POSITIVE SIGNAL TO FIIS AND FPIs – NO MAT PRIOR TO APRIL 1, 2015

Background

Section 115JB of India's Income-tax Act, 1961 (the "**IT Act**"), provides for taxation of those companies who, despite showing high profits in their books and paying substantial dividends, do not pay or pay only marginal taxes, by taking advantage of the various tax concessions and incentives available under the IT Act. Minimum Alternate Tax ("**MAT**") was made applicable to such companies by deeming a certain percentage of their book profits as taxable income to be computed under Indian company law.

A controversy arose with respect to the applicability of the MAT provisions on Foreign Institutional Investors ("**FIIs**") and Foreign Portfolio Investors ("**FPIs**") mainly due to inconsistent rulings of India's Authority for Advance Rulings ("**AAR**") on the issue. In 2012, in the *Castleton* case, the AAR (departing from its previous rulings) held that MAT was applicable to foreign companies even if they did not have a Permanent Establishment ("**PE**") or a place of business in India. Based on this ruling, the tax authorities issued show cause notices on FPIs and FIIs as to why MAT should not be levied on the capital gains earned by them in the previous years.

FIIs were alarmed, and some of them approached the courts. Moreover, in May 2013, Castleton had already filed a Special Leave Petition in India's Supreme Court challenging the AAR order.

In view of the controversy generated, the Finance Minister rationalized the MAT provisions in the Finance Act 2015, and excluded from MAT the income of foreign companies earned in the form of capital gains, interest, royalty or fees for technical services. However, the amendments only applied prospectively from April 1, 2015, and the tax authorities continued to pursue MAT demands against FIIs and FPIs for previous years.

This prompted the Finance Minister, on May 20, 2015, to constitute a three member committee headed by Justice A. P. Shah ("**APSC**") to look into the matter. The APSC presented its report to the Indian government on August 25, 2015.

APSC report – key pointers

The APSC report has recommended that MAT should not apply to FPIs and FIIs. Some of the main discussion items and reasons as to why MAT should not apply on FPIs or FIIs are as under.

- The intention of the Indian legislature was for MAT to apply only to Indian companies governed by the regulatory requirement of the Companies Act, 1956, and not foreign companies. The argument of the tax authorities that section 115JB of the IT Act merely prescribes a general standard for preparation of financial accounts, which should be followed regardless of whether a company is governed by the Companies Act, is incorrect.

- Normally, FPIs do not have offices or employees of their own in India, and they carry on their decision making activities outside India. The purchase and sale of securities in India is done by a Securities Exchange Board of India ("**SEBI**") registered stockbroker, and the local custodian provides settlement

services to FPIs. None of these entities makes any investment decisions on behalf of FPIs. Therefore, FPIs only act through independent agents without any physical presence in India.

- Applying MAT provisions to FIIs and FPIs will render the separate tax provisions for FIIs and FPIs redundant. Further, regardless of the interpretation given to section 115JB of the IT Act, it cannot apply where a beneficial tax treaty exemption is available. The AAR's *Castleton's* interpretation based on the non-obstante clause in section 115JB is incorrect.

- The 2015 amendments are clarificatory in nature, and, therefore, their prospective application cannot be used to apply a different interpretation pre- 2015.

- Many BRICs and OECD countries do not levy MAT on foreign companies or persons unless they have a physical presence or PE in such countries. India is, therefore, perceived as an exception in terms of its tax treatment of FIIs or FPIs.

Conclusion

The APSC has recommended the government to: (a) amend the IT Act to clarify the "complete inapplicability" of MAT provisions to FIIs and FPIs; or (b) issue a circular clarifying the "complete inapplicability" of MAT provisions to FIIs and FPIs. The Finance Minister is reviewing the recommendations of the APSC, and based on press reports, it appears that a circular affirming the findings of the APSC will be issued shortly.

However, the APSC has not expressed any view on whether a foreign company (other than an FPI) having a PE or place of business in India is covered by the MAT provisions. This issue will have to be decided by the Supreme Court (hopefully, in the *Castleton* case), especially because the APSC has observed that it does not agree with the AAR's ruling in *Castleton*.

In any event, the Indian government's acceptance of the APSC will surely send a positive signal to FPIs and FIIs. This shows that the Indian government is concerned about inconsistency and removal of uncertainties in tax matters.