ON INDIAN INCOME TAX LAW

Indian Income Tax Law is governed by the Income-tax Act, 1961 and rules made thereunder. Amongst other things, the act chiefly governs the situs of taxation, tax residency, charge of tax, classification of income, incentives/tax holidays/exemptions, tax rates and withholding of taxes, transfer pricing (or base erosion of profits test) and other anti-avoidance provisions. India has also entered into double taxation avoidance agreements with various countries. These FAQs answers some of the common queries relating to applicability and scope of Income-tax Act, 1961.

Q. Which is the governing law for income tax in India?

A. The Income-tax Act, 1961 and Income-tax Rules, 1962 are the governing laws for income tax in India.

Q. Who needs to pay income-tax in India?

A. A person resident in India and a non-resident deriving income from a source situated in India.

Q. What is the basis of taxation?

A. India basically follows residence-based taxation. However, for non-residents, India follows source-based taxation. Double taxation avoidance agreements signed with other countries ensure that an income is not taxed twice.

Q. Who is a resident Indian?

A. 'Tax Residency Test' - Presently, an individual is tax resident in India if he/she is in India for at least - '

a. 182 days' during current year, or '
b. 365 days' in previous four years and '60 days' in current year – However, for Indian citizens and persons of Indian origin, the '60 days' condition would be replaced with '120 days'

A company is resident in India in a given year if,

a. It is incorporated in India, or
b. Its place of effective management (POEM) is in India in that year. POEM means place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made.

A tax resident in India is liable to pay tax in India on his global income. However, a non-resident is taxable in India only for income earned or generated in India and not income earned or generated outside India.

Q. When is a non-resident liable to pay tax in India?

A. A person is liable to pay tax on income accruing or arising in India or deemed to accrue or arise in India. The test for 'deemed to accrue or arise' in India is very wide. Accordingly, a non-resident would be liable to pay tax in India on any income that originates or has its source in India and is hence either accruing or arising in India or 'deemed to accrue or arise' in India.

Q. Typically for a non-resident, what are the categories under which income would be computed for the purposes of charge of tax?

A. Typically, income would be classified under following heads:

- Income from business or profession
- Salary
- Capital gains
- Income from house property (in case non-resident Indian owns any immovable property in India)
- Other income

Q. What are capital gains and how is it generally computed?

A. Capital gains arise on transfer of a 'capital asset'. The term 'capital asset' is defined and would include securities and immovable property amongst other things. 'Capital assets' are further classified as 'short term capital asset' or long term capital asset' depending upon the period of holding in hands of owner immediately before transfer of such capital asset by such owner. The consideration received upon such transfer less the cost of acquisition of such capital asset in hands of owner would be the capital gains in hands of owner/seller of such capital asset. Depending on whether the capital asset if short term or long term, the capital gains would also be classified as such. However, for long term capital assets, the cost of acquisition is generally indexed (based on a cost inflation index) while computing capital gains.

The Act also denotes certain 'transfers' as not leading to capital gains. For instance, transfers under tax neutral corporate restructuring exercises are not treated as 'transfers' leading to capital gains. Further, w.r.t capital gains generated in hands of owner/sellers, the Act also provides certain exemption/deduction mechanisms, subject to fulfilment of conditions, which would effectively minimize tax on capital gains.

The Act is wide and provides various scenarios for determining 'cost of acquisition' in hands of owner and 'period of holding' in hands of owner. The rate of tax on such capital gains would be different for different capital assets and different categories of owners/sellers. For instance, typically, short term capital gains are taxed higher than ling term capital gains, residents are subject to different rates from non-residents, etc.

Q. What is transfer pricing and when is it applicable?

A. Transfer pricing is a form of 'Base Erosion of Profits Test'. It is an anti-abuse provision and it implies rules and methods for pricing 'international transaction' between two or more 'associated enterprises', either or both of whom are non-residents. 'Associated enterprises' essentially mean enterprises under common control. Both 'associated enterprise' and 'international transaction' are widely defined.

Income arising from such transactions must be computed using the arm's length price principle i.e. the amount payable if the trading entities were unrelated or uncontrolled.

Presently, there are 5 (five) notified methods of determining arm's length price:

- Comparable Uncontrolled Price (CUP) Method;
- Resale Price Method (RPM);
- Cost Plus Method (CPM);
- Profit Split Method (PSM);
- Transactional Net Margin Method (TNMM);

Q. For a foreign parent and Indian subsidiary what would be the typical mode of repatriation of profits?

A. Typically, such repatriation from Indian subsidiary to foreign parent would assume following forms:

a. Dividend
b. Capital gains vide transfer of shares or buy-back mechanism
c. Bonus shares
d. Royalties

The tax implications for each are different.

Q. For an Indian subsidiary company, what is difference between normal corporate tax and minimum alternate tax (MAT)?

A. In India, corporate entities compute their taxable income under 'normal provisions' after availing applicable deductions, exemptions and incentives. Minimum Alternate Tax (MAT) is a separate chapter for computing taxable income of Indian corporates. The objective of MAT is to ensure that a corporate entity pays some minimum tax (i.e. at least 15%) on its 'book profits'. 'Book profits' are computed in a specific manner and are derived from net profits as per P&L. In case the tax computed under 'normal provisions' of Income-tax Act, 1961 is found to be lower than MAT (say, due to tax incentives or exemptions available under 'normal provisions'), the company would need to pay tax under MAT provisions. The difference between excess of such MAT over such 'normal tax' for that particular year would become available for carry forward and set off as MAT credit for next 15 years. In a later year, when the company pays 'normal tax' in subsequent year such MAT credit shall be available to be set off against such 'normal tax' in such subsequent year in prescribed manner.

Q. What is TDS?

A. TDS means Tax deducted at Source. It is the global equivalent of 'withholding' or withholding taxes'. TDS provisions are included as a separate chapter in Income-tax Act, 1961. TDS provisions operate on the concept that every person making specified type of payments to any person shall deduct tax at the rates prescribed in the Income-tax Act, 1961 at source and deposit the same into the government's account. Further, different TDS rates have been prescribed for different payments and different categories of recipients

Q. What are the income tax norms with regard to tax losses of an Indian subsidiary company, especially for carry forward for future set off and also lapse?

A. Under Income-tax Act, 1961, a corporate entity would have 'business loss' and 'unabsorbed depreciation'. Business losses are allowed to be carried forward for a period of 8 years for set off against business income in future. Unabsorbed depreciation may be carried forward for set off without any limitation. Further, carry forward of business losses by corporates would be impacted by change in majority beneficial shareholding of such company in any year.

Q. What are the typical schemes for restructuring that are recognized as tax neutral under Indian income tax law?
A. Amalgamations or mergers, demergers or hive-offs, Slump sale (business purchase agreements or business transfer agreements), cross-border mergers/amalgamations and conversion of status of entity are the chief modes of corporate restructuring in India that are also recognized under Income-tax Act, 1961. However, one would need to satisfy certain conditions under the Act to ensure tax neutrality accorded to such schemes of restructuring under the Act.

Q. What are tax treaties or Double taxation Avoidance Agreements (DTAAs) signed by Government of India?
A. A non-resident would be subject to tax under Income-tax Act, 1961 w.r.t income arising or accruing or deemed to accrue or arise in India. In case, the non-resident
a. is the beneficial owner of such income form India, and
b. is tax resident of a foreign country with which India has signed a DTAA (tax treaty), and
c. is eligible to claim benefits under the relevant provisions of such tax treaty, then

such non-resident shall be eligible to invoke relevant treaty provisions that provide him a beneficial treatment vis-à-vis tax treatment under Income-tax Act, 1961. Such benefit would typically be reduced tax impact or even shifting taxation incidence entirely from India to his country of residence. The application of tax treaty provisions vis-à-vis Income-tax Act, 1961 is a technical exercise and is also an interpretative issue that may be subject to litigation. Nevertheless, the underlying principle of tax treaties is that such non-resident should be eligible to claim the more beneficial treatment, either under Income-tax Act 1961 or the tax treaty.