dhruva

INVESTING IN INDIA

JANUARY 2025

TABLE OF CONTENTS

FROM OUR CEO

As we enter the year 2025, we see several challenges globally, we have a new administration in the USA, with potential levy of imposition of tariffs. Elsewhere, we are witnessing a big tussle between globalisation on the one hand and nationalism on the other. OECD is making frantic efforts to implement the two-pillar solution.

In a world with global uncertainties on account of war in the Europe and hostilities in the Arab world, India has emerged as a stable vibrant democracy, with a large captive consumption base and as a reliable supply chain which is an effective alternate to China.

We have a stable government with the third term of Prime Minister Narendra Modi. India has always been at the forefront in service sector. The government is now focusing on the manufacturing sector and a number of incentives have been rolled out as a part of Make in India program.

The government has chalked out an ambitious plan to make India a developed nation by 2047 when India celebrates 100 years of independence. The Viksit Bharat Program aims to promote high technology manufacture, help Global Capability Centres and at the same time promote entrepreneurship. As a result, over the last few years, India has seen amongst the highest foreign direct investment inflows and is among the fastest growing large economies in the world.

It may not be an exaggeration to say that every large global organisation would need to have India as a part of its global strategy.

With that background, we at Dhruva Advisors LLP are delighted to present our India Invest publication. This publication seeks to set out the tax and regulatory framework for those wanting to Invest in India.

We hope you will find the publication useful and would be delighted to have your inputs/suggestions.

Warm Regards
Dinesh Kanabar
CEO

Introduction

India's dynamic and multifaceted economy continues to attract global investors seeking growth and diversification opportunities. With its robust democratic framework, strategic geographic positioning, young population, and evolving market trends, India offers a unique landscape for inbound investments. However, the intricacies of structuring investments, navigating regulatory challenges, and optimising financial strategies necessitate a nuanced understanding of the Indian business and tax environment.

This publication delves into critical aspects of inbound investment, addressing both strategic and operational considerations:

Corporate Structures: Choosing the right entity—be it a branch, LLP, or company—is critical for optimising operational efficiency and compliance.

Funding Strategies: Striking the right balance between owned and borrowed capital while adhering to thin capitalisation rules can significantly rationalize tax liability.

Foreign Direct Investment (FDI): Navigating regulations and downstream investment rules, deferred consideration mechanisms, and sector-specific restrictions ensures smooth execution and long-term viability.

Internalization: Evaluating the strategic and tax implications of reversing overseas headquarters to align with India's booming economy and market opportunities.

Digital Taxation: Providing insights into Equalization Levy and Significant Economic Presence (SEP), pivotal in addressing digital economy taxation.

Permanent Establishment (PE): Challenges in attributing income to Agency PE, Fixed Place PE, and Service PE, with a specific focus on prevalent issues such as Engineering, Procurement Construction (EPC), global employee secondments, cross-border leasing, contract manufacturing, trading/marketing supply chains, etc.

Cross-Border Transactions: Navigating payments to non-residents for software, royalties, management fees, and other services, interest and dividend, alongside the interplay with source and residence state tax treaties.

BEPS and Multilateral Instruments: Understanding India's position on Base Erosion and Profit Shifting (BEPS), Most Favoured Nation (MFN) clauses, and Multilateral Instruments (MLI).

Treaty Benefits amidst Anti-Abuse Rules: Analysing the impact of treaty provisions under grandfathering clauses, General Anti-Avoidance Rules (GAAR), and the Principal Purpose Test (PPT), with specific attention to key jurisdictions like Mauritius and Singapore.

Employee Taxation: Managing taxation issues arising from employee deputations, Employee Stock Option Plans (ESOPs), and other cross-border arrangements.

Litigation Trends: Exploring the faceless tax regime and alternative dispute resolution mechanisms.

Information Exchange: The impact of more robust information-sharing protocols, both domestically between different tax departments and across-borders between jurisdictions and their legal enforcement agencies.

Distribution and Business Models: Addressing the nuances of limited-risk distributors, marketing intangibles, etc. The discussion further explores the Profit Split Method and the localisation of integrated principal structures through innovative approaches.

Intra-Group Services: Providing clarity on the valuation and documentation of intangible intra-group services, which often present challenges due to their inherent intangibility.

Group Captive Centres (GCCs): Evaluating the operational and financial trajectory of GCCs in India, with a focus on distinguishing routine activities from non-routine ones to ensure compliance with tax laws and transfer pricing norms.

Dispute Resolution: Offering insights into resolving past tax disputes through Mutual Agreement Procedures (MAPs) and leveraging Advance Pricing Agreements (APAs), Safe Harbours, and secondary adjustments to pre-empt potential or resolve existing tax conflicts.

Exit and Liquidation Options: Examining structured pathways such as sale, merger, liquidation, and strike-off while addressing the tax and regulatory nuances of each approach.

Indirect Share Transfers: Addressing the taxation complexities surrounding underlying asset transfer through direct and indirect shareholding structures.

Repatriation of Funds: Unpacking tax implications and procedural considerations for repatriating profits through dividends, buybacks, and other mechanisms.

Structuring Investment Success: Examining the role of innovative fund frameworks, including AIFs and securitisation models, in diversifying investment portfolios and optimizing returns, and providing insights into the growing adoption of REITs and InvITS as vehicles for pooling and monetising assets in real estate and infrastructure sectors.

Unlocking GIFT City's Potential: Exploring the financing and investment prospects that make GIFT City an attractive destination for businesses seeking tax efficiency, access to global markets, and state-of-the-art infrastructure.

Export-Oriented Units (EOUs) and Schemes Comparison: A comparative perspective on MOOWR (Manufacture and Other Operations in Warehouse Regulations), Special Economic Zones (SEZs), and EOUs to identify the best framework for export-driven businesses.

Production Linked Incentive (PLI) and Central Government Schemes: An overview of PLI and other central schemes to bolster domestic manufacturing, encourage innovation, and reduce dependency on imports across various sectors.

Foreign Trade Policy 2023: Insights into the policy's roadmap for bolstering India's economy, including schemes designed to incentivise exporters and enhance India's global trade position.

State Industrial Policies: An analysis of state-level initiatives, providing a "red-carpet" approach to industrial growth, with key examples highlighting unique policy advantages and sector-specific incentives.

Setting Up Manufacturing and Service Units: Key considerations such as classification of goods/services, rate validation, and structure optimisation must be considered to ensure compliance and tax efficiency while establishing manufacturing and service units.

At **Dhruva Advisors LLP,** we are committed to empowering stakeholders by providing clarity and practical guidance on navigating these changes. This publication is a testament to our dedication to enabling businesses to make investments in India & thrive in an increasingly interconnected and regulated world to leverage India's technological advancements, deep manufacturing capabilities, and skill-based synergies for cost optimisation in their businesses and supply chains.

We trust that this publication will serve as a valuable tool in understanding and addressing the challenges and opportunities presented by India's tax & regulatory environment.

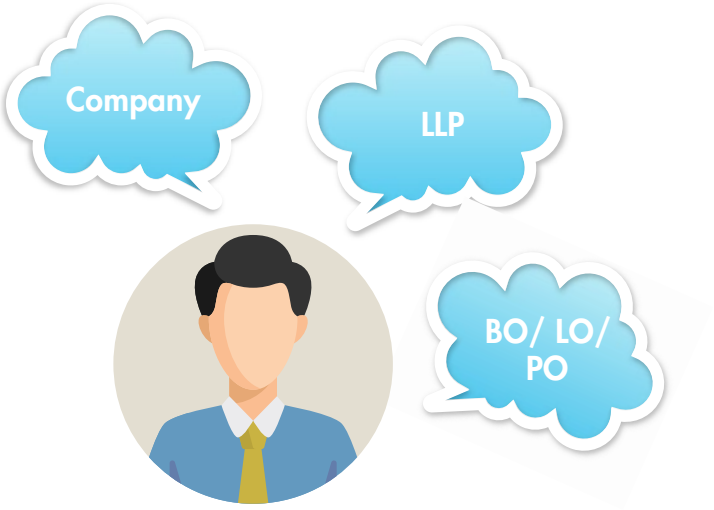
We welcome your feedback and look forward to fostering meaningful discussions in this dynamic domain.

A. Inbound Investment

1. Corporate Conundrum: Navigating the Entity Landscape for Optimal Investment Structures[1]

One of the critical aspects of investment in India is choosing the right investment vehicle – a branch office (BO)/ liaison office (LO)/ project office (PO), or a company or a limited liability partnership (LLP) – each vehicle will determine how the funds are infused and the options for repatriation of profits/ capital back to the investor. A BO is generally engaged in the same business activity undertaken by the parent. Permissible activities include exporting/importing goods/ services, R&D, rendering technical support, etc. A LO, on the other hand, represents the parent in India, promotes imports / exports, promotes technical/ financial collaboration, etc. A PO is a project-specific office in India. Concerning corporate vehicles, a company can engage in the activities as provided in its memorandum duly approved by the Registrar of Companies (RoC). On the other hand, an LLP is a vehicle regulated by the RoC in which the partners pool in their contribution and undertake business activities as defined in the LLP deed.

While the umbrella consideration in all forms will be the Reserve Bank of India (RBI) regulations specific to each investment vehicle, care needs to be taken for the applicability of other laws such as corporate laws, LLP act, stamp duty, taxes, and reporting/ compliance requirements.



Key considerations

	Company	LLP	BO	LO	PO
Financial criteria for the investor/ investment vehicle	No minimum share capital is required	No minimal contribution is required	Profit-making track record for immediately preceding 5 years in the home country + net worth of at least USD 100,000	Profit-making track record for immediately preceding 3 years in the home country + net worth of at least USD 50,000	General permission without any financial criteria

1. This article is contributed by Vaibhav Gupta (Partner, Dhruva Advisors) and Pooja Agarwala (Principal, Dhruva Advisors)

	Company	LLP	BO	LO	PO
Approvals	RoC approvals are required. Department for Promotion of Industry and Internal Trade (DPIIT) approvals are necessary for specific identified sectors	RoC approvals are required. Foreign Investment in LLP is not allowed if an LLP is engaged in sectors where DPIIT approval is required.	RBI Approval required	RBI Approval required	RBI Approval required
Permitted activities	As per the memorandum of objects filed with the RoC	As per the LLP deed filed with the RoC	Refer Note 1	Refer Note 2	Projects that have secured necessary regulatory approvals and are generally funded from overseas
Time limit for existence	Perpetuity till it decides to wind up	Perpetuity till it decides to dissolve	Usually not meant to be perpetual and may be used for a period of up to 3 years		Till the completion of the project
External borrowings	Allowed subject to RBI regulations		Not allowed		
Domestic borrowings	Allowed, but domestic borrowings cannot be used to acquire shares of Indian companies.		AD Bankers may extend fund-based/ non-fund-based facilities	Not allowed	AD Bankers may extend fund-based/ non-fund-based facilities
Corporate taxes	22%	30%	35%	35%	35%

	Company	LLP	BO	LO	PO
Repatriation of profits/ surplus funds	Dividends can be paid out of tax-paid profits – taxable @20% subject to a DTAA.	Profits from the LLP can be paid to the partners out of tax-paid profits – this is exempt from taxes in India.	Surplus funds (net of taxes) can be remitted outside India	Not allowed before closure	Surplus funds (net of taxes) can be remitted outside India subject to the satisfaction of the AD Banker.

Selecting the appropriate investment vehicle in India—whether a BO, LO, PO, company, or LLP—is a nuanced decision influenced by regulatory approvals, tax obligations, borrowing capabilities, and repatriation norms. Each structure offers distinct advantages tailored to specific operational needs. With a thorough evaluation of the legal, tax, and compliance landscapes, foreign investors can make informed decisions that align with their business objectives and ensure seamless operations in India.

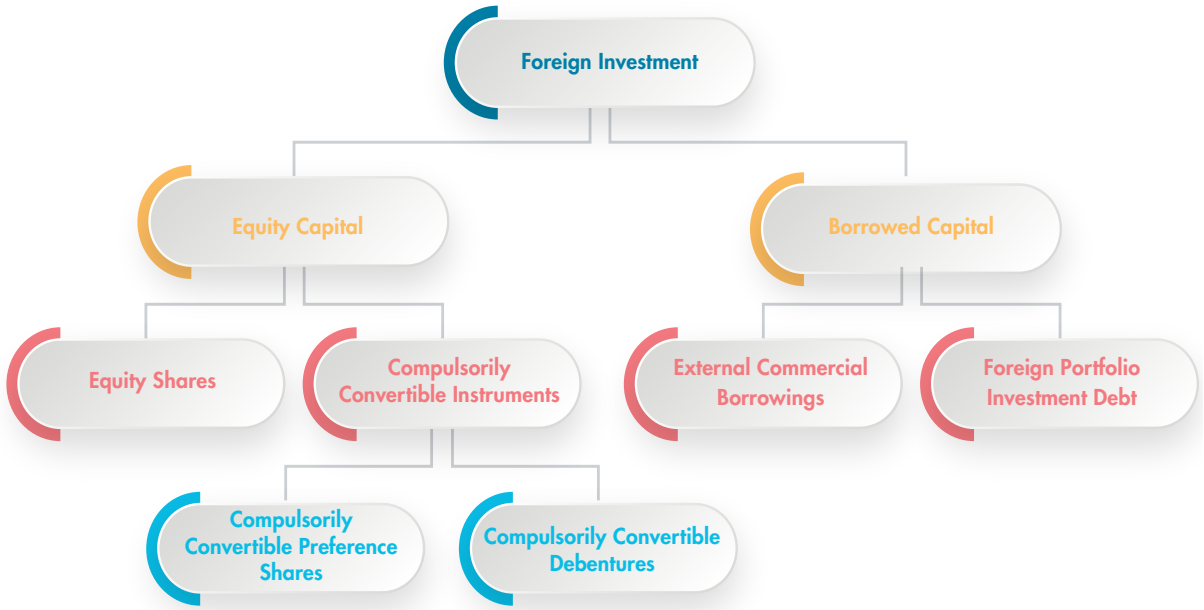
Note 1 - Normally, the branch office should be engaged in the activity in which the parent company is engaged. i) Export/import of goods ii) Rendering professional or consultancy services (other than the practice of the legal profession in any matter) iii) Carrying out research work in which the parent company is engaged iv) Promoting technical or financial collaborations between Indian companies and parent or overseas group company v) Representing the parent company in India and acting as buying/ selling agent in India vi) Rendering services in Information Technology and development of software in India vi). Rendering technical support to the products supplied by parent/group companies viii) Representing a foreign airline/shipping company.

Note 2 - i. Representing the parent company/group companies in India ii. Promoting export/import from / to India iii. Promoting technical/ financial collaborations between parent/group companies and companies in India iv. Acting as a communication channel between the parent company and Indian companies.

2. Balancing owned and borrowed capital in investment strategies[2]

India is one of the fastest-growing economies globally, and given its growth prospects, it has emerged as a preferred investment destination for foreign investors. Given that India has become a hub for foreign investments and will continue to attract foreign investments, we have broadly discussed the investment options that foreign investors can explore along with key considerations.

In India, businesses can raise foreign capital through various modes, such as:



Key considerations

Equity Capital (Equity Shares and Compulsorily Convertible Instruments [CCI])

- **Sectoral cap:** Depending on the nature of operations of the Indian investee company, Foreign Investments (FI) are allowed under the automatic route and/ or approval route (i.e., post approval of Government), subject to sectoral caps. This has been discussed in detail in Chapter 3.
- **Residential status of investors:** Currently, there is a restriction on undertaking FI from entities that are located or where the beneficial owner of such investing company is situated in or is a citizen of a country that shares a land border with India – such investments can be undertaken only through approval route
- **Pricing guidelines:** FI should be undertaken at a fair value (FV) of the Indian investee company as certified by the valuer. Further, in the case of CCI, the conversion price cannot be less than the FV of equity shares as on the date of issuance of CCI

2. This article is contributed by Vaibhav Gupta (Partner, Dhruva Advisors) Samudra Acharyya (Associate Partner, Dhruva Advisors) and Jagrit Khanna (Principal, Dhruva Advisors)

- **Dividends** distributed by the Indian investee company will be taxed in the hands of the shareholders. The taxes will be withheld depending on the availability of DTAA and at applicable treaty rates

- **Gains** from the sale of shares/ securities are subject to short-term or long-term capital gains tax, depending on the holding period. The taxability and withholding liability will apply depending on the availability and language of the relevant DTAA.

- **Interest on Compulsorily Convertible Debentures (CCDs):** The Indian investee company gets a deduction of the interest paid on the CCDs. However, such deduction is subject to thin capitalization norms, which limits the interest deduction in case of debt raised from associated enterprises to the extent of 30% of EBITDA in a financial year.

  Further, the Indian company paying interest to the foreign shareholders must comply with the withholding tax requirements, subject to the applicability of the relevant DTAA.

Borrowed capital

- **External Commercial Borrowings (ECB):** It involves the raising of commercial loans from non-resident lenders. The ECB norms discuss key aspects like eligible borrowers, recognised lenders, maximum cost of borrowing, end-use restrictions, minimum maturity requirements, etc. Under ECB regulations, funds can also be raised by issuing Non-Convertible Debentures (NCDs) (non-Foreign Portfolio Investment [FPI]). Further, they are interest-bearing with a fixed maturity date.

- **FPI Debt under Regular Route:** It allows Foreign Portfolio Investors (FPIs) to invest in corporate bonds within the limits prescribed by the Reserve Bank of India (RBI). There are no specific requirements for a committed portfolio size. However, there are concentration limits or minimum maturity periods that restrict the maximum exposure to any single issuer or group of issuers, ensuring diversification within the portfolio.

- **FPI Debt under VRR Route:** The Voluntary Retention Route (VRR) offers FPIs more flexibility in terms of investment limits and regulatory requirements. FPIs must commit to maintaining a "committed portfolio size" for a minimum retention period of 3 years. The aspects around minimum maturity period or concentration limits are not applicable in the case of VRR. This encourages long-term investment while offering greater regulatory flexibility.

- **Tax:** An Indian company paying interest on borrowed capital gets a tax deduction of the same, subject to the thin capitalization norms. Further, Indian companies paying interest to foreign shareholders must comply with the withholding tax requirements, subject to the applicability of the relevant DTAA.

We have provided below a brief comparison concerning various modes of capital:

Parameters	Equity / CCI	ECB	FPI Debt
Nature of Investors	Non-resident including FPI	Recognised non-resident lenders	FPI
Nature of capital	Non-repayable	Repayable	Repayable
Divident / Interest	Dividend (Interest in case of CCDs)	Interest	Interest
Restriction on interest payout	No (in case of CCDs)	Yes	No
Tax deduction for payer	Yes, on CCDs	Yes	Yes
Tax withholding on dividend / interest	Yes	Yes	Yes
Minimum average maturity period	No	Yes	Yes under Regular Route

Leveraged Inbound Acquisition

For an inbound acquisition where the acquisition is through an offshore acquirer, the lending market essentially comprises international banks, capital markets, financial institutions and offshore debt funds. However, there could be certain restrictions under the Indian exchange control provisions for such financing on account of the pledge of shares of the Indian entity etc.

In such a scenario, one can evaluate the acquisition of the Indian target entity through a foreign-owned and controlled operating company (FOCC) incorporated in India (which is a subsidiary of an offshore entity).

FOCC can raise ECB, but these cannot be used for equity investments in India. For an acquisition by an FOCC, finance cannot be provided by Indian financial institutions since the FOCCs are not permitted to leverage in the Indian market for the acquisition of shares (downstream investment).

However, for leveraged acquisition through an FOCC, one can explore raising debt by FOCC by issuing listed NCDs, which are subscribed by FPIs. Hence, leverage buyout in India by foreign investors needs to navigate through a complex web of prohibitive regulations.

Given that each instrument / option has its own set of regulatory requirements and tax implications, it becomes imperative to navigate and choose the right strategy based on the specific needs and goals of the business. Considering the above, businesses/ investors can effectively raise capital while complying with the applicable laws.

3. Unveiling the Nuances of Foreign Direct Investment[3]

Foreign Direct Investment (FDI) has been a significant driver of economic growth in India. It offers a substantial opportunity for foreign companies to establish or expand their operations within the country and for Indian businesses to raise growth capital. India has continuously evolved its FDI policies to create a conducive investment environment, balancing economic development with national security considerations. Given India's tight exchange control laws, we have encapsulated the key aspects of foreign direct investment laws that foreign investors should be aware of while making investment decisions in India.

Key considerations

Regulatory Framework and Routes of FDI

India allows FDI through two main routes:

- **Automatic Route:** Under this route, foreign entities do not require prior approval from the Government of India or the Reserve Bank of India (RBI) to invest in Indian companies. Most sectors have now been opened to 100% FDI under the automatic route, simplifying the investment process. Critical sectors covered under this route include manufacturing, e-commerce (under the marketplace model), construction-development (excluding real estate business), and pharmaceuticals (greenfield). However, there are specific sectors, such as insurance, pension, stock exchanges, clearing corporations, commodities, and power exchanges, where 100% FDI is not permitted. Further, FDI under the automatic route is allowed in a Limited Liability Partnership (LLP) provided it operates in sectors or activities where foreign investment up to 100% is permitted under the automatic route and there are no FDI-linked performance conditions.
- **Government Route:** In specific sectors, foreign investments are subject to prior approval from the Government of India. These sectors include defence, broadcasting, print media, digital media, space, multi-brand retail trading, and certain areas of the financial services sector. Investments under this route are scrutinised for compliance with national security and strategic interests.

Sector-Specific FDI Policies

Certain sectors in India have specific conditions attached to FDI, either in percentage caps or operational conditions. Some of these sectors are provided below:

- **Single Brand Retail Trading (SBRT):** FDI up to 100% is permitted under the automatic route for SBRT, subject to mandatory sourcing of 30% of the value of goods purchased from India for companies with FDI exceeding 51%.
- **Multi-Brand Retail Trading (MBRT):** FDI in MBRT is permitted up to 51% with government approval. Conditions include a minimum investment of USD 100 million, at least 50% of which must be invested in backend infrastructure within three years. At least 30% of the value of manufactured or processed goods procured should be sourced from micro, small, and medium Indian enterprises, and the retail stores should only be located in cities with a population of more than 1 million.
- **Defence Sector:** FDI up to 74% is allowed under the automatic route, while beyond that, up to 100% is permitted with government approval in cases where it is expected to result in access to modern technology. Investments in this sector are subject to security clearance and guidelines issued by the Ministry of Defence.

3. This article is contributed by Vaibhav Gupta (Partner, Dhruva Advisors)

- **Space sector:** FDI was recently liberalised in April 2024. The sector cap allows 100% FDI, but government approval is mandated in specific sub-categories beyond a threshold. Government approval is required to manufacture satellites if foreign investments exceed 74%. In contrast, approval is required in case of investments beyond 49% for launch vehicles and the creation of spaceports.

Pricing Guidelines

The pricing of shares in FDI transactions is subject to regulatory guidelines to ensure fair valuation and protect stakeholders' interests.

- **Issue of shares to non-residents or transfer of shares by residents** to non-residents cannot be done at less than the fair market value of the shares, determined based on valuation conducted per internationally accepted pricing methodologies.

- **Transfer of shares by non-residents to residents:** At the time of exit, when foreign investors sell their shares in Indian companies to Indian residents, such transfer cannot be done at a price exceeding the fair market value of such shares.

Downstream Investments by Foreign-Owned or Controlled Companies

A foreign-owned or controlled company (FOCC) is an Indian company in which more than 50% of the ownership is with a resident outside India or which is controlled by a resident outside India. Control covers not only the right to appoint majority directors on the board of the Indian company but also the right to control management or policy decisions in the company. An FOCC is allowed to make downstream investments in other Indian companies, subject to certain conditions:

- **Sectoral Cap Compliance:** The Indian company receiving downstream investment must comply with the sectoral caps on FDI and adhere to any applicable conditionalities.

- **Source of funds:** An FOCC can make downstream investments through internal accruals or out of funds brought from outside India. It is not allowed to borrow funds in domestic Indian markets to make downstream investments.

- **Reporting Obligations:** The Indian company making the downstream investment must comply with reporting requirements, including filing Form DI with the RBI within 30 days of the investment.

Deferred Consideration in FDI Transactions

In FDI transactions involving the transfer of shares, parties may agree to defer a portion of the consideration for a later date, allowing flexibility in payment terms. This is known as deferred consideration. The critical regulatory provisions related to deferred consideration are:

- **Time limit:** The deferred amount can be settled within 18 months from the date of the agreement.

- **Amount:** Up to 25% of the total consideration can be deferred for a maximum period of 18 months.

- **Escrow:** The deferred consideration may be held in an escrow account under the regulatory supervision of authorised dealers in India.

Interestingly, deferred consideration transactions are prohibited for an FOCC making downstream investments in an Indian company.

Swap of securities

Issue of securities by an Indian company to a non-resident is permitted against the swap of equity capital of a foreign company. Similarly, the transfer of securities of an Indian company between a resident and a non-resident is also permitted through a swap of equity capital of a foreign company.

Press Note 3 (2020) – Investments from Neighbouring Countries

Press Note 3, introduced in April 2020, governs investments from countries that share land borders with India. This note is particularly significant as it addresses concerns related to national security and the ownership of critical assets:

- **Government Approval Mandatory:** All investments from entities based in neighbouring countries or where the beneficial owner of investment into India is situated in or is a citizen of any such country require prior government approval.
- **Applicability:** This restriction applies to direct and indirect investments, making it comprehensive.
- **Objective:** The primary objective of Press Note 3 is to curb opportunistic takeovers/acquisitions of Indian companies during periods of market volatility, ensuring that such investments do not compromise India's strategic interests.

Filing and Compliance Requirements

Compliance and timely filings can be supported since non-compliance has penal consequences. Compliance with the RBI needs to be made through the authorised dealers.

- **Form FC-GPR:** This form must be filed with the RBI within 30 days of issuing shares to foreign investors. It captures details of the capital inflows and the company's shareholding pattern. Further, if the form FC-GPR is not filed and acknowledged by the RBI, the non-resident's subsequent transfer of shares is not permissible.
- **Form FC-TRS:** This form reports the transfer of shares from a resident to a non-resident and vice versa. The form FC-TRS needs to be filed within 60 days of the transfer of shares or remittance of funds, whichever is earlier.
- **Foreign Inward Remittance Certificate (FIRC):** This certificate is issued by banks to confirm the receipt of funds from abroad. It is necessary for compliance with RBI regulations and for filing Form FC-GPR.

For foreign companies looking to invest in India, it is crucial to consider the following:

- **Sectoral Caps and Conditions:** Understanding the specific conditions for FDI in the targeted sector is essential to ensure compliance with Indian regulations.
- **Due Diligence:** Conduct thorough due diligence, particularly regarding the ownership structure and compliance history of Indian entities.
- **Regulatory Filings:** Timely and accurate filing of forms and adherence to pricing guidelines are critical to avoid penalties and ensure smooth operations.

India's FDI landscape offers significant opportunities for foreign investors, supported by a robust regulatory framework to protect investors and the nation's economic interests. Indian FDI policies are dynamic and subject to change. Staying updated on policy changes, such as those introduced through press notes or amendments, is vital for maintaining compliance.

4. Inside Out: Evaluating Internalization (Reverse flipping)[4]

Internalisation, commonly called "reverse flipping," involves a strategic change in a shareholding structure wherein the entity's value is moved back to India. Under internalisation, Indian operating companies, which a foreign holding company earlier owned, are now directly owned by the Indian shareholders. In this process, shares held by the non-resident and resident shareholders at the foreign holding company level are swapped for shares in the Indian operating company. Further, reverse flipping can also be done through corporate restructuring, such as a merger or demerger of the foreign entity into the Indian operating company.

Why is reverse flipping gaining relevance?

The trend of reverse flipping in India is driven by several factors, including favourable valuations for exit opportunities through IPOs, evolving consumer and investor attitudes towards Indian companies, cost efficiency and much more. High-profile companies like PhonePe, Groww, Razorpay, and Zepto have undergone internalisation, and many multinational enterprises (MNEs) are considering similar moves.

Key drivers include regulatory and tax reforms, such as the introduction of GST, the Insolvency and Bankruptcy Code, reduced corporate tax rates and capital gains and abolishment of angel tax, which enhance the ease of doing business. Additionally, India's robust economic growth, large consumer market, improved digital infrastructure through initiatives like Digital India, and various government incentives such as subsidies, tax holidays, and startup support make India an attractive destination for reverse flipping.

While there are many advantages of reverse flipping, there are tax and regulatory aspects that must be considered before deciding to reverse flip the structure.

Key considerations

Taxation

- **Capital gains tax:** The tax implications would be driven by the method of reverse flipping, the residency status of shareholders and the foreign entity's jurisdiction.

  If implemented through an in-bound merger/ demerger, there may be no tax in India, subject to qualifying conditions. However, exit tax or capital gains tax implications could exist in the jurisdiction where the foreign holding company is domiciled (e.g., the USA). Regarding the tax implications in the hands of shareholders in their home jurisdiction, assessing whether the exemption is available for share transfer pursuant to corporate restructuring is essential. Further, certain countries do not allow outbound mergers/ demergers; other options must be considered in those cases.

  In case of a share swap, there may be capital gains tax in India for non-resident shareholders (under indirect transfer provisions), subject to benefits, if any, under a DTAA. Also, a share swap could be taxable in the home jurisdiction of non-resident shareholders and foreign companies. Due to potential taxes in multiple jurisdictions, it is essential to assess the possibility of claiming foreign tax credits.

4. This article is contributed by Mehul Bheda (Partner, Dhruva Advisors) Nitin Bohra (Associate Partner, Dhruva Advisors) Manjit Bhimajiani (Associate Partner, Dhruva Advisors) Drishti Kankariya (Principal, Dhruva Advisors) Ketan Sakhala (Manager, Dhruva Advisors) and Nehal Jain (Manager, Dhruva Advisors)

- **Tax losses of Indian company:** Since internalisation involves a change in immediate shareholding of the Indian entity, the brought forward tax losses could potentially lapse

- **Transfer Pricing:** Post internalisation of the foreign operating cum holding company, the intra-group transactions between the Indian company and other foreign group companies are likely to trigger the requirement of compliance with transfer pricing provisions. Going ahead, companies need to demonstrate that the terms of intra-group transactions are at arm's length and require meticulous documentation.

Regulatory

- **Foreign Exchange Management Act (FEMA):** Reserve Bank of India (RBI) approval is required if the value of the share swap exceeds certain thresholds (currently USD 1 Billion). However, merger/ demerger does not require such approval if conditions under Cross Border Merger Regulations are complied with.

  However, government approval under Press Note 3 would be required where immediate/ ultimate foreign investors belong to countries that share land borders with India, which could lead to uncertainties.

- **Approval of sectoral regulator:** Businesses regulated by sectoral authorities (e.g., RBI, Insurance Regulatory and Development Authority of India (IRDAI), Real Estate Regulatory Authority (RERA) must secure their approval for restructuring exercises or if there is a change in shareholding.

- **Approval of NCLT:** Approval of NCLT / fast track merger: Any corporate actions, such as mergers or demergers in India, require approval from the National Company Law Tribunal (NCLT), which can be cumbersome and time-consuming. In 2024, the Indian Government paved the way by which foreign holding companies are allowed to merge with their Indian wholly owned subsidiaries through a fast-track merger route. However, the transferor and the transferee entities are still required to obtain the RBI approval. This will facilitate completion of reverse flipping in a time-bound and efficient manner.

- **Employee Stock Option Plans (ESOPs):** After reverse flipping, the Indian entity may need to issue its ESOPs to the continuing employees in lieu of ESOPs issued by the holding company. The issue of ESOPs to non-resident employees should comply with FEMA. Further, the minimum one-year vesting period under Indian company law starts from the date of grant by the Indian entity, excluding the period for which options were held in the foreign entity.

While the reverse flipping process involves navigating complex tax and regulatory landscapes, the potential benefits, including access to capital markets and improved valuations, make it an attractive strategic option. Companies and all the stakeholders must carefully assess these factors and engage with experts to ensure a smooth transition and maximise the benefits of internalisation.

5. Understanding the impact of taxes on share issue and transfers[5]

India's regulatory landscape for taxation poses unique challenges and considerations for non-residents looking to invest in the country's dynamic economy. Certain taxes have been designed to regulate investments and wealth transfers, which can significantly impact foreign investors' financial outcomes and decision-making processes. Understanding their implications is crucial for non-residents navigating India's investment environment.

The Finance Act of 2012 introduced angel tax, governed by section 56(2)(viib) of the Income-tax Act, 1961 (the Act), which imposed taxes on investments received by closely held Indian companies that exceed the fair market value (FMV) of their shares (the trigger of tax was on share issuing companies receiving subscription monies). This provision was introduced with the aim of preventing money laundering through inflated share premiums. The scope of this section was earlier restricted to shares issued to residents, which was subsequently extended to non-residents vide Finance Act, 2023. However, the Finance (No. 2) Act 2024 abolished this tax on companies from the financial year (FY) 24-25 onwards. This change means that any premium received with effect from 01 April 2024, by companies that exceed the FMV of its shares will, in the future, **not** be taxable in the hands of the recipient company.

However, suppose the shares of a company (listed or unlisted) are issued or transferred at a discount to the FMV. In that case, the difference between the FMV and the consideration is taxed in the hands of the recipient as Gift tax. The Gift Tax in India, governed by section 56(2)(x) of the Act, applies to recipients of gifts (whether cash or specified properties) exceeding INR 50,000 in a financial year. Properties covered under the Gift tax regime *inter-alia* include shares, securities and immovable properties. Gifts received from relatives or through inheritance are a few exclusions from the purview of Gift Tax.

The FMV of equity shares for Gift tax must be computed based on the intrinsic value method, adjusted for stamp duty value or intrinsic value or market value for certain classes of assets, such as immovable properties, jewellery, shares and securities.

It is pertinent to note that there is no exclusion for the applicability of Gift Tax to non-residents. Accordingly, any receipt of properties, including shares or securities of Indian companies, by a non-resident below the FMV will be subject to the rigours of Gift Tax, and subject to any treaty benefits.

Non-resident investors must also comply with pricing norms under the Indian exchange control regulations. Shares cannot be issued to non-resident investors below the FMV, which must be determined per internationally accepted pricing methodologies. Hence, for non-residents, the transaction must occur at such minimum value if the FMV is higher per exchange control laws.

This interplay between tax and exchange control laws on the issue and transfer of shares requires careful analysis to avoid any non-compliance or tax impacts. This can also lead to companies obtaining multiple valuation reports from independent valuers for a single transaction to satisfy both sets of regulations, thus increasing compliance costs and complexity.

It is interesting to note that under domestic law, when any amount is received /credited by a company, consisting of share application money, share capital, share premium, or any such amount for which the company does not explain the

5. This article is contributed by Mehul Bheda (Partner, Dhruva Advisors) Nitin Bohra (Associate Partner, Dhruva Advisors) Manjit Bhimajiani (Associate Partner, Dhruva Advisors) Drishti Kankariya (Principal, Dhruva Advisors) Ketan Sakhala (Manager, Dhruva Advisors) and Nehal Jain (Manager, Dhruva Advisors)

nature and source or the explanation provided to the tax officer is not satisfactory, the amount so credited is taxed in the hands of the company as unexplained credits. Such amount is taxed at 60% plus a surcharge of 25% and applicable cess of 4%, aggregating the total tax liability to 78%. Hence, it is imperative that on the issue of shares, sufficient documents are maintained by the company on the identity and creditworthiness of the investors and the genuineness of the transaction to mitigate any taxes on unexplained credits.

Understanding tax on share issues and transfers is crucial for non-resident investors looking for investment opportunities in India's evolving economy.

B. Operations

1. Taxing the Digital Realm: Exploring Equalization Levy and SEP[6]

The evolution of new business models in the digital economy results in tax challenges in determining nexus, characterisation of income, etc. Organisation for Economic Cooperation & Development (OECD) identified two options –

- Nexus based on economic presence
- Digital Service Tax (DST)

To tax the "digitalised" economy, businesses beyond pure e-commerce retailers/ marketplace and brick-and-mortar businesses that depend upon digital interfaces are brought into the tax area to operate and garner customers/ clients.

Contours of the unilateral levies introduced by India

Significant Economic Presence (SEP)

SEP is constituted when:

- Transaction in respect of goods and services and property carried out by a non-resident with any person in India, including provisions of download of data or software in India;
- Systematic and continuous soliciting of business activities or engaging in interaction with such number of users in India, irrespective of the place of agreement, whether services are rendered in India or otherwise, and even if the non-resident does not have a place of business in India.

Criteria	SEP Thresholds
Revenue from Indian transactions	INR 2 crore (approx. USD 235,000)
Number of users	300,000 users

SEP will not apply in case of *treaty override* [India has tax treaties with most countries] due to the absence of "permanent establishment" (PE) in India.

Equalization Levy [EL]

Type of Service	Rate	Threshold
Specified Services which cover online advertisement, any provision for digital advertising space or any other facility or service for online advertisement under business-to-business (B2B) transactions	6%*	INR 100,000 (approx. USD 1,175)
E-commerce Supply or Services (withdrawn by domestic amendment to the tax law for e-commerce supply or services with effect from August 1 2024)	2%*	INR 20 million (approx. USD 270,000)

*EL in Indian law is not akin to income tax, and obtaining tax credit in a resident country can be challenging.

6. This article is contributed by Amit Aggarwal (Associate Partner, Dhruva Advisors)

Until 31 July 2024, EL was applicable to non-resident e-commerce operators (ECO) who owned, operated or managed digital or electronic facilities or platforms. The rate of EL was 2% on consideration received from e-commerce supply or services made or provided or facilitated by it–

i. to a person resident in India;
i. to a non-resident from– (a) the sale of an advertisement, which targets a customer who is resident in India; or (b) the sale of data collected from a person who is resident in India;
i. to a person who buys goods or services, or both, using an IP address located in India.

EL covered

- Online supply of goods owned by ECO or facilitated by it
- Online services provided by ECO or facilitated by it.

The terms "online sale of goods" and "online provision of services" covered any of the following activities, if undertaken online:

- Acceptance of an offer for sale
- Placing a purchase order
- Acceptance of a purchase order
- Payment of the consideration
- Supply of goods or provision of services, partly or wholly

Thus, it is used to cover online retailers, car aggregators, hotel aggregators, food delivery platforms, various online bookings, etc.

EL applicability was not free from doubt when the digital medium is neither owned nor managed by the multinational enterprises (MNEs) but by third parties.

The withdrawal of EL on the above transactions brings certainty.

If a transaction is characterised as 'royalty' of 'FTS' under the tax law (which is taxable on a gross basis, i.e., without deduction of expenses), then EL did not apply.

Digitalised businesses will need to factor in tax costs arising from operation 'with' [and not necessarily 'in'] source countries like India.

MNEs should undertake a tax evaluation to support a NIL tax position in applicable cases [e.g., Non-taxability under DTAA if not covered by royalty article and/ or FTS article and EL also not applicable as the scope is curtailed]. Evaluating tax return filing requirements and appropriate disclosures for SEP is also required.

With Base Erosion and Profit Shifting (BEPS 2.0) on the anvil, the scope of a unilateral levy like EL fades. Given that Pillar One of the OECD Inclusive Framework's proposed two-pillar solution requires the waiver of DSTs as a precondition, adopting the Pillar One proposal by India could lead to the removal of EL. Further, a SEP withdrawal is not uncertain, given the treaty override of SEP and a measure covered under the existing bilateral tax framework. Developing countries like India will focus on additional tax revenue supplements (like Pillar I and Pillar II taxes in BEPS) to shape the taxation of the digitalised economy in India.

2. Navigating Permanent Establishment (PE) Taxation in India: Insights from Recent Tax Treaty Framework and Judicial Precedents[7]

As India's economy expands and business adopt newer technologies, the complexities around permanent establishment (PE) taxation are evolving significantly. Foreign companies increasingly engage in various operations in India, from marketing and supply chain management to contract manufacturing and warehousing. Consequently, the PE landscape has become more intricate, compelling companies to stay informed on both tax treaties and judicial rulings. This article delves into recent developments in India's PE taxation, examining the interpretations of various PE types under India's tax treaty framework and drawing insights from landmark cases in recent years.

The PE concept is a foundational principle, serving as a threshold for foreign entities to be taxed in India on business profits derived from Indian sources.

In the *Formula One World Championship Ltd.*[8] case, the Supreme Court observed that although temporary, the exclusive and repetitive use of a racing track in India constituted a PE.

This year, in the *Progressive Rail* Case[9], the Tax Tribunal, Delhi, examined PE implications of infrastructure usage for foreign enterprises operating in India. The case involved a Canadian company that entered into agreements with an Indian entity to avail logistics and rail freight services focusing on using railway infrastructure. The ITAT concluded that the foreign entity constituted a PE in India despite having no physical premises or employees directly present in the country. The tribunal found that the Indian entity's infrastructure, including access to railway lines and facilities, effectively created a "fixed place PE" for the Canadian company, as these facilities were regularly available for the foreign enterprise's business activities.

In the above context, Indian courts and tribunals have delivered numerous judgments on PE, focusing on critical aspects like fixed place, dependent agency, construction PE, and service PEs under evolving business models.

Business models triggering PE and Key Judicial Interpretations

India's PE taxation is highly facts-driven, with each type of PE being subject to nuanced interpretations. Let us explore how various Rulings have shaped the treatment of various PE forms, especially in business contexts relevant to foreign companies operating in India.

Marketing, Supply Chain, and Agency PE

Marketing and supply chain activities, especially when combined with distribution functions, can trigger PE risks in India. Agency PE, as defined under most tax treaties, arises when an Indian entity habitually exercises authority to conclude contracts on behalf of a foreign enterprise or secures order for the principal or, in the case of certain tax treaties, maintains stock for delivery on behalf of the principal.

Marketing and supply chain activities, particularly where they involve contractual authority and deeper local engagement, have heightened the PE risks in India. Agency PE, as traditionally defined under most tax treaties, arises when an Indian entity habitually exercises authority to conclude contracts on behalf of a foreign enterprise.

7. This article is contributed by Abhishek Mundada (Partner, Dhruva Advisors) Amit Aggarwal (Associate Partner, Dhruva Advisors) and Pragati Arora (Principal, Dhruva Advisors)
8. Delhi [2017] 80 taxmann.com 373 (SC)/[2017] 247 Taxman 153 (SC)[07-03-2017]
9. [W.P.(C) No 12405/2019 to 12411/2019]

International tax updates in the last few years, like in OECD Commentary arising from Base Erosion & Profit Shifting (BEPS) as well as Indian domestic law changes, have clarified that even substantial / principle role/involvement in finalising/ concluding transactions and deep customer interface in the supply chain may constitute an agency PE.

The OECD's BEPS framework seems to have aligned with a certain aggressive position of Indian Tax Authority in interpreting even existing tax treaties. This view considers substantive roles like negotiation, contract formation, and substantial marketing activities leading to contract conclusion or securing / obtaining orders performed by local affiliates as triggering PE.

Indian courts may henceforth emphasise analysing the substance of these activities over their formal roles.

This broader interpretation implies that multinational corporations must carefully structure their Indian operations to manage agency and sales support function-related PE exposure, including a robust transfer pricing function for the marketing distribution channel.

Employee Secondment and Fixed Place / Service PE

Employee secondment arrangements are closely examined by Indian tax authorities to ascertain if a fixed place or service PE has been created. Indian cases have emphasised that the presence of expatriates in India, where they remain economically integrated with the Indian entity, may lead to a PE.

In judgments such as *Morgan Stanley & Co. Inc.*[10] and *Nortel Networks India International Inc.*[11], the courts have held that for seconded employees to establish a PE, they must work under the control and supervision of the Foreign entity rather than the Indian enterprise.

EPC Contracts and Project PE

Engineering, procurement, and construction (EPC) contracts often create PEs under the 'construction PE' or project PE clause in tax treaties. In India, a PE is deemed to exist if project activities exceed a threshold period specified in the applicable DTAA, typically six months. The Indian judiciary has upheld that the entire duration of EPC projects (including preparatory or auxiliary activities) should be considered when assessing the threshold.

In the *Samsung Heavy Industries*[12] *case,* the Supreme Court ruled that mobilisation work for an offshore project counted towards PE duration, affirming India's position that even preliminary activities contribute to project PE determination. EPC contractors must, therefore, carefully monitor project timelines and consider auxiliary activities' implications on PE risk.

Cross-border Leasing

Cross-border leasing of equipment, particularly in sectors like aviation and maritime, has been under scrutiny in India to determine if the leased asset creates a PE. Judicial precedents suggest that equipment leasing to form a PE must be actively used within Indian territory over a sustained period. A mere dry lease of equipment without control over the equipment by the lessor may trigger royalty taxation. On the other hand, a wet lease with manpower support to operate and maintain the equipment can result in allegations of fixed-place PE taxation if the business of the foreign lessor is conducted through such equipment for a prolonged period.

10. (2007) 292 ITR 416
11. [TS-355-ITAT-2014(DEL)]
12. (Civil Appeal No. 12183 of 2016)

Contract Manufacturing / Tolling

The PE risk in India differs based on who holds title to the raw materials and finished goods. Further, for contract manufacturing/tolling arrangements, Courts consider if the foreign enterprise has a fixed place or control over manufacturing processes.

In *contract manufacturing*[13], when the foreign principal can retain title over both raw material and finished good with supervision f factory, it often indicates tighter control over production and distribution, heightening the risk of a PE in India. Courts may see this control as an indication of a fixed place PE, if the foreign principal's involvement and authority over the goods or factory in India is significant. Further, in some tax treaties like with Switzerland, agency PE definition includes activity of manufacturing or processing goods for foreign principal in agency PE creating activities for a dependent agent [e.g.: who manufactures goods only for principal and does not act in ordinary course of business]. PE risk mitigation measures need to be adopted accordingly by modification of the supply chain structure .

In contrast, in a *tolling arrangement*[14] where the local manufacturer holds title to the inventory, the foreign principal's control may be substantially reduced. Even otherwise, it is arguable that there are no men, materials, or equipment for foreign enterprise in India, and hence, there is no PE.

Warehousing in India

Warehousing facilities pose a unique PE challenge, particularly when goods are stored in India for distribution. Further, while certain tax treaties may specifically include 'warehouse' as deemed PE, only certain tax treaties provide for a so-called 'delivery exception' to PE and consider mere delivery from the warehouse as an auxiliary activity.

Certain jurisprudence[15] in India has held that storing goods in India for rapid dispatch (i.e., a pull request from customer for taking delivery from warehouse] created a significant presence, constituting a PE. This indicates that the functional use of warehousing plays a crucial role in PE assessments, underscoring the need for careful operational planning. Foreign companies can still apply their own fact pattern to distinguish such rulings where no control is provided over the warehouse or have other logistic arrangements including having the India affiliate engaging the logistic service provider for delivery to customers in India.

Global Sourcing and Liaison / Representative Offices

Foreign companies often set up liaison or representative offices in India to source or facilitate trade. Typically, these offices do not constitute a PE if they only perform preparatory or auxiliary activities. However, tax authorities may contend with PE status if liaison offices engage in substantive business activities.

In the UAE Exchange Centre Ltd.[16] case, the Supreme Court emphasised that liaison offices solely conducting communication and coordination functions are not considered PEs. Businesses must ensure that liaison offices limit their scope to avoid inadvertently creating a PE.

13. In contract manufacturing, a company employs another company's production facilities from procurement to manufacture of final goods
14. Toll manufacturing occurs when the parent firm supplies the manufacturer with raw materials and design while maintaining some control over the production process
15. M/s Seagate Singapore International Headquarters Pvt. Ltd. (AAR)
16. (Civil Appeal No. 9775 of 2011)

Strategies for Managing PE Risks in India

For multinational corporations, understanding and managing PE risk in India is critical. Effective PE risk management strategies include:

- **Limiting Local Activities:** Companies should ensure that Indian operations remain strictly within preparatory or auxiliary activities unless a PE is intended. For example, warehousing should be limited to storage functions without integrating distribution channels or taking benefit of the 'delivery' exception clause in certain tax treaties to take it out of the ambit of fixed place PE taxation.

- **Well-defined Employee Agreements:** Employee secondment arrangements should explicitly state the control and supervision structure and risk & responsibility of work with the domestic employer to avoid creating a PE for the foreign enterprise. There should be an Assignment Agreement between the expatriate and the seconding company, an Employment agreement between the Indian employer and the expatriate demonstrating the above profile of the Indian employer, and a Secondment Agreement between the seconding company and the Indian employer for cross charge of all salary / remuneration, in case salary is paid overseas for administrative convenience. The concept of lien and other factors in cases like Morgan Stanley (Supreme Court)[17] and Centrica (Delhi High Court)[18] needs abundant consideration.

- **Project Timeline Monitoring:** EPC contractors and other project-driven entities should closely monitor project timelines in India, as exceeding PE thresholds trigger tax liabilities. Careful consideration needs to be taken in cases of splitting of work and joint execution by affiliate entities in India.

- **Liaison Functions:** Liaison offices should limit their functions to communication and administrative support, as even business negotiations may result in PE allegations in India. Further, these activities should not be similar to what the head office is undertaking for the group [say as an agent], as the execution of the core functions of the head office may lead to a fixed place PE risk.

- **Robust Transfer Pricing function:** Further, a meticulous benchmarking of the functional, asset & risk matrix (FAR) of the PE can help tide over arbitrary or ad-hoc attribution of global profits to PE.

The PE taxation landscape in India continues to evolve, with judicial precedents reinforcing a more functional and substantive approach to PE determination. Businesses must align their operations in India with these evolving interpretations to minimise tax exposure while complying with India's tax regulations. Navigating PE risks effectively requires a combination of proactive operational planning, documentation of local activities, and close adherence to the substance of India's tax treaties and recent judicial rulings.

17. (2007) 292 ITR 416
18. 364 ITR 336 (Delhi)

3. Profit Attribution to Permanent Establishments: Challenges, Principles, and Pathways to Certainty[19]

India's burgeoning economic landscape has made it an attractive destination for global enterprises. However, with the increase in cross-border business activities, the issue of profit attribution to Permanent Establishments (PEs) has gained prominence. A PE, established when a foreign enterprise has a substantial presence in India, is one of main triggers invoking tax liability under the Income-tax Act, 1961, or an applicable Double Taxation Avoidance Agreement (DTAA) for the non-residents. It should be noted that as much as determining the existence of a PE is a contentious issue in India, attributing profits to the PE has been equally contentious, leading to significant litigation. This chapter explores the key challenges, Indian Tax Authority's approach, key judicial rulings, and practical strategies for addressing profit attribution issues.

India's domestic framework to profit attribution and its interplay with the Authorized OECD Approach

India has consistently expressed reservations about the Authorized OECD Approach (AOA) to profit attribution, as outlined in the revised Article 7 of the OECD Model Tax Convention 2017. Under the AOA, the Functions, Assets, and Risks (FAR) analysis is a cornerstone in profit attribution to a PE. This method aims to allocate profits based on the economic contributions of a PE, reflecting the value created through its functions performed, assets deployed, and risks assumed.

However, the Indian Tax Authority contends[20] that this method primarily focuses on supply-side activities, attributing residual profits predominantly to the head office and often disregarding the significant role of demand-side factors in value creation. Accordingly, it contends that this approach disproportionately benefits capital-exporting nations and undermines the taxing rights of developing economies, where market presence and consumer demand significantly contribute to business profits.

India's current framework for profit attribution is rooted in Rule 10 of the Income-tax Rules, 1962, which provides a discretionary approach for determining profits attributable to a PE. Although Rule 10 allows flexibility, its lack of specific guidelines has led to inconsistencies, disputes, and prolonged litigation. In the face of evolving global business models, particularly in the digital economy, and the expanded scope of PE definitions introduced by the OECD's BEPS Action Plan 7, India recognised the need for a more structured and equitable framework to address challenges posed by Rule 10 while aligning with its unique economic context.

To address these inadequacies, the Central Board of Direct Taxes (CBDT) constituted a committee to propose reforms. In 2019, the committee recommended replacing Rule 10 with a formulary approach to profit attribution, introducing a three-factor formula based on sales, manpower, and assets, emphasising both supply-side and demand-side contributions. The proposed weightage was 50% for sales, 25% for manpower, and 25% for assets, emphasising India's role as a market jurisdiction.

The primary goals of the committee were to provide clarity and predictability in profit attribution, reduce litigation through a transparent and uniform methodology, and align with India's position as

19. This article is contributed by Aditya Hans (Partner, Dhruva Advisors) and Ashish Jain (Principal, Dhruva Advisors)
20. Proposal for amendment of Rules for profit attribution to permanent establishment prepared by the Committee, dated 18th April, 2019, formed by Central Board of Direct Taxes

a significant market and service economy. The formulary approach aimed to address modern business complexities, particularly those arising from digital and cross-border transactions, ensuring that the framework remained adaptable to evolving global tax norms.

However, the proposed framework faced criticism for following a formulary approach rather than economic principles. The overemphasis on sales disproportionately favoured market jurisdictions, potentially inflating India's tax base. Critics argued that the simplification risked oversimplifying complex business models, particularly those involving intangibles. Additionally, implementing the framework posed administrative challenges, such as segmenting activities and gathering necessary data. The report also failed to fully address specific attribution issues in cases like Engineering, Procurement, Construction (EPC) contracts and Dependent Agent Permanent Establishment (DAPEs), where FAR-based approaches are often more appropriate.

The proposed amendments to Rule 10 have not been implemented even after five years, reflecting the government's cautious approach. As of today, there are no prescribed guidelines on attributing profits to PE in India, and tax authorities and taxpayers interpret Rule 10 in a manner which favours them.

It should be noted that the domestic law also provides for presumptive taxation for certain categories of businesses arising on undertaking specific activities like shipping, operating cruise ships, civil construction, aircraft operation and exploration of mineral oils. Foreign companies undertaking such activities can explore considering the presumptive taxation route under the domestic law to attain certainty with regard to tax exposure arising due to establishing PE in India.

Judicial precedents on profit attribution

The lack of proper guidelines to attribute profits to PE is certain to have disputes on the issue. The Courts in India have, time and again, stepped in to resolve disputes on the issue of profit attribution. However, it has been observed that Courts have had to resort to formulary approaches for attributing profits to PEs in the absence of robust profit attribution studies furnished by taxpayers.

In *Rolls Royce Singapore Pte. Ltd. v. Asstt. DIT*[21], the Delhi High Court, attributed 10% of revenue from spare parts sales to the Indian PE. The decision stemmed from the taxpayer's inability to furnish detailed accounts, justifying a lower attribution. Similarly, in *Hyundai Heavy Industries Co. Ltd.*[22], the Supreme Court attributed 10% of gross receipts from installation and commissioning activities to the PE. The Court's reliance on this simplified formula was a direct result of the lack of India-centric accounts that could precisely allocate profits based on FAR analysis.

In the context of DAPE, Courts have also relied on similar approaches due to the absence of detailed documentation and FAR-based analysis. In *Daikin Industries Ltd. v. Asstt. CIT*[23], the Delhi Tax Tribunal, applied a profit attribution formula whereby 30% of net profits, calculated at 10% of total sales, were attributed to the DAPE. The Tribunal justified this approach by noting that the taxpayer's transfer pricing documentation did not fully reflect the functions, assets, and risks associated with the dependent agent's activities in India. Similarly, in

21. [2013] 40 taxmann.com 351 (Delhi)/[2014] 223 Taxman 126 (Delhi) (MAG)[27-07-2012]
22. [2007] 161 Taxman 191 (SC)/[2007] 291 ITR 482 (SC)/[2007] 210 CTR 178 (SC)[18-05-2007]
23. [2012] 25 taxmann.com 569 (Delhi)

Rolls Royce Plc v. DIT[24], the Delhi High Court upheld the attribution of 35% of total profits to the Indian DAPE, emphasising that the dependent agent played a significant role in concluding contracts and generating revenue in India, and the taxpayer had not provided adequate evidence to support a lower attribution.

It should also be noted that Indian courts have also upheld the arm's length principle as an appropriate method for profit attribution. Cases like *Morgan Stanley*[25] and *Hyatt International*[26] have validated this approach, emphasising that arm's length remuneration sufficiently attributes profits to a PE. These rulings align with global tax standards, offering foreign enterprises a degree of predictability.

These rulings underscore that the judiciary often relies on formulary approaches when taxpayers fail to meet the burden of proof through proper documentation and FAR analysis. The Courts' decisions in these cases emphasise the importance of robust profit attribution studies, as the lack thereof compels authorities to adopt generalised methods that may not always fully reflect the economic realities of the enterprise's operations in India.

Attribution of Profits to DAPE

It is often observed that where a foreign entity argues on a technical front that its activities have not constituted a PE in India as per the provisions of Article 5, the possibility of the Indian Income-tax authorities asserting a PE in India cannot be entirely dismissed. The burden of proving the existence of a PE lies with the authorities, as established by the Supreme Court in *e-Funds IT Solutions*[27] and *Samsung Heavy Industries*[28]. The attribution of profits to a DAPE is contentious, raising the question of whether arm's length remuneration to the agent fully captures the profits attributable to activities in India. Under Article 7, profits must be attributed as if the PE were a distinct and independent enterprise.

Recent rulings, including *Hyatt International Southwest Asia Ltd.*[29], have emphasised that profits should be attributed to a PE irrespective of global losses, highlighting the importance of assessing functions, assets, and risks (FAR) independently. If a foreign entity is deemed to have a PE, profits attributable to it would be taxed at the applicable corporate tax rates, with compliance requirements under domestic tax and transfer pricing regulations. Where books of accounts are insufficient, Rule 10 of the Income-tax Rules empowers authorities to adopt presumptive, proportionate, or other suitable methods for computing attributable profits, often leading to aggressive assessments ranging from 10% to 40% of global profits or based on arbitrary turnover percentages.

The Supreme Court's ruling in *Morgan Stanley & Co. Inc.*[30] offers a counterargument, emphasising that if transactions between the foreign enterprise and its Indian entity are at arm's length, no further profits should be attributed to the PE. Several judgments, including *Set Satellite (Singapore) Pte. Ltd.*[31], reiterated this principle, concluding that no additional profit attribution is warranted once correct arm's length pricing is applied. However, the Indian Tax Authority challenges this position,

24. [2011] 13 taxmann.com 233 (Delhi)
25. (2007) 292 ITR 416
26. [TS-693-HC-2024(DEL)]
27. (2017) 399 ITR 34 (SC)
28. [2020] 426 ITR 1 (SC)
29. (2024 SCC OnLine Del 6546)
30. (2007) 292 ITR 416
31. [2010] 132 TTJ 459(MUM.)

suggesting that a DAPE is a distinct taxable presence, requiring independent profit attribution under Article 7. This view posits that arm's length remuneration under Article 9 may not fully account for the economic value created through significant people functions (SPFs) undertaken by the DAPE on behalf of the foreign principal. For instance, activities like credit risk management, customer relationship development, and inventory handling go beyond the functions of a typical agent, effectively positioning the DAPE as a distributor. In such cases, additional profits corresponding to these SPFs and assumed risks should be attributed to the DAPE.

To address this, a detailed profit attribution study is imperative. This begins with a comprehensive FAR analysis to identify functions performed, risks assumed, and assets utilised by the DAPE that extend beyond the dependent agent's remuneration. The next step involves determining an appropriate profit attribution study comparing the DAPE's activities with independent entities performing similar roles, such as distributors, can serve as a reliable basis. For instance, if the DAPE acts as a distributor, its profits can be benchmarked against independent distributors' margins, deducting the agent's remuneration to arrive at the incremental profits attributable to the DAPE. This ensures fair allocation of taxing rights while aligning with international tax principles.

Attribution of Profits under Engineering, Procurement, and Construction (EPC) Contracts

Engineering, Procurement, and Construction (EPC) contracts, often used in large-scale infrastructure projects, present unique complexities in profit attribution. These contracts involve offshore and onshore components, such as design, supply, installation, and commissioning. The challenge arises when Indian tax authorities seek to attribute profits from offshore activities to the Indian PE, arguing that these activities are interlinked with onshore operations. Taxpayers, on the other hand, maintain that offshore activities should remain outside India's tax net, as they are independent of the Indian PE.

Judicial precedents have provided addressed this contentious issue to some extent. In *Hyundai Heavy Industries*[32], the Supreme Court ruled that profits from offshore supply were not taxable in India, as these transactions were independent of the Indian PE, while onshore activities were taxable. Similarly, in *Ishikawajima-Harima Heavy Industries*[33], the Court reinforced the principle of territoriality, holding that profits from offshore activities cannot be taxed unless they are directly connected to the Indian PE. The *Linde AG* case further emphasised the use of FAR analysis to allocate profits, ensuring that only onshore value additions are subject to Indian taxation.

Despite these rulings, the segmentation of onshore and offshore activities remains a challenge. Tax authorities frequently argue that offshore components, like design and procurement and even project management, are integrally linked to onshore execution, justifying higher profit attribution to the PE. This issue becomes more pronounced when the Indian PE facilitates offshore activities, such as negotiating contracts or providing logistical support, leading to disputes over the appropriate profit allocation.

To address these complexities, businesses must adopt robust strategies, including detailed FAR

32. [2007] 161 Taxman 191 (SC)/[2007] 291 ITR 482 (SC)/[2007] 210 CTR 178 (SC)[18-05-2007]
33. 288 ITR 408

analyses, segmentation of contract components, and reliance on transfer pricing principles for inter-company transactions. Judicial rulings highlight the importance of maintaining robust documentation and segregating onshore and offshore activities to defend against excessive attribution claims.

Profit attribution to PEs in India presents challenges for foreign enterprises. Profit attribution is inherently fact-intensive, requiring a meticulous analysis of business models, transactions, and economic realities. Foreign companies must conduct comprehensive FAR analyses for all India-related operations and maintain robust documentation, including inter-company agreements and transfer pricing studies. They may also engage with tax authorities through Advance Pricing Agreements (APAs) to achieve certainty and mitigate litigation risks. With careful preparation, businesses can ensure that their Indian operations remain tax-efficient while fostering a positive relationship with the authorities.

4. Crossing Borders: Understanding Payments to Non-Residents[34]

Understanding taxability and withholding tax on payments to non-residents is crucial for businesses and individuals engaged in cross-border transactions. Determining the taxability of such payments, including for software use, management fees, royalties, and other services, requires a thorough understanding of both the domestic tax laws and international tax principles.

Tax implications in India on payments to Non-residents

Regardless of the taxpayer's residency status, under the India's tax system income sourced from within the country is subject to tax in India. For non-residents, taxable income in India includes all income that accrues or arises or is deemed to accrue or arise in India. This encompasses payments such as interest, royalties, fees for technical services, capital gains, dividends, business income, etc.

Whether a non-resident's payment constitutes 'income' requires careful consideration under the Income-tax Act, 1961 (the Act), in conjunction with applicable Double Taxation Avoidance Agreements (Tax Treaties) and current legal jurisprudence.

Taxability of Royalty and Fees for technical services (FTS)

The determination of taxability, particularly in the case of royalty and FTS, is critical due to the broad scope of the Act.

Section 9(1)(vi) of the Act defines royalty to include payments for transfer of all or any rights (including the granting of license) in respect of inter alia any copyright, patent, invention, model, design and secret formula or process or trademark or similar property, consideration for the use of any patent, invention, model, design, secret formula or process or trademark or similar property and consideration for imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill. Section 9(1)(vii) of the Act defines FTS as fees for rendering Managerial, Technical or Consultancy services.

Cross-border payments like royalties and FTS can be contentious, specifically in terms of what constitutes copyright, underlying factors such as the process involved, access to the database, human element involved, applicability of 'make available', etc., in light of contemporary models under cloud computing, such as software as a service (SaaS), platform as a service (PaaS), infrastructure as a service (IaaS) etc. For example, the Supreme Court's ruling in Engineering Analysis Centre of Excellence (P.) Ltd. v. CIT[35] held that payments for copyrighted software do not constitute 'royalty' under DTAAs, though they may qualify as royalty under the Act.

Benefit from this jurisprudence to IT, broadcast and satellite bandwidth provider / transmission companies, and other software-enabled businesses need to be evaluated.

Diverse Definitions in DTAAs

Non-resident payments must be examined case-by-case, especially in light of the applicable DTAA provisions and legal jurisprudence. Indian tax treaties differ in their definitions of royalties and FTS.

For instance, the FTS clause is absent in certain tax treaties like the India-Brazil DTAA, India-Saudi Arabia DTAA, India-UAE DTAA, etc. FTS has a restrictive definition on account of the 'make

34. This article is contributed by Zeel Gala (Associate Partner, Dhruva Advisors) and Darshana Dattani (Principal, Dhruva Advisors)
35. [2021] 125 taxmann.com 42 (SC)

available' condition as in the India-US DTAA, India-Singapore DTAA, India-UK DTAA, etc. Similarly, the definition of royalty and the inclusion of software also differ amongst India's tax treaties. Treaties with countries like the US, UK, France, Germany, and Singapore do not include payments for the use or right to use computer software as royalties. In contrast, treaties with Russia, Morocco, Turkmenistan, and Romania include such payments.

Other industry verticals

In the case of cross-border leases, like in the shipping & aircraft industry, one needs to examine whether the definition of royalty includes "use of industrial, commercial or scientific equipment".

Investors in companies engaged in EPC contracts / foreign contractors/consortium partners may have to consider the favourable jurisprudence on offshore supplies and undertake a proper evaluation for tenders/ bids to avoid constitution as Association of Persons (AOP) and other tax cost optimisation in the projections to emerge as lowest bidder.

Foreign investors must also carefully examine the taxability of capital gains (CG) as a stream of income on divestiture from India or group corporate restructuring, including taxation of indirect transfers. Investors in companies holding immovable property may have separate tax considerations.

Recently, share buybacks for the investors have sought to be characterised as dividends and inter-play with DTAA provisions will be keenly watched.

Investors in trading companies or undertaking global sourcing from India must be aware of tax issues surrounding the appointment of marketing agents and the establishment of Liaison / Representative offices.

Tax rates, Treaty Benefits and Documentation

Section 195 of the Act mandates that anyone making a payment to a non-resident, which is chargeable to tax in India, deduct tax at source (TDS) at the applicable rates. This ensures taxes are collected on income sourced from India but received by non-residents. Under the Act, payments such as interest (other than those specifically covered), royalties and FTS received by non-resident enterprises (provided income is not attributable to a permanent establishment in India) are taxed at a uniform rate of 20% on a gross basis.

Non-residents can choose to be taxed under the Act or as per the provisions of an applicable DTAA, whichever is more beneficial. Before availing the benefits, non-residents must consider several factors such as applicability of anti-abuse tests such as beneficial ownership test, substance, Principal Purpose Test (PPT), Limitation of Benefits (LOB) and General Anti-Avoidance Provisions (GAAR) etc., and documentation requirements such as a valid Tax Residency Certificate (TRC), a no 'Permanent Establishment' declaration, and Form 10F. Non-residents would also need to obtain a Permanent Account Number (PAN) in India and file income tax returns in India, where the beneficial provisions of the DTAA are availed.

A non-resident may take a specific stance on the taxability of payment, but the resident payer might adopt a more conservative approach regarding withholding tax. In case the payer or payee believes that a payment is not taxable in India (wholly or partially), they can apply to the Indian tax authorities for a certificate to reduce or eliminate the withholding tax on that transaction. This process allows non-resident taxpayers to evaluate the tax implications and potentially reduce the impact of higher taxation.

Equalisation Levy

Equalisation Levy (EL) at 2% on 'e-commerce supply or services' was introduced on 01 April 2020, to tax digital transactions. However, with its removal vide Finance Act (No. 2) of 2024 with effect from 01 August 2024, determining if transactions qualify as royalty or FTS under the Act remains crucial.

Subject to Tax Rule (STTR)

STTR, a part of the OECD's Pillar 2 proposals, is a treaty-based rule that addresses tax avoidance through low corporate tax rates in some jurisdictions. It allows source countries to tax certain cross-border payments, such as interest and royalties, among others, when the recipient is in a jurisdiction with a corporate tax rate below 9%.

STTR applies if the total amount of these payments exceeds EUR 1 million (or EUR 250,000 if the jurisdiction's GDP is below EUR 40 billion) during the fiscal year. Taxes under the STTR are assessed annually after the fiscal year ends rather than through withholding taxes. The recipient jurisdiction does not need to exempt these payments or offer a tax credit for the STTR tax.

Certain payments and cases are excluded from the STTR; if withholding taxes already reach or exceed the specified rate, the STTR does not apply. Implementation of STTR will occur through amendments to bilateral tax treaties using the Multilateral Instrument (MLI) or through bilateral renegotiations.

The interplay between Indian tax law and STTR

The interplay between withholding tax requirements under the Act and STTR requires careful consideration by taxpayers dealing with international transactions.

While the STTR does not impose a tax, it allows jurisdictions to tax covered income if domestic tax rates in the country of residence are lower than the prescribed 9%. Thus, payments made to non-residents from India might still fall under the STTR, depending on the applicable tax rates and definitions in treaties.

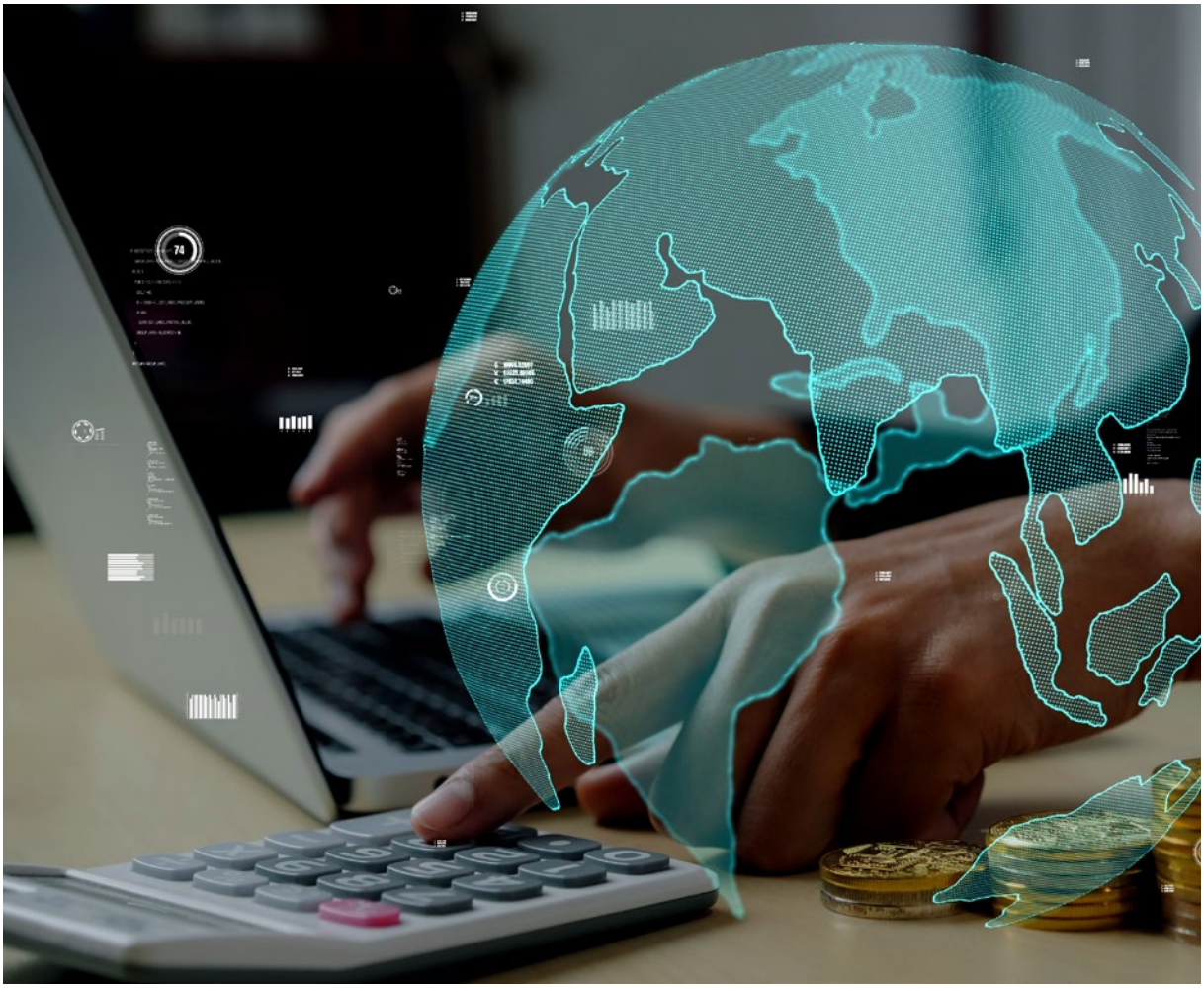
At first glance, STTR might not apply to payments made from India to non-residents due to the existing withholding tax provisions. However, a careful evaluation is needed for the following:

- **Lower Withholding Rates Under Domestic Law:** A reduced withholding rate for interest payments applies under Section 194LC of the Act.
- **Lower Withholding Rates Under Tax Treaties,** such as a 7.5% withholding rate on interest payments to Mauritius as per the DTAA.
- **Limited Definitions in Tax Treaties:** For instance, the definition of the nature of payment is absent or restricted in the applicable DTAA, e.g., the definition of 'fees for included services' (FIS) in the India-US DTAA.
- **Interpretative Issues:** Where the definitions of payments, like 'royalty' or 'services', require detailed analysis on a case-by-case basis.

Taxpayers engaged in international transactions involving India must meticulously assess the nature of their payments in light of the relevant provisions under the Act, the applicable DTAA, and prevailing legal precedents. This careful analysis is crucial for determining both the taxability of the transactions and the requisite tax withholding obligations in India.

STTR is a significant step in asserting source country taxation from India and other developing countries' perspectives. Although the Indian budget presented in July 2024 did not address the Pillar 2 proposals, the Indian Government has established a committee to assess these proposals from India's perspective.

Nonetheless, as a part of determining the taxability and withholding tax requirements, MNE groups would need to track the implementation of STTR in countries where they operate, including India. They must assess its jurisdictional applicability, maintain proper documentation, and ensure compliance with tax treaties to manage tax liabilities and avoid issues like double taxation or penalties.



5. Understanding India's Position on BEPS MLI and MFN Clause[36]

India's approach to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS MLI), as well as the Most-Favoured Nation (MFN) clause, holds significant implications for businesses and investors with cross-border operations.

India's Engagement with BEPS MLI

India joined 68 countries in signing the BEPS MLI on 07 June 2017, and subsequently deposited its instrument of ratification with its final position on 25 June 2019.

Pursuant to the above, the MLI entered into force on 01 October 2019 and became applicable to various tax treaties of India from 01 April 2020, including those with Australia, France, Japan, the UK, and more. However, the MLI does not cover noteworthy treaties with the US, Mauritius, Germany, and China.

India's ratification of the BEPS MLI highlights its commitment to international collaboration to effectively implement BEPS measures. Provisions within the MLI bolster India's ability to counteract treaty abuse, improve dispute resolution mechanisms, and align its tax treaties with global standards.

A bird's eye view of India's position[37] on some of the key provisions of BEPS MLI that would impact its tax treaties are provided below.

- **Tax Residency for Dual Residents:** To be determined through the Mutual Agreement Procedure (MAP), ensuring a fair and transparent resolution of tax residency issues.
- **Elimination of Double Taxation:** India has adopted the credit method to ensure that income is not taxed twice in different jurisdictions.
- **Updated Preamble:** The new preamble clarifies the intention to eliminate double taxation without creating opportunities for double non-taxation or reduced taxation through tax evasion or avoidance.
- **Prevention of Treaty Abuse:** India has adopted the Principal Purpose Test (PPT) as an interim measure, with plans to negotiate Limitation of Benefits (LOB) provisions bilaterally.

  Notably, investments made from inter alia Singapore, Netherlands, Cyprus and Luxembourg would need to pass the PPT muster if DTAA relief is to be claimed. Accordingly, in such cases, critical decisions relevant to a deal (which factor treaty benefits), such as choice of jurisdiction for investment in India, instrument (equity/debt/quasi-equity) for investment, mode of acquisition, etc. will have to be examined through the lens of the PPT, when evaluating the availability of DTAA relief.
- **Dividend Taxation:** A minimum holding period of 365 days is required to benefit from reduced tax rates, except in the India-Portugal treaty.
- **Capital Gains Taxation:** Potential amendments to provisions concerning capital gains from the alienation of shares or interests deriving substantial value from immovable property.
- **Permanent Establishment (PE) Scope:** India has also adopted the broader PE definition to counteract artificial avoidance of PE status, with expanded scope for marketing support / sales

36. This article is contributed by Zeel Gala (Associate Partner, Dhruva Advisors) and Darshana Dattani (Principal, Dhruva Advisors)
37. For evaluating extent of modification of the Indian tax treaty, India's MLI positions need to be compared with the MLI positions taken by its counterpart.

agency functions in the distribution supply chain. To address avoidance of PE through specific activity exemptions, it has opted for Option A, which provides an exemption from PE only if the activities carried out are of a preparatory and auxiliary nature. Similarly, the BEPS provisions to address avoidance of PE by splitting the contracts will also be applicable.

While India has accepted the above changes to the PE definition provided in the MLI, several of India's treaty partners have not followed the same suit. For instance, Canada, Sweden, and the UAE have made reservations regarding all PE provisions of MLI. Some of India's tax treaties, which would be modified due to one or more of these changes, include those with Australia, Japan, the Netherlands, and Russia.

- **Improved Dispute resolution:** India has reserved its right not to adopt the modified MLI provisions on the basis that it will meet the minimum standard by allowing MAP access in the resident state and implementing bilateral notification or consultation process

India has also chosen not to apply certain provisions of the MLI to its tax treaties, such as provisions to address transparent entities and the Mandatory Binding Treaty Arbitration (MBTA).

India-Mauritius DTAA

Although the BEPS MLI does not cover the India Mauritius DTAA, as Mauritius did not include India under the list of covered tax agreements, Mauritius opted for bilateral negotiations with India to incorporate the Action 6 provisions into the treaty through an amending protocol. Consequently, the protocol to amend the DTAA was signed on 07 March 2024.

The Protocol proposes to replace the Preamble to specifically provide that the DTAA intends to avoid double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion/tax avoidance (including on account of treaty shopping, etc.). It also proposes introducing a PPT aligned with the BEPS MLI.

The Protocol will enter into force when Mauritius and India notify the Protocol per their domestic laws.

India's approach to the MFN Clause

The MFN clause ensures that if a country grants a favourable trade concession to one treaty partner, the same treatment must be extended to other partners. The favourable treatment could be with respect to the rate applicable, scope of the article, etc. This clause promotes equitable treatment and prevents discrimination based on the country of residence.

India has the MFN clauses included in its DTAAs with a limited number of countries, such as Belgium, France, the Netherlands, the United Kingdom, Spain, Sweden, and Switzerland.

A legal dispute emerged over whether the Indian government must issue a notification to grant MFN benefits or if these benefits automatically apply. The Supreme Court of India, in a landmark ruling involving Nestle SA and others[38], clarified that a government notification is required to invoke the MFN clause and has recently dismissed the review petition filed against this decision[39]. Furthermore, the MFN clause applies only if the third country was an OECD member when signing the DTAA with India.

38. [2023] 155 taxmann.com 384 (SC)
39. [2024] 165 taxmann.com 334 (SC)

In March 2024, the Indian government issued[40] a notification amending the India-Spain DTAA, reducing the tax rate on royalties and fees for technical services (FTS) from 20% to 10%, in line with the MFN clause from the India-Germany DTAA. However, the definitions of "royalty" and "FTS" remain unchanged in the India-Spain DTAA. The selective application of MFN benefits requires careful legal consideration, especially when corresponding tax credits are not provided in the investor's country of residence.

Consequent to the above SC decision, the benefits of the MFN clauses in India's tax treaties stand restricted, which will significantly impact the MNE's investment and operations in India. The above decision would significantly impact MNEs who have taken positions where a more beneficial rate for dividends, interest, royalties or fees for technical services based on the MFN clause included in the applicable DTAA is being claimed.

Taxpayers may explore tax dispute resolution mechanisms where MFN benefit has been challenged due to adverse judicial views on the subject.

India's proactive adoption of BEPS measures, such as thin capitalisation, Country-by-Country Reporting (CbCR), and digital economy taxation (equalisation levy[41], significant economic presence), reflects its commitment to aligning with global tax standards while safeguarding its national interests. The nuanced implementation of the MFN clause will play a crucial role in shaping India's DTAA network and its interactions with international partners.

While conducting business with and within India, MNEs must carefully evaluate the effects of the MLI on India's DTAA network. This includes considering the implications of the PPT and its interaction with the General Anti-Avoidance Rules (GAAR) under domestic law and its impact on grandfathered income and investments. MNEs should also review their existing operating structures in light of the expanded PE rules. From an MFN perspective, MNEs need to verify that India has officially recognised any benefits under MFN clauses through a notification before claiming them, particularly if their country of residence does not grant a corresponding tax credit. Additionally, given the concessional rate announced for the India-Spain DTAA under the MFN clause, it will be noteworthy to observe whether India will issue separate notifications for each country where an MFN clause applies.

40. Notification No 33/2024 dated 19 March 2024
41. Removed with effect from 1 August 2024 vide the Finance Act (No.2) of 2024

6. Cross-Border Considerations: Tax Challenges in Employee Mobility and Employee Stock Option Plans (ESOPs)[42]

Section A: Cross-Border Employee Mobility

As multinational corporations expand into emerging economies, they drive increased cross-border movement of people to cater to their business needs, knowledge enhancement, cost reduction, etc. Movement can be inbound or outbound, i.e., a person based in the home country (USA) working in the host country (India) and vice versa. While the increased movement of people offers numerous benefits, it also brings various complexities.

Key considerations

- **Determining the ideal model:** Depending upon the nature of the assignment, viz., short-term, medium-term, long-term, project-based, or permanent relocation, there may be different models available.

Mobility model		
Secondment	**Deputation**	**Permanent transfer**
Temporary assignment from one organisation to another (contract of service)	It is not an assignment of employment, but the person acts on behalf of the company who deputes (contract for service)	Relocation of an employee from a foreign country to India for his remaining period of employment on the payroll of the Indian company.

Payroll models		
Host payroll	Home payroll	Split payroll

- **Impact on personal income tax:** Taxability in India depends on residential status, which hinges on the number of days spent in India. In the case of residents and ordinary residents, global income is taxed in India. Impact on personal tax plays a critical role since companies must ensure that expatriates' net take-home salaries are unaffected. Additionally, suppose an employee is considered as a resident in their home as well as in the host country, recourse must be made to a tie-breaker test under the relevant DTAA to determine the final residential status, which varies based on individual circumstances.

- **Corporate tax and withholding obligations:** For administrative ease, salaries are sometimes paid by a foreign company and later reimbursed by the Indian company on a cost-to-cost basis. However, this reimbursement is often contested as 'fees for technical services' (FTS), leading to an additional funds outflow. Accurate documentation, including carefully drafted employment agreements that specify the entity controlling and directing the employee's work, is essential to prevent such reimbursements from being treated as FTS. Additionally, the presence of expatriates in India could create a Permanent Establishment (PE) risk, including Service PE or Agency PE, potentially leading to taxation of the foreign entity's profits attributable to that PE in India. Further, withholding tax obligations on employee payments must also be complied with.

- **Transfer Pricing:** The transactions between associated enterprises should satisfy the arm's length principle per Indian transfer pricing regulations.

- **Goods and Services Tax (GST):** Amount paid to expatriates in India or outside India has

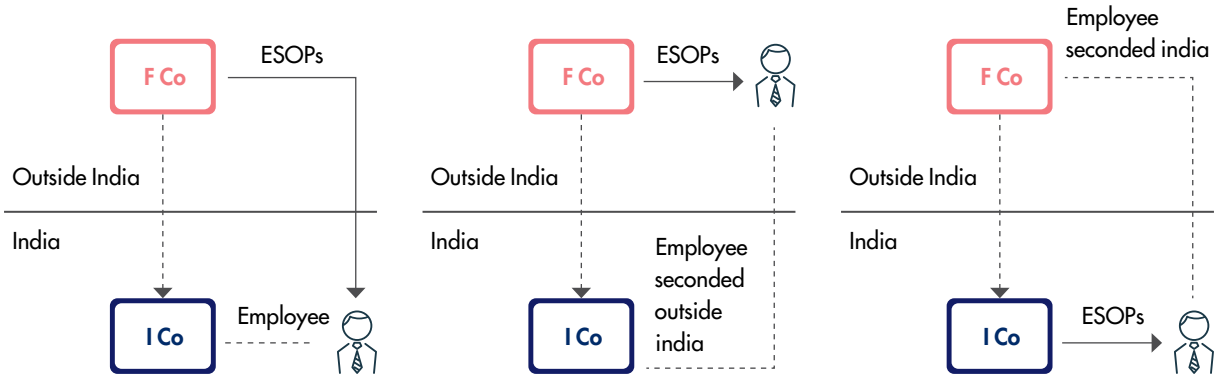
42. This article is contributed by Deepesh Chheda (Partner, Dhruva Advisors) Arpit Doshi (Principal, Dhruva Advisors) and Soham Jog (Senior Associate, Dhruva Advisors)

GST implications in the hands of an Indian entity. The government considers expatriate to be consultants for Indian entities; therefore, GST can be charged on payments made to expatriates. Considering this, the arrangement between foreign and Indian entities towards expatriates needs to be evaluated from a GST perspective.

- **Social Security:** The impact on contributions by employees to their foreign social security account and the requirement of social security contribution in India needs to be evaluated based on the respective Social Security Agreement entered between India and the host country.
- **Immigration Rules:** A foreign national can visit India only with a valid visa, and the purpose of the visit should match with the visa category, such as employment visa, business visa, project visa, etc.
- **Documentation:** Adequate documentation needs detailing the arrangement needs to be maintained so that facts and documentation are aligned.
- **Conclusion:** Selecting the ideal employee mobility model is essential as it influences various aspects such as operational efficiency, cost management, and employee satisfaction, making it critical to carefully assess all relevant factors to ensure the best outcomes.

Section B: Cross-Border ESOPs

The growth in cross-border business frameworks in recent years has led to employees mobility at a global level which has led to an increase in cross-border Employee Stock Option Plan (ESOP) structures. Global businesses in India, new investors proposing to invest in India, and Indian companies with foreign affiliates can all benefit from cross-border ESOP arrangements. Sample scenarios of cross-border ESOPs are encapsulated as follows:



Mr. X, employee of Indian company receiving ESOPs from foreign parent company in India

Mr. X, employee of Indian company seconded to foreign parent company, receiving ESOPs from foreign parent company outside India

Mr. X, employee of foreign parent company seconded to Indian company, receiving ESOPs from Indian company in India

Broad ESOPs Framework in India and Key Considerations:

- **Type of Equity Compensation Plans:** There are several equity compensation plans, but the two most prevalent in India are the Employee Stock Option Scheme (option for the employee to acquire shares of a company), Stock Appreciation Rights (difference between the market value of shares on exercise and grant price settled in cash/shares), etc.

- **Exchange Control & Other Regulations:** Cross-border ESOPs are permissible but must adhere to specific conditions outlined by India's Exchange Control Regulations. It is essential to carefully assess several factors, including the ability to make payments for the grant price, guidelines on repatriation of sales proceeds and dividends, and the necessary regulatory filings with the Reserve Bank of India. Further, other regulations under corporate laws and Securities and Exchange Board of India Regulations (in the case of listed shares) must also be complied with. A thorough evaluation of these aspects is crucial to ensure full compliance with the regulations and to navigate the process effectively.

- **Taxability of ESOPs:** The difference between fair value as on the date of exercise and grant price is taxable in the hands of the employee as a prerequisite (salary). As illustrated by the scenarios given above, there can be complexities when an employee provides services in one country while the company issuing ESOPs is based in another country. Additionally, determining the taxing rights can become intricate if the employee relocates and works in different countries during the ESOP's lifespan. This involves deciding which country has the right to tax—whether it is the employer's country, the ESOP-issuing company's country, the employee's country of residence, or the country where services are rendered. International commentaries generally suggest taxing ESOP perquisites based on the employee's service duration in each country during the vesting period. However, employees may also encounter dual taxation in the country of their residence. Thus, a thorough analysis of specific facts and applicable tax treaties is essential.

- **Deductibility and withholding tax obligation:** ESOPs, as a form of employee remuneration, should be deductible business expenses for employers, a view supported by various High Court rulings, though currently under the Supreme Court review. In principle, these expenses are a legitimate employee compensation cost and integral to business operations. Proper documentation can strengthen this claim. Cross-border ESOPs introduce additional challenges in determining which company is eligible to claim the deduction and obligated to withhold tax (ESOP issuing company or employer company). Transfer Pricing: Cross-border ESOPs may require allocating proportionate ESOP expenses between associated enterprises, adhering to the arm's length principle under Indian transfer pricing regulations.

- **Goods and Services Tax:** Payment made to a foreign holding company for the cost of transferred shares is not taxable under GST; however, if the foreign holding company charges any additional consideration, GST is payable under reverse charge by the Indian company. Similar GST implications will be present in the hands of Indian companies that issue shares to employees of foreign companies. Therefore, ESOP transactions demand consideration from a GST perspective as well.

Taxation of cross-border ESOPs can be intricate. Yet, their potential is widely acknowledged. Therefore, it is crucial to carefully assess the tax implications and consult experts to navigate these complexities and make informed decisions.

7. Latest Litigation Trends in India – Faceless Assessments and Alternate Dispute Resolution[43]

Tax litigation in India involves disputes between taxpayers and the tax authorities. Although tax litigation could arise out of several factual and legal matters, litigation typically arises where the tax authorities take a different position than the taxpayer's returned income.

Typically, litigation arises out of tax assessment proceedings, which are also often called scrutiny proceedings:

- **Assessment/ Scrutiny proceedings:** India is the first country to implement faceless assessments in most cases (except for non-residents and taxpayers whose cases are centralised due to pending or past search and seizure actions). In the assessment proceedings, the tax authorities determine the income and tax liability as against the income and tax liability disclosed by the taxpayer in its return of income.
- **Appeals:** If the taxpayer disagrees with the income/ tax determined in the assessment proceedings, they can prefer an appeal to higher appellate authorities. The first appellate authorities are the Commissioner of Income Tax (Appeals)/ Dispute resolution panel. The taxpayers can prefer appeals against the order of the first appellate authorities to the Income Tax Appellate Tribunal (ITAT) and subsequently to the High Court and the Supreme Court. The tax authorities, too, can prefer an appeal against the order of the Commissioner (Appeals) to the ITAT, High Court, and the Supreme Court.
- **Dispute Resolution**: Various mechanisms, such as the Advance Pricing Mechanism (APA), Mutual Agreement Procedure (MAP), Board for Advance Rulings (BAR), etc., provide alternative routes for resolving disputes.

Tax litigation in India faces several challenges, including significant delays at each level, high complexity due to ever-evolving tax laws, uncertainty in outcomes, multiple High Courts taking different positions, and the risk of high-pitched assessments.

To address some of these challenges and to make the business environment in India more taxpayer-friendly, the Government has introduced a 'faceless' mechanism for Income-tax proceedings, including tax assessments, appeals, and various other procedures under the Income tax law.

The objective behind introducing the faceless mechanism is to reduce the physical interface between the Income-tax Authorities and taxpayers, enable optimal utilisation of resources, and reduce the arbitrary exercise of discretion by tax authorities in concluding assessments and appeals. The faceless scheme eliminated the interface between taxpayers and the tax authorities, with all communications between them being routed through electronic mode.

While the faceless regime acted as a catalyst to foster a business-friendly environment, it has also seen a fair share of practical challenges in implementation, especially at the ground level, some of which are:

- **Lack of Personal Interaction:** The inability to explain complex transactions in person can lead to misunderstanding of facts and cause unnecessary litigation. It also limits the taxpayer's ability to seek quick resolutions to system issues.
- **Limited Response Time granted to taxpayers:** Taxpayers are given a limited time limit requiring responses, resulting in insufficient or inadequate representation.

43. This article is contributed by Sandeep Bhalla (Partner, Dhruva Advisors) and Asmita Dsouza (Associate Partner, Dhruva Advisors)

- **Technical Issues:** The reliance on technology can lead to glitches and delays in submitting bulky and voluminous information. There are also practical issues as most of the tax authorities and even the taxpayers are not fully geared/ trained to work in a faceless manner.
- **No opportunity for Video Conference Mode:** If the taxpayer is not allowed for a personal hearing, it could result in unwarranted adjustments and, thus, unnecessary litigation.

From a taxpayer's perspective, given the elimination of physical interface/interaction under the faceless regime, there is a need to make holistic changes in the entire approach towards representation before the tax authorities. Some of the aspects to be considered while representing cases before the faceless tax authorities are:

- **Accurate Documentation:** Ensure all financial records and documentation are accurate and up-to-date.
- **Timely Responses:** Respond promptly to any notices or queries from the tax authorities.
- **Clear Communication:** Draft precise and reader-friendly submissions to avoid misunderstandings.
- **Leveraging Technology:** The technology can be leveraged in a very efficient manner to ensure that voluminous data can be submitted seamlessly.

While the faceless mechanism is one of the measures introduced for bringing efficiency in the tax administration to reduce the pendency of litigation, over the past few years, the government has undertaken several initiatives such as:

- **Dispute Resolution Scheme -** Introduction of Vivad se Vishwas Scheme, 2024 provides an opportunity for the taxpayer to resolve tax disputes pending before various appellate authorities.
- **Monetary Limits for Appeals:** The government has considerably increased monetary limits for filing appeals before each appellate authorities to reduce unnecessary litigation.
- **BAR/APA/MAP:** The alternate dispute mechanism provides clarity on tax matters, helping to achieve certainty.

The introduction of the faceless regime marks a significant step towards modernising India's tax administration. While challenges remain, particularly regarding technical and procedural issues, the overall impact has been positive, fostering a more transparent and efficient tax environment. Understanding these mechanisms for foreign companies looking to invest in India is crucial for navigating the tax landscape effectively.

8. Information Exchange: Strengthening Collaboration for Enhanced Legal Enforcement in India[44]

India's robust advancements in information exchange mechanisms, both domestically and internationally, are transforming legal enforcement and tax compliance. For foreign investors, staying informed about these developments is crucial, as they directly impact India's business operations and investment strategies.

Key Developments

Unified GST Platform

Since its implementation in 2017, the Unified Goods and Services Tax (GST) Platform, under the aegis of the Goods and Services Tax Network (GSTN), has revolutionised tax compliance in India. Integrating data from over 14 million GST-registered businesses, the platform aggregates vast amounts of information, including millions of invoices, e-way bills, and GST returns. By leveraging artificial intelligence and machine learning, this data is cross-verified in real-time, enabling sophisticated analysis and detection of discrepancies.

This system has proven highly effective in identifying and investigating fake or inconsistent invoicing and fraudulent input credit claims. For instance, in the fiscal year 2023-24 alone, over 6,074 tax avoidance cases involving more than INR 2 trillion were detected.

Moreover, GSTN's integration with other agencies, such as the Income Tax Department, Customs Department, and Enforcement Directorate (ED) under the Prevention of Money Laundering Act (PMLA), has enhanced the ability to comprehensively detect and address irregularities and tax evasion. Data from GST filings are now matched against income tax records, leading to investigations in cases of discrepancies. This seamless integration simplifies business compliance while fortifying the government's ability to enforce tax laws effectively.

Income tax

India has further strengthened income tax compliance through the development of 'Project Insight' an integrated data warehousing and business intelligence platform. This platform captures extensive databases of income tax returns, withholding tax statements, Annual Information Returns (AIR), and Statements of Financial Transactions (SFT). Taxpayers are now required to disclose detailed information, including all bank accounts, unlisted shares, directorships, and foreign assets and income earned abroad. The quoting of a Permanent Account Number (PAN) has also been made mandatory for various transactions for e.g., sale or purchase of any goods or services above INR 2,00,000 per transaction.

The revenue authorities can effectively profile taxpayers and issue notices in high-risk cases by correlating significant financial transactions involving banks, properties, shares, and securities. As per sources, efforts are also underway to expand the scope of third-party reporting to include immigration details, ensuring that all material financial information is available to the tax department in real-time.

Cross-Border Information Exchange

India has significantly expanded its global financial intelligence network with over 100 countries through mechanisms like Common Reporting Standard (CRS), Automatic Exchange of Information (AEOI), Bilateral Tax Information Exchange Agreements (TIEAs), and the Foreign Account Tax Compliance Act (FATCA) agreement with the United States.

44. This article is contributed by Ashish Agarwal (Partner, Dhruva Advisors) and Anuj Shah (Principal, Dhruva Advisors)

These frameworks have led to an exponential increase in the data exchange volume.

The Multilateral Competent Authority Agreement on the Exchange of CbC Reports (the CbC MCAA) for the automatic exchange of Country-by-Country Reports, and the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (the CRS MCAA) for the automatic exchange of financial account information pursuant to the Common Reporting Standard, developed by OECD have facilitated such cross-border information exchanges.

The Exchange of information on request (EOIR) standard requires that information that is "foreseeably relevant" for tax purposes, such as information on the identity of the legal and beneficial owners of assets, companies, and accounts, be available and accessible to tax authorities that can then exchange this information with tax authorities in other jurisdictions, based on an international agreement.

The AEOI standard, covering the Common Reporting Standard and the Crypto-Asset Reporting Framework, requires the annual exchange of a predefined set of information on financial accounts and crypto-asset transactions between tax authorities.

Under the BEPS Action Plan 5 (minimum standard), over 140 members of the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) have committed to counter harmful tax practices with a focus on improving transparency. One part of the Action Plan 5 (minimum standard) is the transparency framework for the compulsory spontaneous exchange of information on certain tax rulings. India can legally issue the following two types of rulings within the scope of the transparency framework: (i) cross-border unilateral APAs and any other cross-border unilateral tax rulings (such as an advance tax ruling) covering transfer pricing or the application of transfer pricing principles and (ii) permanent establishment rulings.

The Foreign Assets Investigation Unit (FAIU), established in 2021 under the Income Tax Department, leverages this extensive data to intensify cross-border financial scrutiny. The FAIU has increased its focus on cryptocurrency holdings, foreign real estate (particularly in the UAE and UK), and identifying beneficial owners of offshore entities. The unit has also strengthened its collaboration with tax authorities in countries like Singapore, Mauritius, and the UAE, leading to the identification of numerous shell companies used for round-tripping funds. This information is used for making case specific investigation under the Indian Black Money (undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015.

Collaboration with MCA

In 2017, a Memorandum of Understanding (MoU) for the exchange of information was signed between the Central Board of Direct Taxes (CBDT) and the Ministry of Corporate Affairs (MCA), which was a significant step towards enhancing the sharing of information and cross-agency coordination. Integration of PAN and TAN with the MCA Portal, along with new rules requiring reporting of beneficial and ultimate beneficial ownership, aims to curb benami transactions[45] and increase transparency.

Effective 30 September 2024, all companies (except small companies) must issue and transfer their shares in dematerialised form. These measures are designed to improve transparency and efficiency in the system, aligning India's corporate governance

45. Benami transaction is a transaction or arrangement whereby the identity of real owner (beneficial owner) of property is concealed by showing someone else (benamidar) as owner on record.

with global standards and making the market more appealing to international investors.

Enhancing Financial Intelligence under PMLA

The Financial Intelligence Unit (FIU), established under the PMLA in 2004, has upgraded its information technology system, now armed with artificial intelligence and machine learning tools, to check money laundering and terrorist financing crimes in the country's economic channels. This upgraded system, FINnet 2.0, includes three key subsystems:

- Collects data from financial entities.
- Performs detailed analytics using CBDT, MCA, and National Payments Corporation of India (NPCI) databases, generating risk scores and summaries of suspicious activities.
- Disseminates intelligence reports to investigative agencies such as the Income Tax Department, ED and Central Bureau of Investigation (CBI).

India's enhanced information exchange mechanisms demand higher compliance standards and transparency from all businesses. By staying informed and adapting to these changes, investors can not only navigate the Indian market more effectively but also gain a competitive edge. Leveraging the expertise of tax and regulatory professionals will be crucial in managing these complexities. These initiatives highlight India's unwavering commitment to fostering a transparent and robust business environment, further solidifying its position as a premier destination for global investment.

C. Transfer Pricing

1. Distribution Models and Integrated Principal Structures: Navigating Tax and Transfer Pricing Challenges in India[46]

With its rapidly expanding economy and vast consumer base, India remains an attractive destination for foreign multinational enterprises (MNEs) looking to tap the ever-growing consumer base. To capitalise on the Indian market, MNEs deploy various distribution models such as marketing and sales support entities, commission agents, limited risk distributors, buy-sell distributors, and full-fledged distributors depending on different commercial and operating objectives. However, navigating the complexities of India's tax and transfer pricing landscape can be challenging, so foreign investors must be well-prepared to address these issues to ensure compliance and mitigate risks.

Distribution function: Appropriate Characterisation

Any transfer pricing analysis requires the appropriate characterisation of the parties involved to apply the correct transfer pricing model. Regarding distribution activities, the concept of limited risk distributors (LRDs) remains the most sought-after business model due to its simplicity and convenience in adaptability. LRDs are typically characterised as entities that undertake limited functions, bear minimal risks, and earn a stable but low return. However, the Indian tax authorities have increasingly scrutinised these entities to ensure that their classification as LRDs aligns with the economic substance of their operations, failing which there could be Transfer Pricing and Permanent Establishment (PE) related risks.

Foreign companies often establish LRDs in India to minimise their tax exposure, but they must be cautious. The Indian tax authorities often challenge LRD arrangements especially if the form of the transaction does not align with the substance. For instance, if an LRD is seen to be performing significant entrepreneurial functions or bearing more risks than stated, it could be reclassified as a higher-risk entity, resulting in substantial transfer pricing adjustments.

Recently, the Base erosion and profit shifting (BEPS) Inclusive Framework (IF)[47] issued the final Amount B document as part of the two-pillar solution to simplify and streamline the application of the arm's length principle to baseline marketing and distribution activities, typically covering LRDs by providing indicative arm's length return on sales for distributors operating in different sectors and across different levels. OECD member countries and many other leading non-OECD economies have widely endorsed the report's contents. However, it is interesting to note that India has placed its reservations on various aspects of the Amount B framework, one of which is the lack of a defined qualitative scoping criterion that countries may adopt to identify distributors performing non-routine activities to apply indicative arm's length returns to baseline marketing and distribution activities. Hence, foreign investors setting up LRDs in India could not apply Amount B to substantiate that the returns allocated to LRDs are at arm's length.

To mitigate such risks, foreign investors must ensure that the functions, assets, and risks (FAR) profile of the LRD accurately reflects its operational reality. This involves maintaining detailed documentation and ensuring that the contractual arrangements are consistent with the actual conduct of the business. Moreover, regular reviews and audits of the LRD's operations can help identify any discrepancies early and take corrective action before they lead to disputes. In scenarios where the distributor's operations involve a higher level of functional intensity, as measured by Selling, General, and Administrative (SG&A) expenses, applying

46. This article is contributed by Aditya Hans (Partner, Dhruva Advisors) and Ashish Jain (Principal, Dhruva Advisors)
47. Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project

the Resale Price Method (RPM) may be more appropriate than the Transactional Net Margin Method (TNMM). The taxpayers may look forward to exploring the Advance Pricing Agreement (APA) route to seek a blessing on the LRD arrangements for nine years (i.e., five prospective years under APA and four previous years under the rollback of APA).

Marketing Intangibles: A Critical Consideration

In India, the issue of marketing intangibles has become a significant point of contention in transfer pricing, particularly for distributors with Advertising, Marketing, and Promotion (AMP) expenses that exceed those of comparable uncontrolled distributors.

Indian tax authorities often contend that when an Indian distributor incurs higher AMP expenses, it effectively creates or enhances marketing intangibles that benefit the foreign parent company and should be compensated for these efforts in addition to the standard distribution return embedded in the goods supplied. Apart from this, the tax authorities also tend to allege that the AMP expenses result in an enduring benefit to the Indian entity and, therefore, should not be treated as revenue expenses which are fully tax deductible.

The challenge for these Indian distributors lies in demonstrating that their AMP expenses are aligned with their role as routine distributors rather than creators of valuable intangibles. The tax authorities often use a bright-line test, comparing AMP expenses as a percentage of sales by the related party distributor with those of comparable uncontrolled distributors to determine the excess that should be recovered as a service fee for creating or enhancing marketing intangibles of the foreign entity. This has led to extensive litigation, as distributors argue that, in the absence of an express agreement, such expenses should not trigger a transfer pricing adjustment.

Given the difficulty of accurately determining whether these expenses lead to the creation of marketing intangibles, many distributors have faced significant adjustments and disputes with the tax authorities. To address these challenges, it is essential to align transfer pricing policies with the actual economic functions of the business. A careful assessment of the functional profile should be undertaken to determine whether the distributor contributes to generating marketing intangibles.

In cases where a distributor does not add significant value to the products, the RPM is often more appropriate than the TNMM. RPM, which focuses on gross profit margins, often provides a better reflection of the distributor's actual functions. Companies should also use statistical and quantitative analysis to substantiate the choice of RPM over TNMM. By analysing the correlation between SG&A expenses and gross profit margins, companies can more effectively demonstrate that their transfer pricing policies align with their operations' economic realities without requiring separate compensation for marketing efforts. This data-driven approach supports the selection of appropriate comparables and justifies the transfer pricing method used.

In situations where a distributor is determined to be undertaking functions that contribute towards creating or enhancing marketing intangibles or consistently incurs AMP / SG&A expenses significantly exceeding those of comparables, the tax authorities have allegedly made TP adjustments seeking compensation for such activities as service fee leading to significant tax exposure. Alternatively, where it is determined that the Indian distributor would end up contributing to the creation of marketing intangibles, it is recommended that

they should explore applying the residual Profit Split Method (PSM) for the determination of arm's length price. The residual PSM would ensure that the Indian distributor is a participant in the overall losses (if any) in the supply chain and that the MNE group does not end up paying taxes in India by continuing to apply a one-sided method.

Although the application of PSM is complex and requires a detailed analysis of value drivers and the relative contributions of each entity involved, it offers a more accurate reflection of the economic realities of the business, particularly in scenarios where both the Indian entity and the foreign parent are engaged in value-creating functions. Applying PSM helps mitigate the risk of transfer pricing disputes in India, especially in cases involving marketing intangibles. It demonstrates to tax authorities that profits are allocated in line with each entity's economic contributions, thereby reducing the chances of adjustments and litigation. It has been observed that APA authorities are pragmatic and have accepted the application of residual PSM for distributors who significantly contribute to the group's overall value chain.

Indianisation of Integrated Principal Structure

The integrated principal structure, a common business model for multinationals, where a principal company, typically located in a low-tax jurisdiction, holds the legal title to goods that are manufactured in low-cost jurisdictions through contract/toll manufacturers and controls the entire supply chain through LRDs / marketing support service entities. However, due to India's regulatory restrictions, this model is not feasible in its traditional form, resulting in the trapping of entrepreneurial profits when the Indian subsidiary undertakes both manufacturing and distribution activities.

To address this challenge, companies often adopt a modified version of the integrated principal structure for India, wherein the Indian subsidiary is treated as a licensed manufacturer or a value-added/licensed distributor and limiting its returns in India through royalties, commission and management charges. A part of the trapped entrepreneurial profits can be repatriated under this modified version. However, this arrangement results in multiple pay-outs from India to the foreign parent or principal, often leading to limited returns or losses in the Indian subsidiary's books, which are frequently challenged by the tax department.

On the contrary, a non-integrated principal model may be considered by MNE groups, wherein the foreign entity continues to perform significant people functions and assumes major risks while the Indian subsidiary performs limited manufacturing and distribution activities. Under this model, residual profits are repatriated to foreign entities as 'bundled royalties'/ industrial franchise fees (IFF) after providing for routine activities in India. IFF may be defended by Comparable Uncontrolled Price Method, corroborated by residual PSM. This model achieves more or less economic results similar to those of the integrated principal structure. Careful planning and documentation are critical to ensure that this structure aligns with both Indian regulations and global business models. While this non-integrated principal model provides a robust framework for addressing the issue of trapping entrepreneurial profits in India along with the potential transfer pricing issues that arise for multiple payouts, the APA route offers an additional layer of certainty and relief to taxpayers. Through the APA process, taxpayers can secure approval for their transfer pricing policies under the non-integrated principal model, thereby reducing the likelihood of future adjustments and fostering a more predictable business environment.

Warehousing in India

The distribution function may also entail warehousing for the foreign supplier, and such an establishment in India may lead to a fixed place permanent establishment (PE) risk. In certain tax treaties entered by India, there is a specific exemption for 'delivery' activities constituting a PE in India, whereas the same benefit is not available with many treaty partners. Challenges remain in ascertaining whether delivery is only a subset of the distribution supply chain or whether the foreign principal is engaged in a comprehensive distribution set-up accompanied by marketing agents and logistics support service providers. Attribution of profits to such warehousing operations in the customer jurisdiction, while hitherto considering low value adding, has been subject to rethink in the international sphere. A scrutiny of such business operations in the context of large multinational trading companies having warehouses in Free Trade Warehousing Zones (FTWZ) is crucial.

Navigating the transfer pricing landscape in India is undoubtedly challenging, particularly for MNEs employing various distribution models. However, by understanding the underlying issues and adopting a strategic approach that includes substance-based characterisation, the application of the Residual PSM where required, and the Indianisation of integrated principal structures, companies can effectively manage their transfer pricing risks. Coupled with the pragmatic approach of pursuing APAs, these strategies provide a pathway to achieving compliance, reducing litigation, and ensuring long-term certainty in India's dynamic market.

While navigating these complexities, foreign investors should remember that there are solutions available - solutions that not only align with the regulatory environment but also protect the business's financial interests. With the right strategies in place, one can unlock the full potential of the Indian market while maintaining control over tax obligations.

2. Defining the Undefined: The Tangibility of Intra-Group Service Charges[48]

In the increasingly interconnected world of global business, Multi-National Enterprises (MNEs) often rely on intra-group services to enhance operational efficiency, achieve economies of scale, and leverage specialised expertise. These services, particularly management service charges, are vital to the smooth functioning of MNEs. However, in India, they also present significant challenges for both taxpayers and tax authorities. The core issue often revolves around demonstrating the receipt and tangible benefits of these services, which has led to extensive litigation and varied judicial interpretations. It is vital to understand these challenges, the importance of robust documentation, judicial precedents and regulatory developments, and potential avenues for resolving disputes.

Challenges Faced by Indian Subsidiaries

Indian subsidiaries of foreign MNEs frequently find themselves under the scrutiny of tax authorities concerning intra-group service charges. The primary points of contention are whether the services were genuinely rendered by the foreign related parties, whether these services provided a measurable benefit to the Indian subsidiary and how the charges for these services are determined. Tax authorities often argue that the services in question are unnecessary, routine in nature, duplicative, or merely shareholder activities, thereby challenging the legitimacy of the claimed deductions. This scrutiny can result in significant transfer pricing adjustments, where substantial portions of the service charges are disallowed, leading to increased tax liabilities for the subsidiaries.

Besides the transfer pricing challenges, tax demands are often levied on failure to withhold appropriate taxes on such management charges. While the domestic law currently provides for a 20%[49] tax withholding on such charges as Fees for Technical, Managerial, and Consulting Services (FTS), the relevant income-tax treaty can offer a NIL [under a 'make available clause'] or a more beneficial tax rate (like 10%) under the treaty. It essentially means that only if the services enable the service recipient in India to absorb and be able to apply the service in future, without recourse to the service provider, then the 'make available' test to quality as what is generally called FIS (Fees for Included Services) will be satisfied and services will become taxable in India.

Judicial Rulings: A Landscape of Divergent Opinions

The Indian judiciary has delivered a series of rulings on intra-group service charges, reflecting a spectrum of interpretations, for instance, in *Gemplus India Pvt. Ltd vs. ACIT*[50], the Bangalore Tribunal disallowed the charges due to the assessee's failure to demonstrate that the fees were commensurate with the actual services received from its Associated Enterprise (AE). The TPO found that the payments were not justified as they were not based on the volume or quality of services rendered, and the costs were allocated based on agreements rather than actual services provided. Similarly, the Mumbai ITAT in *Deloitte Consulting India Pvt. Ltd. vs DCIT*[51] held that the TPO could arrive at NIL arm's length price when the assessee fails to provide adequate details or evidence regarding the services purportedly rendered by the AE.

48. This article is contributed by Aditya Hans (Partner, Dhruva Advisors) and Ashish Jain (Principal, Dhruva Advisors)
49. Surcharge and cess additional
50. [2010] 3 taxmann.com 755 (Bangalore)
51. [2012] 150 TTJ 824 (Mumbai)

Conversely, there have been favourable rulings for taxpayers as well. The Delhi High Court, in **EKL Appliance Ltd. vs DCIT**[52], emphasised that the necessity or prudence of an expenditure should not be questioned by the tax authorities as long as the expenditure was incurred "wholly and exclusively" for business purposes. A similar principle was held by the Delhi Tribunal in the case of *McCann Erickson India Pvt. Ltd.*[53] and Bangalore Tribunal in the case of *Festo Controls Pvt. Ltd.*[54] and *Vinarom Ltd.*[55] The Delhi Tribunal, in the case of *AWB India Pvt. Ltd. vs DCIT*[56], supported the assessee's claim, noting that the nature of the services received was well evidenced through emails, phone calls, reports, etc. and criticised the TPO for disregarding these details. Similarly, the Hyderabad Tribunal, in the case of *TNS India Pvt. Ltd. vs. ACIT*[57], acknowledged the complexities involved in proving the tangibility of intra-group services, emphasising that while direct evidence may be challenging to produce, the overall conduct of business and the detailed documentation provided by the assessee supported the legitimacy of the management fees. A similar principle was upheld by the Delhi Tribunal in the case of *GE Money Financial Services Pvt. Ltd. vs ACIT*[58] and the Mumbai Tribunal in the case of *Dresser Rand India Pvt. Ltd. vs DCIT*[59].

Given the contentious nature of intra-group service charges, maintaining comprehensive and voluminous documentation is not just a best practice – it is a necessity. Service agreements must be detailed, outlining the nature of the services, terms of engagement, and anticipated benefits. The documentation should include a robust benefit test evidencing receipt of services and demonstrating the economic or commercial value derived from those services. Evidence such as emails, reports, meeting minutes, and third-party invoices are a few of the documents that are vital in substantiating these claims. Additionally, transparent and reasonable cost allocation methodologies, supported by external certifications where necessary, are critical to substantiate the basis of determining the service charge. Detailed records, including service deliverables, reports, and time logs from the service-providing entity, further bolster the taxpayer's position.

It is important to note that after an adjustment by the tax officer during a scrutiny assessment, the first two appellate forums function primarily as fact-finding authorities. Any relief based on the submission of satisfactory documentary evidence is typically only achievable at the second appellate forum, the Income Tax Appellate Tribunal (ITAT). The resolution of such disputes generally takes a minimum of five to six years, and by the time a decision is reached, similar adjustments may have been applied for three to four subsequent years, following the precedent set by the tax authorities. The process of substantiating these charges across various appellate levels is both tedious and cumbersome, warranting significant time and management resources. Further, while the High Courts (the next appellate forum after ITAT) are not entitled to entertain any question of facts and the favourable outcome from ITAT is unlikely to be challenged, the tax authorities may still pursue the litigation before the High Court following the

52. [2012] 250 CTR 264 (Delhi)
53. [2012] 24 taxmann.com 21 (Delhi)
54. [2014] 62 SOT 1 (Bangalore)
55. [2007] 104 ITD 234 (Bangalore)
56. [2015] 166 TTJ 521 (Delhi)
57. [2014] 163 TTJ 576 (Hyderabad)
58. [2016] 179 TTJ 588 (Delhi)
59. [2013] 55 SOT 167 (Mumbai)
60. [2023] 454 ITR 121 (SC)

Supreme Court's ruling in the case of Sap Labs[60], stating that the transfer pricing principle was not applied in accordance with the provisions of the Act.

Attempt to certainty through Safe Harbour Rules

Recognising the challenges in this area, the Central Board of Direct Taxes (CBDT) introduced Safe Harbour Rules specifically for intra-group services in 2017. These rules aim to simplify the determination of arm's length prices for certain low-value-adding intra-group services, thereby reducing compliance burdens and the potential for disputes. Key features of the Safe Harbour Rules include a maximum mark-up of 5% on costs for 'eligible services', simplified documentation requirements, and a transaction threshold limit of INR 10 crore (~USD 1.25 million). These provisions offer a more streamlined approach to transfer pricing, particularly for routine intra-group services.

Despite the advantages, the Safe Harbour Rules are not without its limitations. Notably, 'eligible services' exclude certain services, such as sales support, marketing support services, IT services, R&D, and BPO services, which normally form part of overall service offerings by the MNE group. Additionally, the threshold limits may be too restrictive for larger transactions, leaving significant intra-group service charges outside the scope of these rules. While the documentation requirements are simplified, they still require considerable effort, and the subjectivity involved in determining acceptable documentation can lead to continued disputes.

Alternate Dispute Resolution: A Path to Certainty

Recognising the complexities involved in assessing the arm's length price of such transactions, many taxpayers have turned to the Advance Pricing Agreement (APA) process for a more predictable and less contentious resolution. Interestingly, the APA authorities in India prefer to consider a holistic view, where rather than scrutinising each international transaction in isolation, the authorities often assess the arm's length price across a spectrum of related transactions, including intra-group services, using an aggregate approach. This holistic view allows for a more comprehensive understanding of the business operations and the interplay of various transactions, ultimately leading to a more practical resolution.

In practice, the APA process tends to offer a form of validation for intra-group service charges, provided that the Indian entity demonstrates reasonable profitability in its overall business operations. While this approach may not align perfectly with a strict technical interpretation of transfer pricing rules, it is nonetheless a pragmatic solution that effectively mitigates the risk of protracted disputes. By adopting this strategy, the APA process not only fosters a cooperative relationship with tax authorities but also provides a practical pathway to achieving long-term certainty in tax matters, thereby allowing companies to focus more on their business objectives and less on the uncertainties of litigation.

In the context of withholding tax obligations on the Indian subsidiary, a lower NIL withholding tax (WHT) order can be obtained from the tax authorities to support a NIL or reduced tax position. Besides, since less WHT can be visited with interest and penal consequences, an affiliate in India remitting such management charges can consider WHT at full rate, and the foreign company offering such services may consider an independent favourable tax position in the India tax return to be filed, claiming refund of excess WHT in India. All these strategic considerations can be planned in the context of individual fact patterns.

Intra-group service charges represent a complex and often contentious aspect of transfer pricing for MNEs in India. The challenges associated with proving service receipt and benefit, coupled with the diverse judicial rulings, highlight the importance of meticulous documentation and proactive compliance strategies. The litigation route demands significant resources from the company to maintain comprehensive and voluminous documentation and thereafter substantiate the charge at various appellate forums. The introduction of Safe Harbour Rules is a positive development; however, their limited scope and stringent thresholds suggest that further refinement is needed. By leveraging APAs and Mutual Agreement Procedure (MAP), taxpayers can achieve greater certainty and reduce litigation costs and risks. Ultimately, fostering a cooperative approach between taxpayers and tax authorities, grounded in transparency and robust documentation, is crucial for resolving disputes and creating a favourable business environment

3. GCCs in India: Navigating the Journey from Setup to Maturity[61]

India has emerged as a global hub for Global Capability Centres (GCCs), or captive centres, which provide vital services such as IT, business process outsourcing (BPO), analytics, research and development (R&D), and innovation to multinational enterprises (MNEs) worldwide. Over the past two decades, GCCs have flourished in India, contributing significantly to the Indian economy and the global operations of their parent companies.

India hosts over 1,600 GCCs, employing over 1.66 million professionals, generating approximately USD 35.9 billion in revenue annually. Major global corporations, including JP Morgan, IBM, Accenture, and Google, have set up their GCCs in India, and the country is projected to continue attracting global investments in this space. The steady expansion of GCCs in India has been driven by the availability of a highly skilled and cost-effective workforce, state-of-the-art infrastructure, a mature outsourcing industry, and government incentives in Special Economic Zones (SEZs) and International Financial Services Centres (IFSCs).

The role of GCCs has evolved significantly since their inception. Initially, these centres focused on cost optimisation by providing essential back-office functions such as finance and accounting. Today, they are critical in driving innovation, conducting advanced analytics, leading product development, and serving as strategic partners to their global counterparts. The growing importance of these centres highlights the need for a structured approach in navigating the challenges from a tax and regulatory standpoint, which arise throughout the lifecycle of a GCC, from set-up to maturity.

Setting up GCC in India

Setting up a GCC in India is a multi-step process that requires careful planning and consideration across several key areas, including investment decisions, location selection, legal entity formation, and financial planning. While the process may vary depending on the business model and specific objectives of the GCC, a typical set-up takes 6 to 9 months. The following sections provide a detailed overview of the primary considerations during each set-up stage, with an estimated timeline for each step.

Investment Decision

The first decision when setting up a GCC is choosing between a Direct Investment approach or setting up through an Intermediate Holding Company (IHC). For companies considering international tax treaty advantages, structuring via an IHC can offer benefits, provided it satisfies the Principal Purpose Test (PPT). Additionally, companies must ensure that their investment complies with Foreign Direct Investment (FDI) regulations under Foreign Exchange Management Act, 1999 (FEMA), particularly concerning sectoral caps and restrictions.

Location Selection

Selecting the right location in India for your GCC is a crucial step. India offers several operational environments, including Domestic Tariff Areas (DTA) and incentivised zones such as Special Economic Zones (SEZs), Software Technology Parks of India (STPIs), and Export Oriented Units (EOUs). These zones offer various benefits, such as import duty exemptions, export incentives, etc. Other vital factors to consider include skilled talent availability, a conducive business ecosystem, and proximity to clients and suppliers.

61. This article is contributed by Sudhir Nayak (Partner, Dhruva Advisors) Aditya Hans (Partner, Dhruva Advisors) Sunil Nayak (Principal, Dhruva Advisors) Ashish Jain (Principal, Dhruva Advisors) Nilesh Chandak (Senior Associate, Dhruva Advisors) and Hariram Iyer (Senior Associate, Dhruva Advisors)

Legal Entity Formation

The next step is forming a legal entity. In India, businesses generally choose between setting up a Company or a Limited Liability Partnership (LLP). Broad contours of a comparative analysis between a company and LLP are shown below (the table below assumes that a US parent sets up a GCC in India)

Private Limited Company	Limited Liability Partnership
Effective Tax Rate – 36.39% • Corp Tax @ 25.17% • WHT on dividend @ 15% (India -US DTAA)	**Effective Tax Rate – 34.94%** • Corp Tax @ 34.94% • WHT on profit repatriation @ Nil
Corporate Social Responsibility • Mandatory spend @ 2% of PBT	**Corporate Social Responsibility** • No such requirement
Governing Statute • The companies AcT.2013 • More regulated (mandatory board meeting audit rotation, resolution filing	**Governing Statute** • The Limited Liability Partnership Act,2008 • Less regulated compared to company
Raising funds /valuation / structuring • Can raise funds through multiple instruments • Eligible to receive ECB • Multiple options possible for corporate restructuring (say sale, conversion, merger, demerger, buy-back, share split etc.)	**Raising funds/ valuation /structuring** • Limited options of hybrid instruments • Not eligible to receive ECB • Limited options for restructuring of LLP (say sale and conversion)

A substantial share of GCCs in India are structured as companies. To set up a company in India, the following registrations are primarily required –

- Obtain Corporate Identification Number (CIN) and file Memorandum and Articles of Association
- Apply for Director Identification Number (DIN) and Digital Signature Certificates (DSCs) for directors
- Apply for Permanent Account Number (PAN) and Tax Deduction and Collection Account Number (TAN)
- Apply for Goods and Service Tax (GST) Registration, Import Export Code (IEC) and Trade License
- Apply for Profession Tax (PT) Registration, Provident Fund (PF) Registration and Employees' State Insurance (ESI) Registration

Once the entity is set up, it is critical to draft service agreements appropriately between the GCC and the parent entity to define the scope of work and pricing model.

Capital Structure

Choosing the proper capital structure is essential for long-term financial sustainability. Companies need to evaluate the pros and cons of equity versus debt financing. While dividends on equity are not tax-deductible, interest on debt is, making debt an attractive option for financing. However, interest limitation rules and External Commercial Borrowing (ECB) regulations under exchange control regulations must be considered to ensure compliance.

Infrastructure Setup

Setting up physical and IT infrastructure is a significant step in establishing the GCC. This includes securing office space, obtaining necessary licenses, and setting up IT systems such as firewalls and servers. Careful planning is required to ensure the infrastructure is scalable and secure, mainly when the GCC will handle sensitive or proprietary information.

Financial Planning

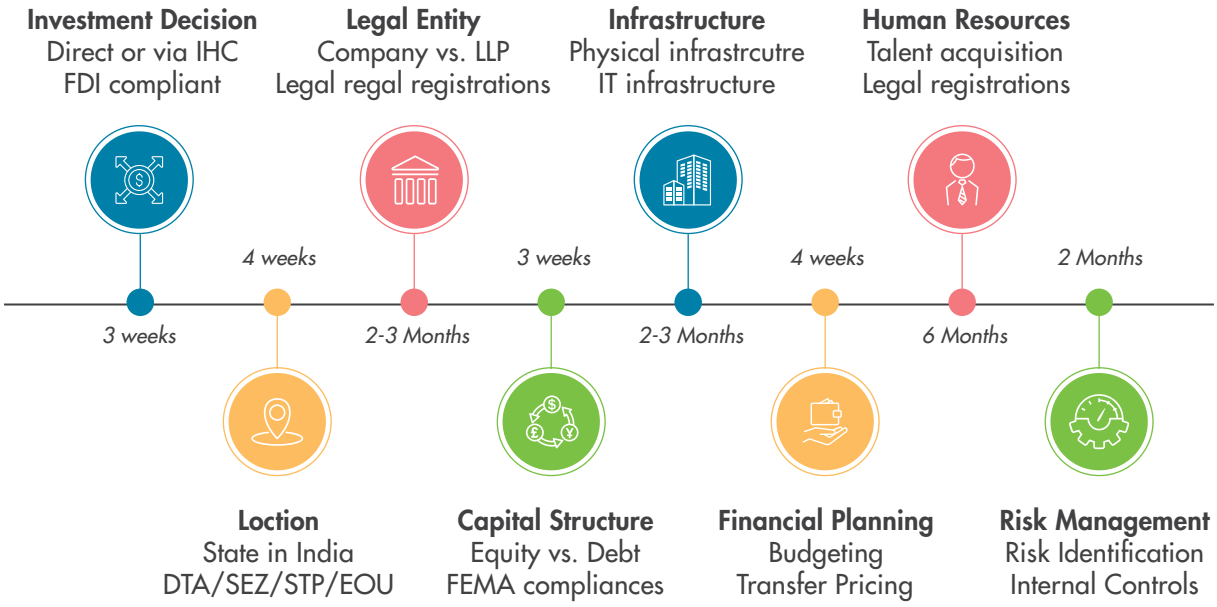
Comprehensive financial planning involves budgeting for both setup costs and ongoing operational expenses. This phase also includes structuring transfer pricing policies, ensuring the inter-company pricing model aligns with Indian regulations, and conducting a FAR (Functions, Assets, and Risks) analysis. Having clear transfer pricing documentation helps prevent future disputes with tax authorities.

Human Resources and Talent Acquisition

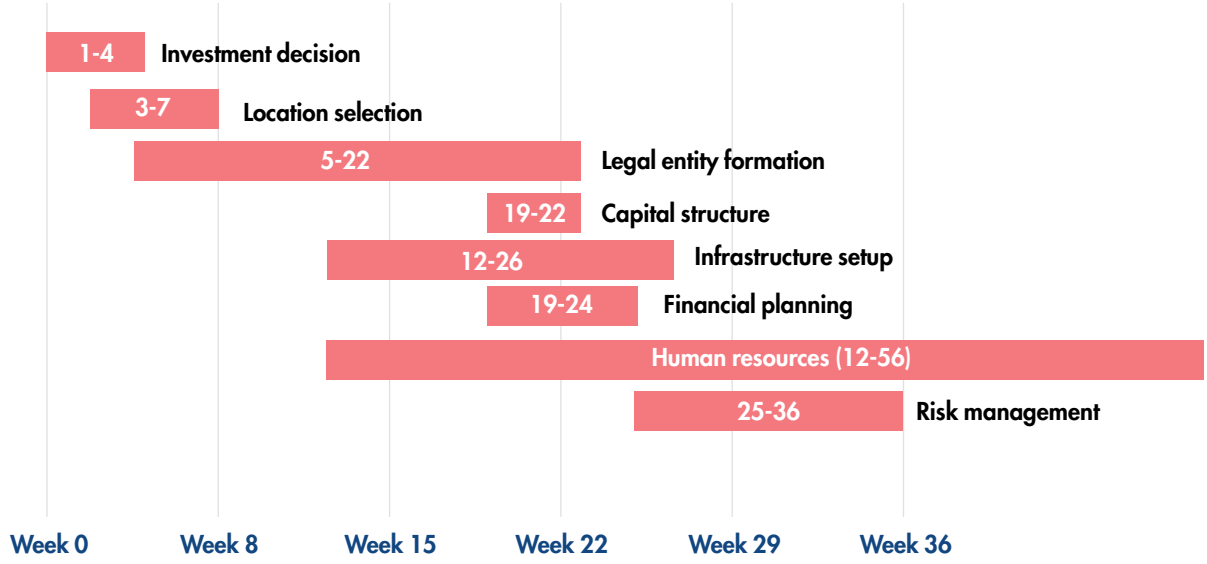
The availability and recruitment of the right talent are critical to the success of a GCC. India offers a large, highly skilled workforce, particularly in sectors like IT, BPO, and R&D. However, companies need to ensure compliance with legal registration requirements related to labour laws, including Provident Fund (PF), Employee State Insurance (ESI), and Professional Tax (P. Tax) registrations.

Risk Management

Risk identification and mitigation are critical to the successful long-term operation of a GCC. Companies must establish a risk management framework that includes internal controls and a business continuity plan to address potential regulatory, operational, and market risks.



The tentative timelines for setup have been captured in the following Gantt chart –



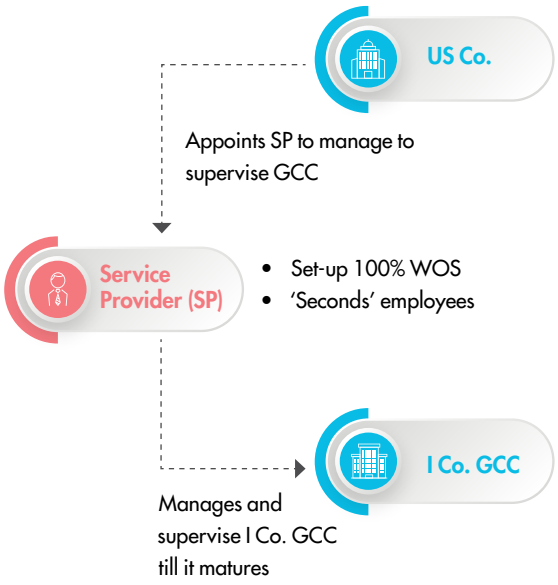
Operating GCCs in India: Business Models, Compliance, and Key Considerations

As Global Capability Centres (GCCs) transition from setup to maturity, their operational phase introduces a range of compliance obligations, regulatory challenges, and strategic decisions around business models. India's regulatory environment demands that companies running GCCs carefully manage their tax and operational compliance while ensuring their business model aligns with global standards and local laws.

Different Business Models for Operating GCCs in India

Once established, GCCs in India operate under several business models depending on the parent company's strategic goals. These models offer varying degrees of control, compliance obligations, and risks and are often selected based on the company's long-term vision for its operations in India.

Conventional Setup

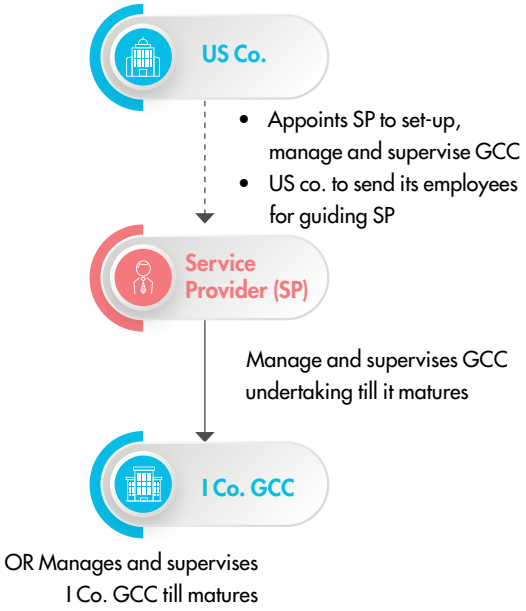


In the **conventional setup,** the parent company (typically a US Co.) establishes a wholly-owned subsidiary (WOS) in India (I Co.). The US Co. sends its employees to the Indian subsidiary to supervise and manage the GCC until it reaches operational maturity.

- **Advantages:** This model allows the parent company to have complete control over the GCC's operations, making it easier to align with global objectives and attract talent as hiring is done under the parent company's brand.
- **Key Considerations:**
  - **Permanent Establishment (PE) Risk:** The secondment of employees can trigger PE risks in India if contracts are not carefully structured. Companies must ensure that secondment arrangements are documented, defining the roles and responsibilities of employees to mitigate PE risks.
  - **Social Security Contributions:** The Indian subsidiary must comply with local labour laws, including contributions to provident funds and social security schemes.

This setup often faces a time lag of about six months before operations can commence due to compliance formalities, but once the GCC matures, it enables a smooth transition to the parent company with minimal operational disruption.

Build-Operate-Transfer (BOT) Setup



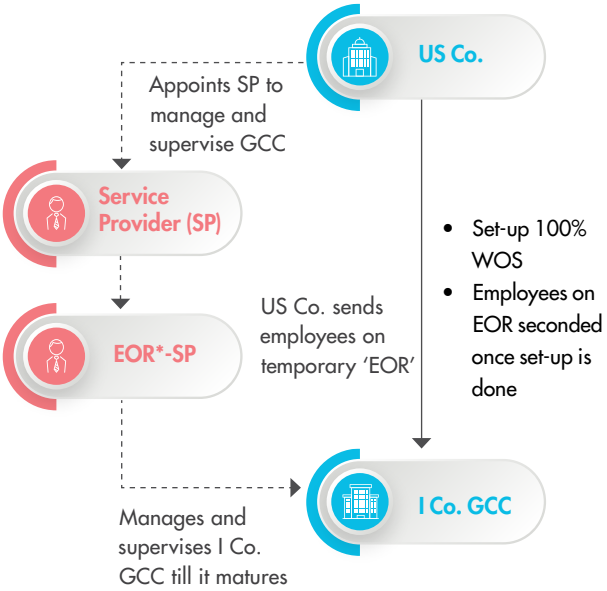
Under the BOT setup, the US Co. appoints a Service Provider (SP) to set up and manage the GCC. The SP manages the GCC's day-to-day operations until the parent company can assume complete control. This model allows for the immediate commencement of operations, even before the Indian subsidiary (I Co.) is fully operational.

- **Advantages:**
  - **Quick Start:** Operations can begin immediately as the service provider is responsible for managing the GCC.
  - **PE Risk Mitigation:** The secondment of employees can trigger PE risks in India if contracts are not carefully structured.

Companies must ensure that secondment arrangements are clearly documented, defining the roles and responsibilities of employees to mitigate PE risks.

- **Key Considerations:**
  - **Talent Acquisition:** Hiring talent under a third-party service provider can be challenging, as candidates may prefer the stability and long-term career prospects offered by direct employment under the parent company.
  - **Tax and Regulatory Implications:** The transition of GCC operations from the service provider to the parent company will involve tax and regulatory implications, particularly around the transfer of employees, intellectual property, and potential asset sales.

Hybrid Setup (EOR Model)



**EOR - Employee on Record*

In the Hybrid or employer-on-record (EOR) setup, the US Co. appoints a service provider to operate the GCC while parallelly initiating the setup of an Indian subsidiary (I Co.). Employees are seconded to the service provider temporarily during the transition period and later transferred to the Indian entity once it is fully set up.

- **Advantages:**
  - This model provides flexibility by allowing the GCC to commence operations immediately while the parent company works on setting up its legal entity in India.
  - It is easier to attract talent since employees will eventually work under the parent company's brand.
- **Key Considerations:**
  - **Secondment and PE Risk:** Similar to the conventional setup, secondment arrangements in the hybrid model can trigger PE risks if not carefully managed.
  - **Social Security and Employee Benefits:** Compliance with local labour laws, including provident funds and social security scheme contributions, is essential for employees seconded under the EOR model.

Key Compliance Requirements for Operating GCCs in India

Once a GCC is operational, it must adhere to various tax, labour, and corporate law compliance obligations. Below is an overview of the essential compliance requirements that GCCs must fulfil monthly, quarterly, yearly, and real-time. Provided below is a snapshot of crucial compliance requirements:

Real-time	Monthly	Quarterly	Yearly
Income Tax - Certificate for foreign remittances	**Income Tax** - TDS /TCS	**Income Tax** - TDS /TCS returns - Advance Tax deposit	**Income Tax** - Tax Audit - ITR and related filings - TP audit & return
Indirect taxes - Bill of entry for import - E – way bills for goods movement - Generation of E-invoices	**Indirect taxes** - GST Returns - SEZ Returns	**Indirect taxes** - Progress reports for SEZ	**Indirect taxes** - GST Annual Return - GST Reconciliation statement - Annual SEZ Return
Others - Intimation filing to RBI for capital account transactions	**Labour Laws** - Social Security contributions & return filing	**Companies Act** - Mandatory Board meetings	**Companies Act** - Statutory Audit - Annual Return - AGM
			Others - FEMA annual return

Cash management for GCCs in India

Effective cash management is crucial for GCCs as it ensures that operational costs are covered, profits are efficiently managed, and cash can be repatriated with minimal tax impact. Proper cash management enables GCCs to maintain liquidity, fund expansion, and optimise their financial structures, which is vital in a competitive global landscape. GCCs typically use a Cost-plus markup pricing model, leading to profit accumulation over time.

GCCs can engage in the following cash management options –

- **Safe Harbour:** Offers certainty in early years when costs are lower.
- **Advance Pricing Agreement:** Helps achieve a lower mark-up, reducing cash accumulation.
- **Litigation Route:** Though it may be aggressive, it can secure lower mark-ups through legal means.
- **Cost Optimization:** Differentiate between principal and vendor costs to manage expenses effectively.

Key Considerations for Operating GCCs in India

Critical considerations for Operating GCCs in India have been encapsulated in the diagram below -

Operating a GCC in India offers MNEs a strategic advantage but also comes with a host of tax, regulatory, and operational challenges. By selecting a suitable business model, ensuring robust compliance, and mitigating risks related to transfer pricing, PE, and labour laws, companies can optimise their operations and contribute meaningfully to the global value chain. Thoughtful planning and adherence to India's tax and regulatory framework will enable GCCs to operate smoothly and achieve long-term success in India.

4. Transfer Pricing – Alternate Dispute Resolution[62]

Both litigation and legislation have significantly shaped the Indian transfer pricing landscape. India is often regarded as one of the most challenging countries for transfer pricing disputes, leading to negative perceptions of the country's business-friendly environment for investors.

The substantial transfer pricing adjustments and lengthy domestic litigation process compelled the Indian government to take measures to resolve these disputes more efficiently and offer taxpayers avenues for reducing litigation by providing advance certainty.

The Government has taken the following steps as alternate dispute resolution mechanisms in the last decade:

- Focus on Advance Pricing Agreement (APA)
- Resolution through Mutual Agreement Procedure (MAP)
- Revision of Safe Harbour Rules (SHR)

The introduction of the APA programme in 2012 and the SHR in 2013 marked a significant shift. The SHR provided a forward-looking approach to managing transfer pricing risks. On the other hand, the MAP focused on resolving past disputes.

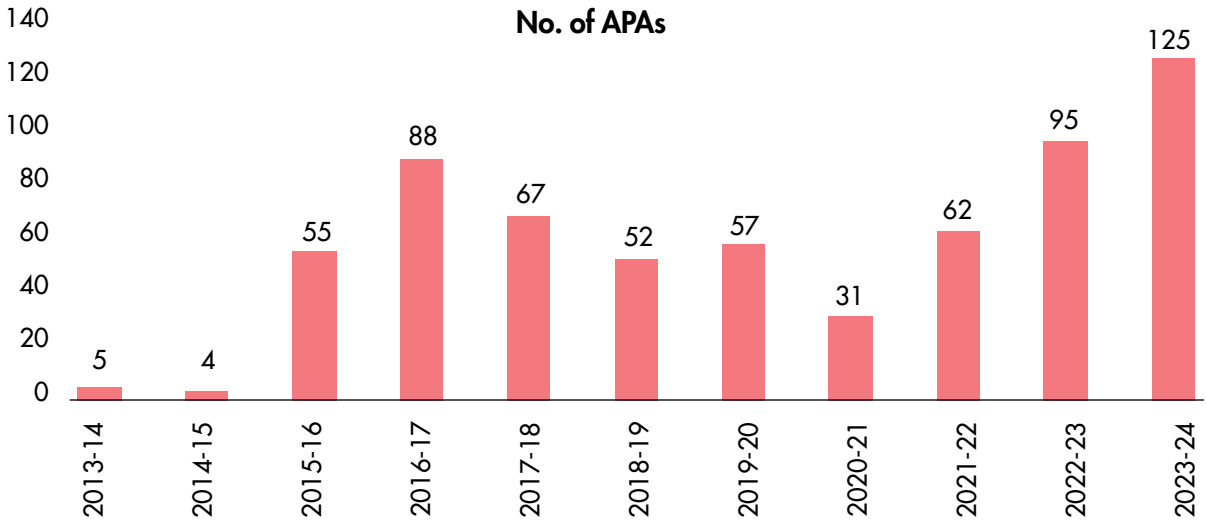
Advance Pricing Agreement (APA)

APA is an agreement between a taxpayer and the tax authority establishing the transfer pricing methodology for the Taxpayer's international transactions. In India, the APA program provides Taxpayers with certainty for up to nine financial years, which includes a five-year prospective period and a four-year rollback. Disputes under an APA can be resolved through either a Unilateral APA (UAPA), an agreement solely between the taxpayer and the government, or a Bilateral APA (BAPA), which involves agreements between two tax administrations and the taxpayers.

Once APAs are concluded, they bind the taxpayer and tax authorities. They serve as an essential policy document as an APA includes the arm's length price of an international transaction between AEs, the transfer pricing methodology to be used to determine this price, the duration for which the APA will apply, and the 'critical assumptions' under which the APA will remain valid. This comprehensive approach ensures that tax authorities and businesses have a clear and agreed-upon framework, fostering a more stable and predictable tax environment for cross-border transactions.

The CBDT has released a report and regular updates which contain statistics about the APA Programme. With 125 APAs signed in FY 2023-24, India recorded the highest number of APAs signed in a year. The total number of APAs since the inception of the APA programme has gone up to 641, comprising 506 UAPAs and 135 BAPAs. India has signed the highest number of BAPA applications with the USA, followed by the UK and Japan and balance with the rest of the world, which includes Finland, South Korea, Ireland, Switzerland, Sweden, Singapore, Germany, Denmark, Netherlands, Italy, Canada, and Australia.

62. This article is contributed by Rahul Mehta (Associate Partner, Dhruva Advisors) and Komal Mehta (Manager, Dhruva Advisors)



Despite starting late compared to other economies, India's APA Programme has shown significant progress. The 500th APA was signed in the 11th year, outperforming some major economies in terms of the number of agreements signed. The US took 14 years to reach this milestone. China, which started its APA Programme in 2005, has signed 226 APAs until 2021. The impact of the APA programme in increasing the ease of doing business is evident from the number of years for which it has brought certainty in transfer pricing matters and reduced litigation. During FY 2023-24, the APA programme has provided tax certainty in respect of more than 700 assessment years.

It is important to note that before the APA programme was introduced, the majority of cases of transfer pricing litigation were faced by captive services companies engaged in IT and IT-enabled services. Today, the highest number of APAs signed pertain to the I-T industry, banking and insurance, and engineering services.

The success of the APA programme and the increased number of signed APAs in the last couple of years have increased the confidence of multinational groups in making new investments in India.

Mutual Agreement Procedure (MAP)

When an adjustment imposed by Tax Authorities results in economic or jurisdictional double taxation, the taxpayer can seek relief through the MAP provided under the Double Tax Avoidance Agreement (DTAA). MAP resolves disputes that lead to double taxation by offering an alternative dispute resolution method. Under MAP, a taxpayer adversely affected can approach the Competent Authority in their country of residence.

As MAP allows corresponding adjustments (i.e., tax adjustments made by one country in response to an adjustment by another to prevent double taxation of the same income), MAP has enabled MNEs to avoid economic double taxation by facilitating corresponding adjustments in the other countries. MAP addresses issues such as transfer pricing adjustments, the attribution of income to Permanent Establishments, and disputes over income characterisation.

The MAP process gained further momentum after a Press Release on 27th November 2017, in which the CBDT clarified and relaxed India's stance on accepting transfer pricing applications for MAP

and Bilateral Advance Pricing Agreement (BAPA) cases, even with countries where Article 9(2) of the OECD Model Tax Commentary is absent.

In November 2024, the OECD published the '2023 MAP Statistics' for jurisdictions participating in the OECD/G20 BEPS framework. These statistics show India resolved 92 transfer pricing-related MAP cases in 2023. There were no instances of MAP access being denied. India's MAP partners for the TP cases included Australia, Switzerland, Germany, France, the United Kingdom, Japan, Korea, Sweden, the United States, etc.

Over the last decade, India has made significant efforts to resolve a higher number of cases through MAP. As per the MAP Guidance issued by CBDT dated 7 August 2020, India has provided an indicative timeline to resolve disputes under a MAP within 24 months, much less than the current average period of 37 months.

Safe Harbour Rules (SHR)

CBDT established SHR to simplify compliance, initially issued in 2013 and extended through various notifications up to FY 2020-21. SHRs lay down circumstances in which income tax authorities can accept the transfer price declared by the taxpayer for particular specific nature of transactions, such as SDS, ITeS, KPO, contract R&D for SDS / generic pharmaceutical drugs, corporate guarantee, low value-added intra-group services, manufacture and export of core / non-core auto components and intra-group loan transactions.

Initially, the Safe Harbour rules were not well accepted as the markup for captive services was considered very high. Accordingly, in 2017, SHRs were revised with a considerable reduction in these rates, restricted only to smaller companies. These revised rates helped increase the number of taxpayers opting for SHRs. However, there have been increased representations at various forums advocating that these rules can be improved further to encourage more taxpayers to participate and get upfront certainty for eligible transactions. As per the Finance Act 2024, the scope of safe harbour rules has been expanded further to increase taxpayer participation and reduce litigation and accordingly, the SHR has been amended in November 2024[63]. As per the said notification, the SHR is now extended to foreign companies engaged in the business of selling raw diamonds in any notified special zone, provided its profits and gains of business exceed 4% of the gross receipts from such business.

The Indian government's consistent efforts to reduce transfer pricing litigation have yielded positive results, gaining global recognition in recent years. The solution-oriented approach of APA and MAP authorities has encouraged more taxpayers to resolve disputes through alternative dispute resolution methods.

63. Notification no. G.S.R. 739(E) dated 29 November 2024

5. Transfer Pricing and Secondary Adjustments[64]

Overview

The concept of 'secondary adjustment' was introduced in 2017 to align transfer pricing provisions with international best practices.

"Secondary Adjustment" refers to an adjustment in the books of accounts to reflect the proper allocation of profits following a primary transfer pricing adjustment. This adjustment ensures that discrepancies between the actual profit and the cash account are corrected. It simply mandates the need to account for and bring back funds to India if a transfer pricing adjustment occurs.

For example, if an Indian company (I Co.) purchases materials from its associated enterprise (F Co.) for INR 100, but the arm's length price is determined to be INR 80, a transfer pricing adjustment would previously only affect the income tax return, leaving a mismatch between the company's actual profits and its books of accounts.

The Secondary Adjustment rule addresses this by requiring the excess INR 20 to be reflected in the accounts and repatriated to India within a specified period.

These Secondary Adjustment regulations are detailed under Section 92CE of the Indian Income Tax Act, 1961, (the Act) and Rule 10CB of the Income Tax Rules, 1962 (the Rules). Section 92CE mandates that any primary adjustment exceeding INR 10 million, applicable from the Assessment Year (AY) 2017-18 onwards, must be repatriated within a defined timeframe.

Applicability of Secondary adjustment

- by the taxpayer, voluntarily, in the return of income;
- by the Assessing Officer and accepted by the taxpayer;
- Resolution of Advance Pricing Agreement (APA);
- by the taxpayer as per the provisions of Safe Harbour Rules (SHR); and
- under the resolution of a Mutual Agreement Procedure (MAP).

Global Practices for Secondary Adjustments

- **Constructive Dividends:** This method treats excess profits from a primary adjustment as dividends, triggering a dividend distribution tax or withholding tax according to local laws. Tax authorities prefer this approach due to the immediate tax inflow. However, challenges arise in applying this method to transactions between fellow subsidiaries and determining whether shareholders can claim foreign tax credits for the taxes paid.
- **Constructive Equity Contributions:** This method treats unrepatriated primary adjustments as a capital contribution to the taxpayer. Although it is a simple approach for parent-subsidiary transactions, tax authorities are generally not favoured due to the lack of immediate impact on taxable income and the regulatory challenges associated with increasing share capital.
- **Constructive Loans:** Unrepatriated primary adjustments are treated as a deemed loan or advance, with interest charged on the outstanding balance. While this method is neutral regarding the relationship between the transacting parties, it presents challenges that may impact subsequent years until repatriation occurs.

64. This article is contributed by Rahul Mehta (Associate Partner, Dhruva Advisors) and Komal Mehta (Manager, Dhruva Advisors)

- Below is the table where secondary adjustments are applicable:

Sr No	List of relevant countries	Applicable
1	China	No
2	Germany	Yes
3	Japan	No
4	Netherlands	Yes
5	Singapore	No
6	South Korea	Yes
7	UAE	No
8	UK	No
9	USA	Yes
10	Switzerland	Yes
11	Sweden	No
12	Finland	Yes

In India, secondary adjustments are considered as constructive loans. If the "excess money" is not repatriated within the prescribed time, such excess money shall be deemed an advance made by the taxpayer to such AE. Further, interest on such advances shall be computed as the income of the taxpayer[65] in the prescribed manner as per Rule 10CB(2) of the Rules.

Time limit for repatriation of excess money and interest rate pursuant to secondary adjustment

The Central Board for Direct Taxes (CBDT) vide Notification No. 52 of 2017, dated 15 June 2017, has issued rules to support the implementation of the above provision by prescribing the time limit for repatriation and the method of computing the interest as follows:

i. at the 1-year marginal cost of fund lending rate of SBI as of 1st of April of the relevant PY + 325 basis points in the cases where the international transaction is denominated in INR or

ii. at 6-month LIBOR as of 30th September of the relevant PY + 300 basis points in the cases where the international transaction is denominated in foreign currency.

While implementing these provisions, certain difficulties were noted regarding the primary adjustment that arises under an APA and MAP. To address these difficulties, CBDT amended the Rules through its notification dated 30 September 2019, further clarifying certain aspects summarised below.

a. Cash repatriation on conclusion of APA (Amended Rule 10CB(iii)[66]:

- If the APA has been entered into on or before the due date for filing a tax return for the relevant fiscal year – On or before 90 days from the date for filing the tax return
- If the APA has been entered into after the due date of filing the tax return for the relevant fiscal year – On or before 90 days from the end of the month in which the APA has been entered.

b. Cash repatriation on conclusion of MAP (Amended Rule 10CB(v))[67]:

On or before 90 days from the date on which the tax officer gives effect to the MAP resolution

65. Section 92CE(2)
66. Substituted by IT (Eleventh Amendment) Rules, 2019, w.e.f. 30th September 2019.
67. Substituted by IT (Eleventh Amendment) Rules, 2019, w.e.f. 30th September 2019.

c. Cash repatriation in case of multiple AEs [Explanation provided in Section 92CE(2)[68]]:

Transactions with multiple AEs present practical difficulties, as allocating primary adjustments and issuing separate invoices for each AE can be challenging. To simplify this, the CBDT's 2019 amendment to section 92CE allows compensation from a single AE, typically the parent entity, on behalf of all AEs.

d. Option to pay one-time tax (Section 92CE(2A) to (2D)[69]:

Taxpayers can opt to pay a one-time additional tax of 18% plus a 12% surcharge on primary adjustments to avoid ongoing interest imputation until the excess money is repatriated. This option eliminates the need for further secondary adjustments, but no credit or deduction is allowed for this tax. The tax payment is final, and interest imputation ceases upon payment.

India's 'secondary adjustment' provision, introduced in 2017, aligns transfer pricing with global standards by requiring the repatriation of excess funds arising from primary adjustments. These rules promote transparency and compliance by ensuring the repatriation of excess funds and providing mechanisms like one-time tax options. Businesses must proactively adopt robust transfer pricing policies, supported by comprehensive documentation, to mitigate risks. As India continues to refine these provisions, companies have the opportunity to navigate complexities effectively and achieve greater certainty in their cross-border dealings.

68. Inserted in Finance Act, 2019
69. Inserted in Finance Act, 2019 w.e.f 01 September 2019

D. Exit considerations

1. Key Considerations for a Smooth Exit[70]

For inbound investors, understanding the available exit options is as crucial as making the initial investment decision. A well-planned exit strategy ensures investors can efficiently close operations, maximise returns, and minimise potential legal or financial risks. Whether due to changes in market conditions, shifting business priorities, or the natural end of an investment cycle, knowing the regulatory landscape and processes for winding down a business helps investors navigate complexities smoothly. Proper foresight into these exit mechanisms is critical to protecting investments and securing a seamless transition when the time comes to exit.

The options available for an Indian entity to exit or shut down operations in India are influenced by various factors. These include, but are not limited to, the entity's legal structure—such as whether it is a private limited company or LLP — as each type has distinct regulatory requirements and procedures for closure. Additionally, the reasons for the exit play a critical role; for instance, a business may seek closure due to financial difficulties, strategic realignment, market exit, or regulatory changes. Other considerations include the company's financial health, outstanding liabilities, the scale of operations, and compliance with local laws and regulations. Understanding these factors is essential for devising a suitable exit strategy that aligns with the entity's circumstances and objectives, ensuring a smooth and legally compliant transition.

Broadly, the options for exit include the sale of the company to a willing third-party buyer, merger of the company with another existing company, voluntary liquidation of the company under the Insolvency and Bankruptcy Code (IBC) or strike off of the company's name under the Companies Act, 2013. Key considerations under each of the options are elucidated below:

Sale of the Indian entity to a third-party buyer

- **General conditions:** This is the most straightforward option wherein only a willing third-party buyer is required as a pre-condition.
- **Time frame:** The timeline for completing exit formalities would generally be about 1 to 2 months, depending on the availability of a buyer.
- **Tax implications:** Capital gains at the time of sale must be evaluated, which could vary depending on the investment holding period.
- **Other considerations:** Valuation requirements must be met under Income Tax law and exchange control regulations.

Merger of the company with another existing company

- **General conditions:** NCLT approval and approvals from sectoral regulators could be required as a pre-condition to give effect to the merger.
- **Time frame:** The timeline for completing exit formalities would generally be about 8 to 10 months, depending on obtaining the relevant approvals.
- **Tax implications:** Indian income tax law prescribes certain conditions for mergers to be tax-neutral.
- **Other considerations:** Valuation requirements could need to be met.

70. This article is contributed by Aditya Hans (Partner, Dhruva Advisors) and Nilesh Chandak (Senior Associate, Dhruva Advisors)

Voluntary liquidation process under IBC

- **General conditions:** An Indian company can initiate voluntary liquidation if it has no debts or can pay its debts in full from the liquidation proceeds. Furthermore, a board resolution from the company's directors is required stating the intention to liquidate the company voluntarily. The company must pass a special resolution within four weeks of the declaration to initiate voluntary liquidation and appoint an insolvency professional as the liquidator. Where the company has debts, creditors representing two-thirds of the debt value must approve this resolution. NCLT approval is required to formally liquidate the entity along with a no-objection certificate (NOC) from relevant authorities (Income Tax, labour welfare regulators, etc.)
- **Time frame:** The IBC voluntary liquidation process generally takes about 12 months (assuming all NOCs are obtained in a timely manner).
- **Tax implications:** Proceeds distributed on liquidation could be treated as deemed dividend to the extent of accumulated profits and capital gains beyond that level. The company could further be required to analyse the availability of DTAA benefits.
- **Other considerations:** No major litigation needs to be ongoing. If the company is subject to ongoing litigation, the tax authorities may not be willing to issue an NOC, which could result in a delay in liquidation.

Strike off of the company's name under the Companies Act 2013

- **General conditions:** A pre-condition for strike off is that the company has failed to commence its business within 1 year of operation or the company is not carrying on any business for a period of 2 immediately preceding FYs and has not made any application within such period for obtaining the status of a dormant company. Furthermore, the company must ensure that before filing an application, it extinguishes all its liabilities and passes a special resolution or obtains the consent of 75% of members in terms of paid-up share capital for applying with the ROC.
- **Time frame:** The strike-off process generally takes about six months (assuming all relevant NOCs are timely obtained). However, given that there should be no active business for two years to trigger this option, the timeline effectively stretches to two and a half years.
- **Tax implications:** Selling assets before strike-off could attract capital gains taxation. The loss arising from extinguishment of shares on strike-off of the company shall be available against other capital gain, subject to certain conditions.
- **Other considerations:** The company's directors could be required to issue an indemnity bond to acknowledge the continuation of their liability on behalf of the company.

Understanding the various exit options is critical for inbound investors seeking to wind down operations in India efficiently. Each option comes with its own regulatory, legal, and tax considerations, making it essential to assess the company's size, financial health, and long-term objectives before deciding on the best approach. While a sale or merger offers strategic realignment or asset monetisation opportunities, voluntary liquidation and strike-off provide more straightforward routes for smaller or dormant entities. Strategies for cash repatriation before exit have been enunciated in Chapter 4 of this section. By carefully evaluating these pathways and seeking professional guidance, investors can ensure a smooth and compliant exit that maximises value and minimises legal and financial risks.

2. Navigating treaty benefits amidst PPT, GAAR and grandfathering[71]

India has a comprehensive network of tax treaties to ensure tax certainty and efficiency of cross-border transactions. Relief under a DTAA depends upon the type of income and the applicability of the relevant provisions. For e.g., business profits can be taxed in the source country only to the extent of profits attributed to a permanent establishment in the source country. In contrast, the DTAA limits the rate to which income in the nature of interest, dividend, royalty or fees for technical services can be taxed in the source country. The lower rate of tax for interest and dividend income under the treaty may be subject to 'beneficial ownership' conditions.

The Indian tax treaties with Singapore and Mauritius restrict taxation of capital gains arising on alienation of shares *'acquired'* before 01 April 2017 (generally referred to as '*grandfathering*') in the source country. However, the DTAA is unclear as to whether such benefits shall be allowed for shares received after 01 April 2017, pursuant to business restructuring or bonus shares against the shares purchased before 01 April 2017.

The DTAA benefits are subject to the fulfilment of certain criteria such as the Principal Purposes Test (PPT) and/or General Anti-Avoidance Rules (GAAR). The treaty benefits shall be denied under the PPT rule if it is proved that *'one of the principal purposes'* for entering into the arrangement was to obtain a tax benefit unless such benefit would be per the object and purpose of the treaty. The revised preamble also restricts the treaty benefits in the case of treaty-shopping arrangements and double non-taxation situations.

The revised preamble and PPT impact Indian DTAAs with various countries, including the Netherlands, Singapore, Australia, United Arab Emirates, Japan, etc. India recently signed a protocol with Mauritius to incorporate the PPT and revised preamble. PPT may also impact the benefits of the Most Favoured Nation clause under DTAAs with Belgium, France, Netherlands, Spain, etc. Similarly, the grandfathering benefit under Singapore and Mauritius can also be challenged on the grounds of PPT. Due to the PPT clause, various structures and arrangements need a relook, e.g., holding structures, tax residency structures, financing arrangements through debt, loans, leasing arrangements, and other repatriation arrangements like dividends, royalties, etc.

India has codified GAAR provisions under the domestic tax laws to discourage tax avoidance practices. Based on the doctrine of 'substance over form,' GAAR may restrict the treaty benefits on income arising from *impermissible avoidance arrangement.* An arrangement would be considered an impermissible avoidance arrangement if the primary purpose of such arrangement is to obtain tax benefits and it lacks commercial substance. Further, the transactions involving round-tripping, accommodating parties, etc., may be subject to GAAR, and the treaty benefits may be denied.

It is also important to note that GAAR and PPT operate simultaneously and need to be satisfied independently. PPT can be applied only to a tax treaty scenario; however, if GAAR is invoked, the benefit of the tax treaties can be denied under the domestic law. GAAR can be applicable when the *'main purpose'* of the transaction is to avail tax benefits. In contrast, PPT can be applied when availing of the tax benefit is *'one of the principal purposes'*. While the applicability of PPT does not warrant prior approval and applies without any threshold, GAAR can be applied only when the tax benefit is more than INR 3 crores for a previous year with prior approval of the collegium of prescribed authorities. Further, GAAR does not apply to income arising on the transfer of investments made before 01 April 2017, whereas no grandfathering relief is available when the PPT clause is invoked.

GAAR and PPT clauses aim to prevent the misuse of domestic laws or tax treaties by targeting arrangements that are primarily structured to obtain tax benefits. Businesses and investors need to carefully design and document their international transactions and structures to ensure that they do not attract GAAR and PPT clauses in order to avoid any potential denial of benefits.

71. This article is contributed by Umesh Gala (Partner, Dhruva Advisors) Mrugen Trivedi (Senior Advisor, Dhruva Advisors) Rushi Shah (Manager, Dhruva Advisors) and Nishi Doshi (Senior Associate, Dhruva Advisors)

3. Addressing taxation challenges in the indirect transfer of shares[72]

Generally, capital gains arising from the transfer of shares in an Indian company by a non-resident are taxable under the Act. To mitigate tax liabilities in India, multinational companies often held shares of Indian companies through intermediate overseas holding companies. Overseas holding company may also be preferred for other non-tax considerations. Under such a structure, the taxpayer could claim that capital gains from the transfer of shares of companies outside India were not subject to Indian tax laws. To counter such tax avoidance strategies and prevent revenue leakage, the Indian legislature introduced provisions to tax capital gains from the 'indirect transfer' of Indian shares, retrospectively from 01 April 1962.

As per the 'indirect transfer' provisions, any capital gain arising from the transfer of a share or interest in a company registered or incorporated outside India is taxable in India if more than 50% of the value of the share or interest is derived from assets located in India. These provisions apply only when the value of the Indian assets exceeds INR 100 million.

The capital gains will be taxed in India only to the extent attributable to assets situated in India. Guidelines for the applicability of 'indirect transfer' provisions are available, but there is a lack of clarity regarding attribution. Without specific guidelines regarding attribution, the complexity and subjectivity involved in attributing capital gain may become a matter of contention between the taxpayer and the tax department. A person responsible for making a payment towards purchase consideration shall be liable to withhold and deposit taxes at source in India. Further, reporting obligation is cast on the Indian concern whose shares are held by overseas intermediate holding companies. An overseas restructuring may involve tax implications in India under the indirect transfer provisions.

Non-resident investors should consider potential relief available under respective tax treaties. The tax implications of capital gains arising from an 'indirect transfer' will vary depending on the language of the relevant Capital Gains article in the tax treaties. For instance, India's tax treaties with the USA and the UK generally allow the source country to tax capital gains in line with its domestic laws. In such scenarios, capital gains from indirect transfers may get taxed in India, and the taxpayer may not get any relief under these tax treaties.

Conversely, some of India's tax treaties with countries like Singapore, Mauritius, the Netherlands, Australia, Germany, and the UAE restrict the source country's right to tax capital gains only to situations where the income arises from the transfer of shares of a company resident in the source country. Indian Courts[73] have examined whether capital gains from indirect transfers qualify for treaty benefits. The courts have held that capital gains from indirect transfers are not taxable under respective tax treaties, such as those with France, Belgium, and Germany.

Given the expansive scope of the General Anti-Avoidance Rules (GAAR) in Indian law and the application of the Principal Purpose Test (PPT), taxpayers must reassess their holding structures. Taxpayers should critically evaluate their positions under relevant tax treaties and maintain thorough documentation to justify the business rationale for setting up such entities in the selected jurisdiction. So long as the principles and requirements of the tax treaties are met, taxpayers can benefit from these agreements. However, interpreting and applying these rules can be complex and may involve legal challenges. Therefore, a comprehensive review and analysis are essential to ensure compliance and proactively address potential issues.

72. This article is contributed by Umesh Gala (Partner, Dhruva Advisors) Mrugen Trivedi (Senior Advisor, Dhruva Advisors) Rushi Shah (Manager, Dhruva Advisors) and Nishi Doshi (Senior Associate, Dhruva Advisors)

73. Sanofi Pasteur Holding SA v. Department of Revenue Ministry of Finance- [2013] 354 ITR 316 (Andhra Pradesh), Sofina S.A. v. ACIT- [2020] 79 ITR(T) 489 (Mumbai - Trib.), Gea Refrigeration Technologies GmbH, In re- [2018] 401 ITR 115 (AAR - New Delhi).

4. Unpacking the tax implications of repatriating funds from India[74]

As India continues to attract global investors with its robust economic growth and vast market potential, non-resident investors often face the challenge of repatriating their profits back to their home countries. Understanding the strategies and regulatory framework for cash repatriation is essential for investors to optimise their returns and ensure compliance with Indian laws.

Cash repatriation is crucial for investors seeking to realise returns on their investments. One of the most common methods is through dividends. Dividend refers to the distribution of profits by a company to its shareholders. It enables fund repatriation to equity and/or preference shareholders of a company. As per domestic law, dividends distributed by Indian companies are taxed in the hands of the non-resident recipient at the rate of 20%[75]. However, Double Taxation Avoidance Agreements (DTAAs) can reduce the tax burden for non-resident shareholders. The Reserve Bank of India (RBI) permits the repatriation of dividends without prior approval, streamlining the process for investors.

Another viable option is earning interest on loans provided to Indian companies. Non-resident investors can repatriate interest earnings, which are typically subject to a 20% withholding tax as per domestic law. However, DTAAs can reduce this tax rate. Compliance with the RBI's External Commercial Borrowing (ECB) guidelines, which include interest rate limits and end-use restrictions, is mandatory to ensure a smooth transaction. Interest on Compulsorily Convertible Debentures CCDs issued by Indian companies to non-resident investors can also be repatriated by them without complying with ECB guidelines. However, Indian companies that borrow from a non-resident who is an associated enterprise of the Indian company will be subject to thin capitalisation rules, i.e., the interest expense will be allowed to the Indian company only to the extent of 30% of EBITDA or actual cost whichever is lower.

For those leveraging intellectual property, royalties and fees for technical services provide a lucrative repatriation method. These payments are subject to a 20%[56] withholding tax per domestic law, which can be lowered under DTAAs. Payments must comply with the regulations under the Foreign Exchange Management Act, 1999 (FEMA) and require proper documentation, including contracts and proof of services rendered.

A less common but effective method is the reduction of share capital, where companies reduce their share capital and pay the amount to shareholders that is more than their needs. Capital reduction involves the reduction of the share capital of a company either by reducing the face value of a share or by cancelling the paid-up or unpaid portion of shares of a company. It provides an exit and fund repatriation from the company to the shareholders. This method can be deployed where the company has a cash surplus but lacks sufficient reserves to distribute funds through dividends. Distribution of funds through capital reduction would be treated as dividends (to the extent of accumulated profits of the company) and capital gains (amount received in excess of accumulated earnings of the company). Reduction of capital involves a Court (National Company Law Tribunal) driven process, which entails a higher time frame. FEMA guidelines in relation to pricing norms will need to be adhered to.

The buyback of shares is another strategic option. Consequent to the Finance Act 2024, for buybacks

74. This article is contributed by Mehul Bheda (Partner, Dhruva Advisors) Nitin Bohra (Associate Partner, Dhruva Advisors) Manjit Bhimajiani (Associate Partner, Dhruva Advisors) Drishti Kankariya (Principal, Dhruva Advisors) and Ketan Sakhala (Manager, Dhruva Advisors) and Nehal Jain (Manager, Dhruva Advisors)

75. Surcharge and cess additional

implemented from 1st October 2024 onwards, the proceeds from buyback will be taxed in the hands of shareholders as dividends, and the cost available in the hands of shareholders will be available to them as a capital loss. Buybacks must comply with the Companies Act, Securities and Exchange Board of India (SEBI) regulations and RBI guidelines.

Another method that is gaining popularity is issuing listed bonus preference shares / debentures to non-residents with RBI approval. The security received as a bonus can be sold after complying with FEMA regulations. Tax implications on such sales should be carefully evaluated.

Critical considerations for non-resident investors include withholding taxes, which can be mitigated through DTAAs. These agreements are crucial for reducing the tax burden and avoiding double taxation. Transfer pricing regulations ensure that transactions between related parties are at arm's length, preventing penalties. Foreign exchange regulations governed by the RBI under FEMA are essential for the legal repatriation of funds, and proper compliance and documentation are vital to avoid fines and delays.

An altogether simplistic approach followed by some of the MNCs who routinely generate surplus cash and intend to repatriate the same on an ongoing basis is to choose or convert their entity into a Limited Liability Partnership (commonly referred to as LLP). While the downside here is that the tax rate applicable to LLPs is higher (than the rate applicable to a company) at 34.94%, the better part is profits are tax-exempt in the hands of partners, and the same is fully repatriable as well. One could consider this approach after considering factors such as the pros and cons of choice of entity, availability of tax credit/taxation in the home jurisdiction of partners on the profits earned from LLP, etc.

This overview provides a starting point for exploring the most suitable cash repatriation strategies tailored to specific needs and circumstances.

E. Fund set-ups

1. Establishing a Fund in IFSC in GIFT City: Navigating the Regulatory and Tax Landscape[76]

Entities in Gujarat International Finance Tec-City (GIFT City) registered with the International Financial Services Centre Authority (IFSCA) are treated as non-residents under Indian Exchange Control laws (FEMA) and conduct business primarily in foreign currency, offering fund managers unique opportunities. The IFSCA (Fund Management) Regulations, 2022 govern fund management entities ('FMEs'), classifying them into three categories based on the schemes they can launch i.e., Authorised FME, Registered FME (Retail/ Non-Retail) license.

Pre-requisites for FME Registration

Entities seeking registration as an Authorised FME or Registered FME (Non-Retail) must satisfy several conditions to secure IFSCA approval:

a. **Entity Type:** Can be set-up either as a company, a limited liability partnership (LLP), or a branch of an existing company or LLP.

b. **Appointment of Personnel:** Each FME must appoint a Principal Officer responsible for overseeing the entity's activities, including fund management, risk management, and compliance. A Registered FME (Non-Retail) must appoint a Compliance and Risk Manager. All Key Managerial Personnel (KMPs) must have at least five years of relevant experience and meet specific professional qualifications.

c. **Substance Requirements:** The FME must ensure that the Principal Officer and KMPs are based in GIFT IFSC and that the entity has adequate infrastructure, such as office space, equipment, and communication facilities, proportional to the size of its operations. The portfolio composition must be initiated by an officer based in the IFSC, although non-IFSC employees can contribute to research and analysis.

d. **Fit and Proper Requirements:** The FME, its Principal Officer, KMPs, directors, partners, and controlling shareholders must be deemed fit and proper persons at all times. This entails having a record of fairness and integrity and avoiding disqualification as outlined in the FME Regulations.

e. **Net Worth Requirements:** To manage schemes effectively, FMEs must maintain a net worth of USD 75,000 (for Authorised FMEs) or USD 500,000 (for Registered FMEs (Non-Retail)). Branches can maintain this net worth at the parent level, provided the branch has sufficient funds for day-to-day operations.

f. **Borrowing and Leverage:** Schemes under FMEs can borrow funds or engage in leveraging activities, subject to conditions.

g. **NAV Computation:** FMEs must compute the Net Asset Value (NAV) for venture capital schemes annually and for restricted schemes either monthly (for open-ended) or half-yearly (for close-ended schemes).

h. **FME Contribution:** FMEs must maintain a minimum contribution proportional to the targeted corpus of their scheme as specified by IFSCA.

Setting Up Schemes: Venture Capital and Restricted Schemes

FMEs can establish Venture Capital Schemes (VCS) and Restricted Schemes (non-retail) within GIFT IFSC, each with distinct features and regulatory

76. This article is contributed by Punit Shah (Partner, Dhruva Advisors) and Vishal Lohia (Associate Partner, Dhruva Advisors)

requirements. As the GIFT IFSC Scheme is classified as a foreign territory, such Schemes would be required to invest in Indian securities under the foreign direct investment, Foreign Portfolio investment (FPI) and/ or Foreign Venture capital Investment (FVCI) route. For investment under the FPI and FVCI routes, the scheme must register as an FPI with the Securities Exchange Board of India.

Venture Capital Schemes:

These schemes are classified as Category I AIFs and primarily invest in unlisted securities of start-ups, emerging companies, or early-stage ventures focused on new products, services, technologies, or intellectual property. VCS must have a corpus between USD 5 million and USD 200 million. With investor approval, they must be closed-ended with a minimum tenure of three years, extendable by up to two years.

Restricted Schemes (Non-Retail):

Registered FMEs can launch Restricted Schemes, which can be classified as Category I, II, or III AIFs depending on their investment strategy. These schemes can be open-ended or closed-ended and must have a minimum corpus of USD 5 million. Restricted Schemes investing in unlisted companies can allocate up to 25% of the corpus to such securities. Like VCS, Restricted Schemes must adhere to specific investment restrictions and investor eligibility criteria.

Tax Considerations for GIFT IFSC Entities

Entities in GIFT IFSC, including FMEs and their schemes, are considered residents outside India for FEMA purposes but are treated as residents for income tax purposes. This dual status necessitates carefully structuring GIFT IFSC entities to optimise tax benefits.

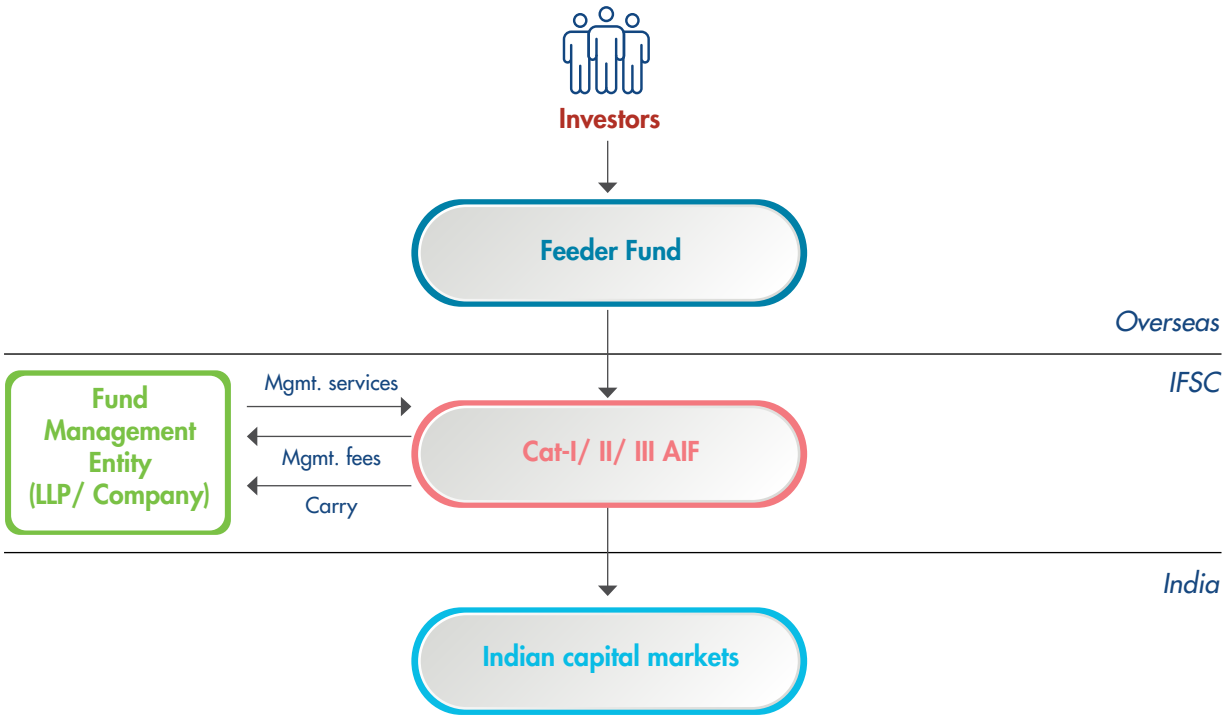
a. **Taxability of Management Fees:** FMEs in GIFT IFSC can benefit from a 100% tax holiday on management fees under Indian tax laws, along with a reduced rate of Minimum Alternate Tax (MAT) or Alternate Minimum Tax (AMT) at 9%. Companies may not be subject to MAT under specific situations.

b. **Taxability of Carry:** Structuring carried interest as performance fees (business income) or capital gains is crucial, particularly given the tax holiday for business income and Goods and Services Tax (GST) exemptions available in GIFT IFSC.

c. **Place of Effective Management (POEM):** Management of GIFT IFSC Funds may not trigger permanent establishment or POEM risks. This is because GIFT IFSC entities are already considered Indian tax residents.

d. **Pass-through Status:** GIFT IFSC schemes classified as Category I or II AIFs enjoy pass-through status under Indian tax laws, meaning income is taxed directly at the investor level. Category III AIFs in IFSC would be taxed at concessional rates, subject to the satisfaction of certain conditions. Other Category III AIFs would be taxed per rates applicable to domestic category AIFs.

A typical structure in IFSC is depicted below:



GIFT City's IFSC presents a compelling opportunity for fund managers seeking to engage in cross-border financial services, particularly within the burgeoning sectors of venture capital and alternative investments. The regulatory framework established by IFSCA, coupled with favourable tax provisions, positions GIFT City as a strategic hub for global financial activities. However, the intricate requirements and conditions laid out in the IFSC (Fund Management) Regulations, 2022 necessitate thorough planning and compliance to fully leverage this financial ecosystem's benefits. Fund managers looking to establish their presence in GIFT City must carefully consider the legal, regulatory, and tax implications to ensure a successful and sustainable operation.

2. Unlocking investment opportunities: NRIs/ OCIs in Indian capital markets via IFSC[77]

The Indian capital markets have historically attracted global investors, including NRIs, OCIs, and Resident Indians, but regulatory caps have limited their participation. Recent reforms by the Securities Exchange Board of India (SEBI), influenced by the Hon'ble Finance Minister's 2019 budget speech, aim to address this issue by leveraging the International Financial Services Centre (IFSC) in Gandhinagar, regulated by the IFSC Authority (IFSCA). These changes seek to enhance access for NRIs and OCIs, aligning with India's position as a global leader in remittance inflows and fostering inclusive investment opportunities. The reforms focus on creating a regulated investment channel into Indian securities via the Foreign Portfolio Investment (FPI) route while addressing concerns over financial irregularities in overseas pooled structures.

Traditionally, NRIs and OCIs have relied on the Portfolio Investment Scheme route, limiting their access to professionally managed funds and overseas pooled structures. SEBI's earlier restrictions on NRI and OCI participation (i.e., individual contributions restricted below 25% and aggregate contributions of 50% of the total corpus) were influenced by concerns over past misuse of Overseas Corporate Bodies (OCBs). However, with IFSCA's assurance of stringent regulatory oversight and risk mitigation, SEBI has considered liberalizing NRI/OCI participation in IFSC-based funds. This move is expected to provide a structured and regulated framework for channelling investments into Indian capital markets, unlocking significant investment potential while safeguarding financial integrity.

In light of the above, effective June 2024, SEBI has permitted 100% contribution by NRIs, OCIs, and RIs in the corpus of the FPIs based out of IFSC in India, regulated by IFSCA with certain disclosure norms under two alternative routes as under:

Alternative route 1:

NRI/ OCI/ RIs investors may contribute up to 100% in the corpus of IFSC-based FPIs where such FPIs will be, inter alia, required to submit copies of Permanent Account Number (PAN) (or other suitable documents in the absence of the same), of all their NRI/ OCI/ RI individual constituents, along with their economic interests in the FPI, to the DDP. In case of non-individual constituents of such FPIs, which are controlled directly or indirectly by one or more NRI/ OCI/ RI individuals, or where NRI/ OCI/RI Individuals together hold 50% or more ownership or economic interest on a complete look through basis, the FPI shall provide the PAN or suitable declaration and identity document of such NRI/ OCI/ RI individuals, along with the percentage of ownership/ economic interest/ control of these NRI/ OCI/ RI individuals in the non-individual entity and the FPI.

Alternative route 2:

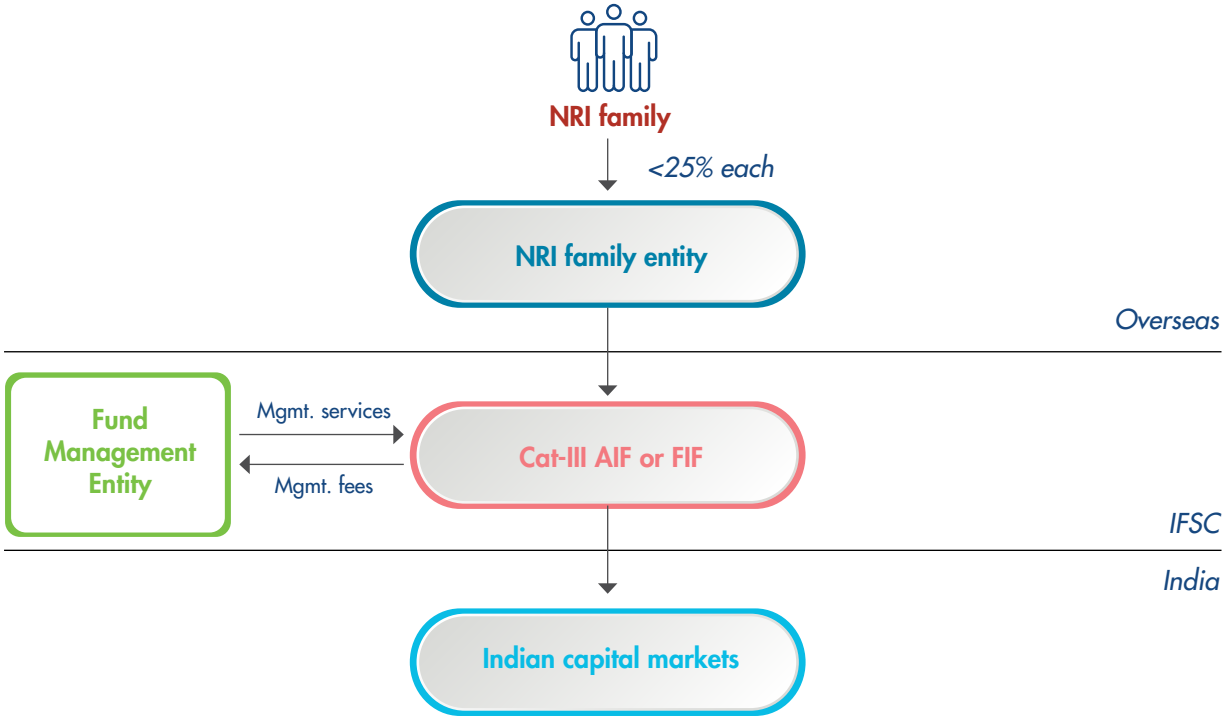
NRI/ OCI/ RI investors may contribute up to 100% in the corpus of IFSC-based FPIs without the FPI being required to submit the documents mentioned above, provided it satisfies certain conditions. Some of these critical conditions are: the fund management entity shall independently take investment decisions without being influenced by the investors in the FPI; such FPI shall be restricted from co-investments; the FPI shall have at least 20 investors with no single investor accounting for more than 25% of the corpus of the FPI; the FPI shall not invest more than 20% of its assets under management in the securities of a single investee company; the investment manager of the FPI is an Asset Management Company of a SEBI registered Mutual Fund which is sponsored by a Bank regulated by the Reserve Bank of India or its IFSC based subsidiary/ branch.

77. This article is contributed by Punit Shah (Partner, Dhruva Advisors) and Vishal Lohia (Associate Partner, Dhruva Advisors)

The FPI in IFSC would be required to obtain a fund management registration and a family investment fund (FIF) license (tailored for NRI families) or a Category III Alternative Investment Fund (Cat III AIF) license as well. Currently, the Indian income-tax laws exempt non-resident investors (including NRIs/ OCIs) of Cat III AIFs from obtaining a PAN, subject to certain conditions. However, the same is inconsistent as PAN would now be required (under the alternative one mentioned above) in the future, as noted by SEBI for NRIs/ OCIs proposing to be part of FPIs based in IFSC.

Given the developments mentioned above, NRIs/ NRI families considering accessing the listed capital markets can now explore their investments through an FPI entity in IFSC, subject to certain conditions.

As mentioned above, NRIs may consider a FIF structure or a Cat-III AIF to invest in Indian capital markets via IFSC. Diagrammatic representation of a typical structure in IFSC for NRI families accessing the Indian capital markets:



Both options will additionally require an FPI license in IFSC. The two options can be evaluated on various parameters, such as possible constituents, licenses/ registration required, minimum corpus, minimum investor contribution, income streams, ability to raise capital from third-party investors, substance requirements, and taxation, before finalizing an appropriate structure.

Also, various aspects, such as the form (company, limited liability partnership, trust) of the FME entity/ FIF/ Cat-III AIF, and capital structure, would need to be considered before implementing the structure in IFSC.

The relaxation of investment norms for NRIs and OCIs in IFSC-based FPIs marks a new era in the Indian financial landscape. This progressive framework promises to enhance the ease of investing in India's burgeoning capital markets, paving the way for a more inclusive and dynamic investment environment.

F. Make in India

1. Strategic Shifts in Trade: India's Foreign Trade Policy 2023[78]

India's Foreign Trade Policy (FTP) 2023 marks a significant evolution in its approach to global trade, aligning with its aspirations to be a leading player on the world stage. Spearheaded by dynamic export sectors like information technology services, engineering goods, and pharmaceuticals, India's export landscape has witnessed remarkable growth, with exports hitting unprecedented levels in FY 2022-23. As the country continues to weave itself into global value chains, FTP 2023 is set to enhance export competitiveness further and attract foreign investments, paving the way for sustained economic growth.

Effective 01 April 2023, FTP 2023 replaces the previous policy, Foreign Trade Policy 2015-2020, which had been extended due to the COVID-19 pandemic. This new policy is a testament to India's evolving trade ambitions, with a clear target of achieving combined exports of goods and services worth USD 2 trillion by 2030. By leveraging strategic initiatives, easing regulations, and negotiating key trade agreements, FTP 2023 seeks to amplify India's global trade presence.

The policy encompasses various programs designed to boost exports and streamline operations, including Export Oriented Units (EOUs), Electronics Hardware Technology Parks (EHTPs), Software Technology Parks (STPs), Bio-Technology Parks (BTPs), and Special Economic Zones (SEZs). These initiatives offer many benefits, including duty-free imports, tax exemptions, and simplified regulatory processes. For instance, the EOU Scheme allows manufacturing and service sectors to import benefits. The SEZ Scheme, governed by the SEZ Act of 2005, continues to offer tax exemptions and a duty-free environment for export-centric units.

FTP 2023 also introduces a range of tax incentives for new businesses, including the Advance Authorization Scheme (AA), Export Promotion Capital Goods Scheme (EPCG), and duty drawback through a deemed exports framework. These incentives are particularly beneficial for handicrafts, agriculture, and pharmaceuticals. Simultaneously, India is negotiating Free Trade Agreements (FTAs) with various countries to boost export-oriented manufacturing. These agreements address critical

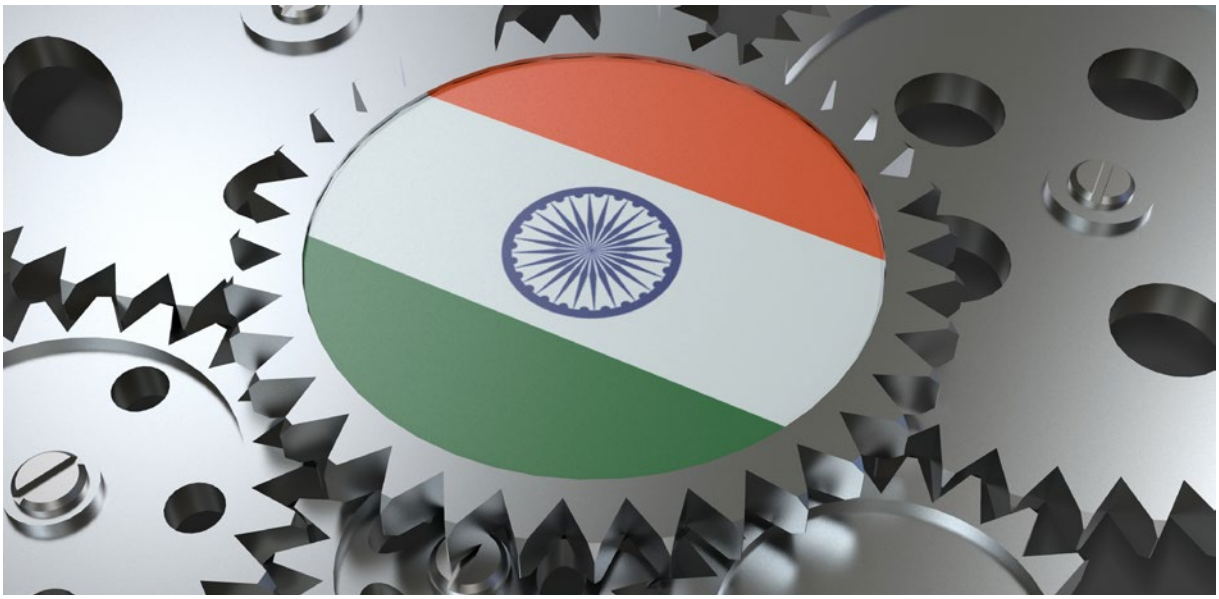
78. This article is contributed by Kulraj Ashpnani (Partner, Dhruva Advisors) and Kiran Tehlani (Senior Associate, Dhruva Advisors)

issues such as tariff reductions, service trade regulations, data localisation, intellectual property rights, and investment promotion.

Beyond the core initiatives, FTP 2023 offers various benefits to foster growth across multiple sectors. The policy includes the Export Promotion Schemes such as the Remission of Duties and Taxes on Exported Products (RoDTEP) and the Rebate of State and Central Taxes and Levies (RoSCTL), which help neutralise the taxes and duties levied on exported goods, thereby enhancing export competitiveness. It also supports small and medium enterprises (SMEs) through programs like the Niryat Bandhu Scheme, which provides mentorship and guidance to new and emerging exporters. Furthermore, the policy encourages the adoption of sustainable practices in export industries, offering incentives for green and environmentally friendly products.

Despite its ambitious goals, FTP 2023 faces critical challenges that could impact its effectiveness. While innovative, the policy's reliance on district-led development and digital platforms may encounter hurdles in implementation. Additionally, the success of cross-border e-commerce initiatives hinges on the rapid improvement of digital infrastructure and logistics. Though aligned with WTO regulations, shifting from export incentives to tax remissions could create uncertainty among exporters, particularly those who have long relied on these incentives.

FTP 2023 presents a positive overall outlook for India's trade environment. The policy's emphasis on enhancing export competitiveness, attracting foreign investments, and embracing digital trade represents a forward-looking approach that aligns with global trends. By addressing the critical areas of infrastructure, regulatory processes, and trade facilitation, FTP 2023 lays a strong foundation for sustainable economic growth. Developing new Towns of Export Excellence (TEE) and extending FTP benefits to e-commerce exports are promising, as they signal India's commitment to fostering a dynamic and interconnected trade ecosystem. Overall, the policy's strategic initiatives and adaptability position India well for continued growth on the global stage.



2. India's PLI and Fiscal Incentive Schemes: Opportunities, Challenges, and the Road Ahead[79]

In recent years, global supply chains have faced unprecedented disruptions due to the COVID-19 pandemic and the escalating trade tensions between the United States and China. These challenges have reshaped the geopolitical landscape, prompting multinational corporations to reconsider their dependency on China. This shift has given rise to the "China-plus-one" strategy, encouraging companies to diversify their supply chains and manufacturing bases to other developing economies, with India emerging as a key contender.

Recognising the potential to capitalise on this shift, the Indian Government launched the 'Atmanirbhar Bharat' initiative in FY 2020, aiming to bolster domestic manufacturing capabilities and position India as a global manufacturing hub. The Production Linked Incentive (PLI) scheme, introduced in March 2020, is central to this initiative. The PLI scheme is designed to enhance India's manufacturing sector by providing financial incentives that increase competitiveness, attract foreign direct investment (FDI), generate employment, and create global manufacturing champions.

Initially, the PLI scheme targeted specific sectors such as electrical components (including mobile phones), pharmaceuticals, and medical devices. However, the scheme has since expanded to encompass 14 sectors with a substantial outlay of INR 2.17 Lakh Crore (approx. USD 25.37 Billion). By design, PLI Schemes incentivise eligible manufacturers for the incremental sales they achieve over a base year. Incentives typically range from 2% to 10% and are granted over a period of 4 to 6 years. The PLI Scheme marks a departure from the earlier fiscal policies, which either offered 'tax holidays' for a fixed period or subsidies as a percentage of investments made. Thus, the PLI Schemes reward high-performing manufacturers based on their investments and sales growth.

In alignment with the broader goals of the Atmanirbhar Bharat initiative, the Indian Government has introduced additional schemes to promote various manufacturing sectors. One such initiative is the 'Modified Programme for Semiconductors and Display Manufacturing Ecosystem,' launched with an outlay of INR 76000 Crores (approx. USD 0.92 billion). This program offers fiscal support covering 50% of the project cost for installing semiconductor and display fabrication units in India.

Another noteworthy initiative is the FAME-India Scheme, aimed at accelerating the adoption of electric vehicles (EVs) in India. Launched in April 2015, the scheme provided upfront incentives for EV purchases. Its second phase, introduced in April 2019 with a more significant outlay of INR 10000 Crores (approx. USD 0.12 billion), concluded in March 2024. During this phase, the electrical two-wheeler market in India experienced exponential growth, underscoring the scheme's success. The burgeoning EV industry is now advocating for extending the FAME-India Scheme to sustain this momentum.

While the potential of these schemes to transform India's manufacturing landscape is immense, their current design and implementation pose some challenges. Bureaucratic hurdles in the approval process, delays in incentive disbursement, high capital requirements, and annual targets (in the form of increased capital investment, domestic value addition, etc.) are some areas which require moderation. In addition, navigating through the legal landscape of these incentive schemes requires constant dialogue and approvals from government departments.

The Government's proactive interventions and timely policy adjustments (depending upon industry demands, geopolitical conditions, economic landscape, etc.) will be vital in overcoming the challenges associated with these schemes and achieving the vision of transforming India into a global manufacturing powerhouse.

79. This article is contributed by Kulraj Ashpnani (Partner, Dhruva Advisors) and Kiran Tehlani (Senior Associate, Dhruva Advisors)

3. SEZ, EOU, MOOWR - the best bet for export-oriented businesses[80]

India has long been a hub for dynamic businesses seeking growth and new avenues for global trade. The Government of India has launched a series of innovative schemes to boost exports, generate employment, and attract domestic and international investments. Export-oriented businesses have varied programmes to choose from, each offering unique incentives and/or facilitation frameworks. The prominent schemes are the Special Economic Zone, Export Oriented Unit scheme, and Manufacturing and Other Operations in Warehouse scheme. This article explores these programs and how they create a thriving ecosystem for businesses looking to expand their reach in the global marketplace.

Special Economic Zones (SEZs)- A Gateway to Global Markets

SEZs are designated areas that provide world-class infrastructure, operational support, and a range of fiscal incentives to stimulate export-oriented operations. SEZ units are permitted to supply goods and services. These enclaves are considered territories outside India for economic benefits. Income Tax exemptions have been phased out, but SEZ units and developers continue to enjoy exemptions from Customs duties on imports and Goods and Services Taxes (GST) on domestic procurements used for authorised operations.

One of the standout features of SEZs is their focus on the export market, which requires units to maintain a positive net foreign exchange (NFE) balance each fiscal year. While SEZ units are primarily geared toward international trade, they can also cater to the domestic market. This flexibility opens up numerous avenues for business growth. SEZ units are required to undertake and complete specified regulatory formalities and compliances.

With their high-quality infrastructure, policy support, and access to global markets, SEZs represent an attractive proposition for businesses looking to scale internationally while optimising their costs and operations.

Export Oriented Units (EOUs)- Fiscal advantages with strategic flexibility

The EOU scheme, initially introduced in 1981, is designed to incentivise businesses that manufacture or process goods for export. The scheme does not contemplate rendering services. EOUs enjoy exemption from Customs duties on imports of raw materials, capital goods, etc. EOUs are required to pay GST on domestic procurements, which may result in working capital blockage.

EOUs can be established anywhere in India, making them ideal for businesses seeking to set up operations without the geographic constraints of SEZs. To qualify as an EOU, a business must export at least 50% of its total production. EOUs are an excellent option for new and established exporters looking to optimise their operations and increase their global footprint.

With its strategic flexibility and fiscal advantages, the EOU scheme allows businesses to achieve cost efficiencies while focusing on expanding their export markets.

80. This article is contributed by Ranjeet Mahtani (Partner, Dhruva Advisors) and Ruturaj Bhide (Principal, Dhruva Advisors)

Manufacturing and Other Operations in Warehouse Regulations (MOOWR) Scheme- A Strategic Solution for Global Manufacturing

The MOOWR scheme enables manufacturing and other operations in a Customs bonded warehouse but is not designed to cater to a rendition of services. Introduced in 2019, manufacturers can import goods (capital goods and inputs) without payment of Customs duty. There is complete remission of the duties for goods produced and exported; applicable import duty on imported inputs is payable if the finished or imported goods are cleared in the domestic market. Similarly, import duty on capital goods must be paid only when such capital goods are removed from the bonded warehouses.

Initially, the scheme encompassed deferral of all components of Customs duty, viz. basic customs duty, integrated goods and services tax (IGST), cesses, etc. However, by virtue of an amendment in 2023, it was stipulated that IGST and cesses must be paid at the time of import, and only the basic duty component will be deferred. These amendments have not yet been notified; however, once in force, these amendments will substantially impact duty deferment benefits, making the MOOWR Scheme less attractive.

Although the MOOWR scheme offers a working capital advantage that encourages domestic manufacturing for the export market, it is hindered by stringent and complex compliance requirements related to the domestic supply of goods. Besides, units are ineligible for export incentives such as Remission of Duties and Taxes on Exported Products (RoDTEP) and All Industry Rate (AIR) of Duty Drawback.

SEZ, EOU, and MOOWR offer distinct advantages, from world-class infrastructure and tax incentives in SEZs to the flexibility and cost advantages provided by EOUs and MOOWR. By carefully evaluating these options, businesses can optimise their operations, streamline their processes, and access new opportunities for success in India's dynamic export market.

4. Key focus areas to set up a manufacturing or a service unit from an indirect tax perspective[81]

India recently became the 5th Largest Economy in the World and is steadily marching to become the 3rd Largest Economy by 2030. The service Sector is the fastest-growing sector in India and is a significant contributor to India's GDP. India is also a favoured destination for setting up manufacturing facilities for various sectors, especially Automobile and Auto parts, Electronics, Textiles, etc. The multiple initiatives of the Government, such as Make in India, Production Linked Incentive (PLI) schemes, etc., have significantly contributed to attracting Foreign Investments to make India a manufacturing hub. The Government is also making continuous efforts to simplify the taxation ecosystem, aiming to create a conducive, business-friendly environment.

Indirect Tax is an integral part of the taxation ecosystem in India. In 2017, India transitioned into an era of 'One Nation One Tax' by introducing the levy of Goods and Services Tax (GST) on supplies of goods and services (except a few goods outside the purview), subsuming the erstwhile taxes such as VAT, Excise, Service Tax, etc.

Some of the key focus areas under GST Law for anyone looking to set up a manufacturing unit and service unit are enumerated below:

- **GST registration –** Every person carrying on business in India must obtain GST registration if the business's turnover crosses the specified threshold limit during a Financial Year. India follows a federal structure of administration where the Centre and States jointly administer the GST Laws. Thus, a separate GST registration must be obtained in all the states where the business is being carried out.

- **GST returns –** A registered person must file separate monthly GST returns declaring the details of supplies made and Input Tax Credit (ITC) available on the purchases made and accordingly paying the tax. An annual return and reconciliation statement must also be filed if the turnover during a Financial Year crosses a specified threshold limit.

- **GST rates and classification –** The broad categories of GST rates are 5%, 12%, 18%, and 28%. The rate of GST applicable to the supply of any goods or services depends on the HSN (in case of goods) or Service Code (in case of services) classification of the supply.

- **Zero-rated supply and FTP benefits –** The export of goods or services is categorised as "zero-rated" supplies, and the exporters are eligible for benefits in the form of a refund of taxes paid under the GST Law. There are various beneficial schemes, such as Advance Authorisation (AA), Export Promotion Capital Goods (EPCG), Manufacture and Other Operations in Warehouse (MOOWR), etc. formulated under the Foreign Trade Policy to incentivise exporters of goods. Obtaining an Import Export Code (IEC) to undertake any export or import of goods is mandatory.

- **Input Tax Credit –** To avoid the cascading effect of taxes, the GST Law allows the ITC of the GST paid on the goods and services procured and used in the course or furtherance of business, except on certain goods and services specifically restricted.

- **Related party transactions –** Transactions with related parties are generally taxed at Open Market Value irrespective of the value adopted for the supply. Specific valuation Rules have been prescribed for such transactions, which apply to both domestic and international transactions.

81. This article is contributed by Niraj Bagri (Partner, Dhruva Advisors) and Somil Bhansali (Principal, Dhruva Advisors)

- **Advance Ruling –** The GST Law prescribes the mechanism for obtaining Advance Rulings from the Authorities in relation to the supply of goods or services being undertaken or proposed to be undertaken by the applicant. This mechanism helps obtain clarity on taxability, eligibility of ITC, etc., for a business to be carried on. The decision of the Authority is binding both on the applicant and the tax department.
- **Use of Technology –** The implementation of GST Law has reduced the requirement for the physical issuance or submission of documents. The Government has designed an online portal where registration applications are made, GST returns are filed, notices are issued, replies are filed, refund applications are filed, etc. There are separate portals that assist in the generation of E-way bills for the movement of goods and the generation of E-invoices prescribed under GST Law. Manual interaction with the GST Officers is being reduced as much as possible.
- **Structure of entity –** The provisions of the GST law, barring a few procedures and compliances, are uniform for business carried on as a public or private limited Company, LLP, etc.

The government has been proactive in making amendments and issuing clarifications to reduce litigations, simplify procedures and compliances, rationalise rates, etc. One of the major factors is digitisation and in-depth use of technology. Implementing GST has been one of the contributors to India climbing the 'Ease of Doing Business' Index.

5. State Industrial Policy[82]

"Industrial policy" refers to the State government's efforts to shape the economy by targeting specific industrial sectors or areas for the development of economic activities. To spur growth, the State government provides benefits in various forms, such as subsidies, tax incentives, infrastructure development support, protective regulations, and research and development (R&D) support etc.

The State Industrial Policy outlines the framework for developing manufacturing facilities or service industries. The benefits are provided based on the location of the manufacturing set-up, the employment generation potential, especially for the local population, and the size of the capital investment, amongst various other factors. The benefits offered are the highest if the manufacturing set-up is established in the least developed areas of the State and gradually reduces as one traverses to the developed regions. The benefits of the State Industrial policy are available subject to the fulfilment of the eligibility criteria and specified terms and conditions of the policy.

The State Policy can be made for general industries, which are further categorised based on the quantum of investments. The categorisation is generally made of micro, small scale, medium scale, mega industries and ultra mega industries, the last category wherein the investments made are generally upwards of USD 200 to 300 million.

Also, the policies can be made to provide impetus to specific sectors. As an example, the following table illustrates the benefits being given by some of the States to specific industries:

Sr No	States	Sectors
1	Gujarat	Auto and auto components, gems and jewellery, pharmaceuticals and medical devices, green energy, electric vehicles and their components, etc.
2	Maharashtra	Logistics parks, fintech, textiles, electronics, retail trade, cloud computing, etc.
3	Karnataka	Engineering and machine tools, sugar, cement and steel, renewable energy, biofuels, etc.
4	Tamil Nadu	Biotechnology, defence and aerospace, electric vehicles, renewable energy, petrochemicals, speciality chemicals, etc.
5	Uttar Pradesh	Tourism, food processing and dairy, information technology, film, defence and aerospace, etc.

82. This article is contributed by Niraj Bagri (Partner, Dhruva Advisors) and Somil Bhansali (Principal, Dhruva Advisors)

The following table illustrates the potential benefits provided by various state policies.

Sr No	Benefits	Value of benefits
1	Subsidy for capital investment	Reimbursement of certain costs incurred for capital expenditure
2	Interest subsidy on long-term loans	Reduction / reimbursement of a certain percentage of the interest rate amount
3	Stamp duties	Reduction / Exemption
4	Electricity duties	Reduction / Exemption
5	Patent support	Reimbursement as per defined limits on costs incurred for filing
6	Quality certification and testing	Reimbursement of proportionate costs
7	Adoption of technology from recognised institutes	Reimbursement of proportionate costs
8	Research and Development costs	Reimbursement of specified costs up to specified limits
9	Skill enhancement training	Reimbursement of specified costs up to specified limits
10	Input SGST on capital goods	Refund of SGST on capital goods in specified cases
11	Green industry incentive	Reimbursement of a certain percentage of costs incurred for setting up environmental protection infrastructure

To avail the benefit of any State policy, an application is required to be made with the nodal agency and obtain requisite approval. The policies require commencement of production / manufacturing as per stated deadlines, registered sale / lease deed for a period equal to or more than a period of incentive, capping on the percentage of contract labour in the total labour force, capping on the percentage of second-hand machinery in the total fixed assets, etc. To summarise, the State Industrial Policy drives balanced regional development and is the torchbearer for inclusive growth.

Glossary

Abbreviation	Description
AAR	Authority for Advance Rulings
AAS	Advance Authorization Scheme
AD Bank	Authorized Dealer bank
AE	Associated Enterprise
AEOI	Automatic Exchange of Information
AIR	Annual Information Return
ALP	Arm's Length Price
AMP	Advertising, Marketing, and Promotion expenses
AOA	Authorized OECD Approach
AOP	Association of Persons
APA	Advance Pricing Agreement
BAR	Board for Advance Rulings
BEPS	Base Erosion and Profit Shifting
BO	Branch Office
BPO	Business Process Outsourcing
BTP	Bio-Technology Park
CbC	Country-by-country
CbC MCAA	Multilateral Competent Authority Agreement on the Exchange of CbC Reports
CbCR	Country-by-Country Reporting
CBDT	Central Board of Direct Taxes
CBI	Central Bureau of Investigation
CCD	Compulsorily Convertible Debentures
CCI	Compulsorily Convertible Instruments
CCPS	Compulsorily fully Convertible Preference Shares
CRS	Common Reporting Standard
DAPE	Dependent Agent Permanent Establishment
DPIIT	Department for Promotion of Industry and Internal Trade
DSC	Digital Signature Certificates
DST	Digital Service Tax

Abbreviation	Description
DTA	Domestic Tariff Areas
DTAA	Double Taxation Avoidance Agreement
EBITDA	Earnings before interest, tax, depreciation and amortization
ECB	External Commercial Borrowing
ECO	E-Commerce Operator
ED	Enforcement Directorate
EHTP	Electronics Hardware Technology Park
EL	Equalization Levy
EOIR	Exchange of information on request
EOU	Export Oriented Unit
EPC	Engineering, Procurement, Construction
EPCG	Export Promotion Capital Goods Scheme
ESI	Employees' State Insurance
ESOP	Employee Stock Option Plans
FAIU	Foreign Assets Investigation Unit
FAR	Functions, Assets, and Risks
FATCA	Foreign Account Tax Compliance Act
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act, 1999
FIRC	Foreign Inward Remittance Certificate
FIS	Fees for Included Services
FIU	Financial Intelligence Unit
FME	Fund Management Entities
FMV	Fair Market Value
FOCC	Foreign Owned and Controlled operating Company
FPI	Foreign Portfolio Investment / Investor
FTA	Free Trade Agreement
FTP	Foreign Trade Policy
FTS	Fees for Technical Services
FTWZ	Free Trade Warehousing Zones

Glossary

Abbreviation	Description
FV	Fair value
FVCI	Foreign Venture Capital Investment / Investor
GAAR	General Anti-Avoidance Rule
GCC	Group Captive Centre
GDP	Gross Domestic Product
GIFT	Gujarat International Finance Tec-City
GST	Goods and Service Tax
IaaS	Infrastructure as a Service
IBC	Insolvency and Bankruptcy Code
IEC	Import Export Code
IF	Inclusive Framework
IFSC	International Financial Service Centre
IFSCA	International Financial Services Centre Authority
IGST	Integrated Goods and Services Tax
IHC	Intermediate Holding Company
INR	Indian Rupees
InVIT	Infrastructure Investment Trusts
IPO	Initial Public Offering
IRDAI	Insurance Regulatory and Development Authority of India
IT & ITES	Information Technology & Information Technology Enabled Services
ITAT	Income-tax Appellate Tribunal
KMP	Key Managerial Personnel
LLP	Limited Liability Partnership
LO	Liaison Office
LOB	Limitation of Benefits
LRD	Limited Risk Distributor
MAP	Mutual Agreement Procedure
MAT	Minimum Alternate Tax
MBRT	Multi-Brand Retail Trading

Abbreviation	Description
MBTA	Mandatory Binding Treaty Arbitration
MCA	Ministry of Corporate Affairs
MFN	Most Favored Nation
MLI	Multilateral Instrument
MNC	Multi-National Company
MNE	Multinational Enterprises
MOOWR	Manufacture and Other Operations in Warehouse Regulations
NCD	Non-Convertible Debentures
NCLT	National Company Law Tribunal
NFE	Net Foreign Exchange
NOC	No Objection Certificate
NPCI	National Payments Corporation of India
NR	Non-Resident
NRI	Non-Resident Individual
OCB	Overseas Corporate Body
OCI	Overseas Citizen of India
OECD	Organization for Economic Co-operation and Development
PaaS	Platform as a Service
PAN	Permanent Account Number
PE	Permanent Establishment
PF	Provident Fund
PLI	Production Linked Incentive
PMLA	Prevention of Money Laundering Act
PO	Project Office
POEM	Place of Effective Management
PPT	Principal Purpose Test
PSM	Profit Split Method
PT	Profession Tax
R&D	Research and Development

Glossary

Abbreviation	Description
RBI	Reserve Bank of India
REIT	Real Estate Investment Trusts
RERA	Real Estate Regulatory Authority
RoC	Registrar of Companies
RoDTEP	Remission of Duties and Taxes on Exported Products
RoSCTL	Rebate of State and Central Taxes and Levies
RPM	Resale Price Method
SaaS	Software as a Service
SBRT	Single Brand Retail Trading
SEBI	Securities and Exchange Board of India
SEP	Significant Economic Presence
SEZ	Special Economic Zone
SFT	Statements of Financial Transactions
SG&A	Selling, General, and Administrative expenses
SGST	State Goods and Service Tax
SHR	Safe Harbour Rule
SME	Small and Medium Enterprises
SPF	Significant People Functions
STPI	Software Technology Parks of India
STTR	Subject to Tax Rule
TAN	Tax Deduction and Collection Account Number
TIEA	Tax Information Exchange Agreement
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
TRC	Tax Residency Certificate
VRR	Voluntary Retention Route

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