customary for the purchaser to initiate a due diligence exercise. Normally, this would incorporate a review of the target's tax affairs."

An alternative approach is for the seller's business to be transferred into a newly formed entity, so the purchaser can take on a clean business and leave its liabilities behind. Such a transfer may have tax implications. When significant sums are involved, it is customary for the purchaser to initiate a due diligence exercise. Normally, this would incorporate a review of the target's tax affairs.

U.S. Taxation of Disposition of Stock in IndiCo

Generally, any gain arising from a sale of stock of a corporation is treated as capital gain in the hands of the seller.[30] In the context of a C.F.C., Code §1248 requires the gain recognized by a U.S. Shareholder on the sale, exchange, redemption of stock, or liquidation of a foreign corporation to be treated as a dividend to the extent of the C.F.C.'s E&P that have not been taxed previously in the U.S.

Code §1248 provides parity of tax treatment for U.S. Shareholders who sell C.F.C. stock in the following two fact patterns:

- In the first, the C.F.C. is a corporation that distributes dividends regularly, providing its U.S. Shareholders with a stream of potentially taxable dividends as provided under U.S. tax law in effect at the time. When the stock of the C.F.C. is sold, the gain reflects solely the increase in value of the business of the C.F.C.
- In the second fact pattern, the C.F.C. is a corporation that accumulates its profits and pays no dividends. When the stock of the C.F.C. is sold, the gain reflects both the increase in the value of the C.F.C.'s business and the retained cash earnings.

In a system where long-term capital gains are taxed at a more favorable tax rate, as was the case in 1962 when Code §1248 was enacted, the second fact pattern resulted in more favorable tax treatment.

The gain is characterized into dividends if, at some time during the five-year period preceding the disposition, the corporation was a C.F.C. while the U.S. Shareholder

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[30] Code §1001.

owned (directly, indirectly, or constructively) shares of stock representing at least 10% of voting power of all shares of the corporation. Although the shareholder's 10% ownership must have coincided with the corporation's status as a C.F.C., Code §1248 applies even though one or both of these conditions is not satisfied when the gain is realized.

In determining the amount of E&P that will cause gain from the sale of shares to be treated as dividends under Code §1248, E&P that was previously included in the shareholder's gross income under Code §951 (*i.e.*, Subpart F and G.I.L.T.I.) and E&P from income that was effectively connected to the conduct of a U.S. trade or business carried on by the foreign corporation are excluded.

The gain treated as a dividend under Code §1248 enjoys the 100% D.R.D. under Code §245A. Hence, it is exempt from U.S. tax for a U.S. corporate seller.[31] Therefore, repatriation of the proceeds from the sale of a C.F.C. into the U.S. can be effected without any U.S. tax, although the gain may be subject to tax in India. The U.S. corporate seller will not be allowed a credit for the Indian taxes in the year of sale or future years.[32] In case of an individual U.S. Shareholder, the gain characterized as dividends are subject to U.S. tax at the rate of up to 20% or 37% (depending on whether the U.S. has signed an income tax treaty with the country of incorporation). The N.I.I.T. of 3.8% is also imposed on the gain in case of an individual shareholder.

CONCLUSION

Based on the above discussion, a parent-subsidiary structure to carry out business in India may result in a zero tax liability in the U.S. in the hands of the U.S. parent. If rules applicable to the computation of income and the timing of recognition of income and expenses are materially identical in both countries, the application of the Subpart F and G.I.L.T.I. H.T.E. could apply to U.S.Co as the Indian corporate tax rate is higher than 18.9%. Where all such factors coalesce, should not be subject to tax on Subpart F Income or G.I.L.T.I. Income in the U.S. on a current basis. As a consequence, any distribution from IndiCo will be treated as being distributed from non-P.T.I. earnings. This distribution will be exempt from U.S. tax if the 100% D.R.D. under code section 245A is available.

As a result, a U.S. investor can carry out business in India and repatriate business profits without incurring any addition U.S. tax. However, any dividend distribution by the U.S. parent to its shareholders will be subject to U.S. tax at the rate of up to 20% if the shareholder is a U.S. citizen or resident or 30% if the shareholder is not a U.S. person and is not entitled to treaty benefits.

U.S.Co will be required to annually file a Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, to report its ownership interest in the Indian subsidiary and certain financial information of the Indian company to the I.R.S.

On the Indian side, the business profits of the Indian company will be subject to a minimum corporate tax of ~25% on net profits. Any distribution to the U.S. parent from its E&P will be treated as a dividend subject to a withholding tax of 15% (under the India-U.S. income tax treaty) in India.

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[31] Code §245A(a)(1).

[32] Code §245A(d)(1).

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