CBDT NOTIFIES RULES ON FAIR MARKET VALUE

Introduction

Reducing tax litigation has been a key focus area for the Modi government. Several initiatives have been taken by the Central Board of Direct Taxes (the "**CBDT**") in the recent past to significantly reduce disputes and provide relief to taxpayers involved in tedious litigation with the revenue authorities.

The CBDT has also issued several notifications on different issues, and is giving taxpayers an opportunity to engage collaboratively with the Indian government to ensure certainty, efficiency and ease of compliance. The salient features of some of the important CBDT notifications are briefly summarized in this update.

CBDT notifies rules to determine the fair market value and prescribes reporting requirements for indirect share transfers of Indian companies

Under the provisions of the Income-tax Act, 1961 (the "**IT Act**"), the income of a non-resident is deemed to arise in India if it arises, directly or indirectly, *inter alia* through the transfer of a capital asset situated in India. Through the Finance Act, 2012, amendments were made in the IT Act under which an offshore capital asset would be considered to be situated in India if it derived a substantial value (directly or indirectly) from assets located in India. Substantial value was, subsequently, clarified to mean: (i) the value of assets located in India exceeding INR100,000,000; <u>and</u> (ii) the assets in India representing at least 50% of the value of all the assets owned by the offshore transferor entity.

On June 28, 2016, the CBDT notified the rules (the "**Rules**") that specify the manner in which the FMV of the assets of a foreign company with underlying Indian assets should be computed. The Rules also specify the reporting format for the Indian entity in which the foreign entity holds assets in India.

S. No.	***Nature of the Asset***	***FMV on specified date (Refer Note 1)***
1	Shares of an Indian company that is listed on a recognized stock exchange (other than those shares covered at point 2 below)	Observable price of the share on the stock exchange that is the higher of the average of the weekly high and low of the closing prices for six (6) months preceding the specified date, or for the two (2) weeks preceding the specified date.
2	Shares of an Indian company listed on a recognized stock exchange and that are held as a part of the shareholding that confers any right of management or control	FMV = (A+B)/C, where A = the market capitalization of the company based on the observable price of its share on a recognized stock exchange B = book value of liabilities of the company on the specified date C = the total number of outstanding shares.
3	Unlisted shares	FMV to be determined by a merchant banker or an accountant ("**CA**")

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		according to internationally accepted pricing methodology ("**IAPM**") for share valuations on an arm's length basis, increased by the liability value.
4	Interest in a partnership firm, limited liability partnership (LLP), or an Association of Persons (AOP)	FMV will *inter alia* be the value on the specified date as determined by a merchant banker or CA in accordance with IAPM and increased by the liability value, if any.
5	Any other asset	FMV of such assets will be the price that they would fetch if sold in the open market on the specified date as determined by a merchant banker or CA, increased by the liability value, if any.
6	All the assets of a foreign company in the case of a transfer between persons who are not "associated persons" and the consideration for transfer is based on a report prepared by a CA or merchant banker of international repute.	FMV of all the assets of the foreign company shall be the value determined by a merchant banker or CA as increased by the value of the liability, if any.
7	All the assets of the foreign company in case of a transfer (other than a transfer specified at point 6 above)	
(a)	Shares of a foreign company or entity listed on a foreign stock exchange	FMV = A+B, where A = market capitalization of the foreign company based on the observable price of its share on the stock exchange. B = book value of liabilities of the company or the entity on the specified date.
(b)	Share of a foreign company or entity not listed on a foreign stock exchange	FMV = A+B, where A = FMV of the foreign company or entity and its subsidiaries on a consolidated basis as determined by a merchant banker or an accountant in accordance with IAPM. B = the book value of liabilities of the company or the entity on the specified date.

Note 1 – Specified date means: (i) the date on which the accounting period of the company/ entity ends immediately preceding the date of transfer of a share or an interest; or (ii) the date of transfer if the book value of the assets on the date of transfer exceeds the book value of the assets on the date specified above in (i) by 15%.

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8.	Computation of income attributable to assets in India	With the formula: A x B/C, where A = the income from the transfer of the share of the company computed as per the IT Act; B = FMV of the assets located in India as on the specified date, from which the share derives its value substantially, computed in accordance with the Income-tax Rules, 1962 (the "**IT Rules**"); and C = the FMV of all the assets of the company as on the specified date, computed in accordance with the IT Rules.

An Indian entity will have to furnish the information prescribed in Form 49D electronically under digital signature to the concerned jurisdictional tax assessing officer within a period of ninety (90) days from the end of the financial year in which any transfer of the shares of a foreign company incorporated outside India takes place. If the transaction in respect of the shares has the effect of, directly or indirectly, transferring the right of management or control of the Indian company, the information will have to be furnished in Form 49D within ninety (90) days of the transaction.

It is important to note that if the transferor of the shares of the company fails to provide information necessary to make the calculations as per the foregoing formulae, then the income attributable to the assets located in India will be determined in such manner as the tax authority deems suitable.

The Indian company will also have to maintain documents, such as details of: (a) the immediate holding company; (b) other entities in India of the group of which the Indian entity is a constituent; (c) the holding structure of the shares of the foreign company before and after the transfer; (d) any transfer contract or agreement entered into in respect of the shares of any foreign company that holds any asset in India through, or in, the Indian entity; (e) financial and accounting statements of the foreign company which, directly or indirectly, holds the assets in India through, or in, the Indian entity for two (2) years prior to the date of transfer of the shares; (f) information relating to the decision or implementation process of the overall arrangement of the transfer; and other such information. The information and documents specified above will have to be maintained for a period of eight (8) years from the end of relevant assessment year.

Our Comments

Tax certainty and clarity have been the buzz words for the past couple of years and, thus, the Rules were keenly awaited. The Rules cover valuation, reporting requirements, methods to compute taxable income, and prescribe internationally accepted valuation norms, all of which is very welcome.

However, the Rules do cast an onerous burden on the Indian company as regards the reporting requirements, which it may not be able to fulfill if the foreign transferor is not able to provide relevant information or if the Indian subsidiary does not have knowledge of the overall offshore arrangement. For such failures by the Indian company, the tax authorities can attribute the entire income as deemed to accrue or arise in India and charge it to tax. Also, certain indirect share transfers may not be taxable in India due to the beneficial capital gains tax provisions under a particular double taxation avoidance agreement. The Rules seem to suggest that even if income is not taxable in India, the Indian company

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will still have to maintain all relevant transaction information and documents for eight (8) years. This seems to be unnecessary and should be clarified.

Start-ups will not have to pay tax on consideration received in excess of FMV of shares – CBDT notifies tax exemption

Usually, start-up companies with a promising future receive angel or venture capital investment at their initial stage. Given that start-up companies are thinly capitalized, angel investments are typically made at a significant premium. The IT Act contains a provision to tax any consideration received by a closely held company that is beyond the FMV of the shares, on issue of shares to residents in India. However, this provision does not get triggered when the share consideration is received: (a) from a non-resident; or (b) by a venture capital undertaking from a venture capital company or venture capital fund duly registered with the Securities Exchange Board of India; or (c) from notified "classes of persons." For this purpose, the CBDT is empowered to notify any class of persons, paying consideration towards issue of shares to which the provision will not apply.

The Notification

Last month, the CBDT issued notification number 45/2016 (the "**Notification**") notifying that a start-up will also not be subject to tax under the IT Act if it receives consideration beyond the FMV of its shares from an Indian resident (which will include an individual, Hindu Undivided Family, company, firm, association of persons, body of individuals, local authority and every artificial juridical person). Note that an entity is considered a start-up until five (5) years from the date of its incorporation and provided its turnover for any financial year does not exceed INR25 crores (approx. US$3,676,470). Moreover, the start-up entity is required to register with the Department of Industrial Policy and Promotion and to work towards "innovation." It must develop, deploy or commercialize new products, processes or services driven by technology or intellectual property. Pursuant to this Notification, any consideration received by a closely-held start-up company from a resident investor in excess of its FMV, will not be taxable in India.

Our Comments

Start-ups can now issue shares to resident investors at higher than fair market value without worrying about tax consequences. However, note that in order to obtain the tax benefit, a start-up needs to get itself registered with the Department of Industrial Policy and Promotion, and the concern is that out of multiple start-ups that will apply for this certification, not all may be eligible because of lack of clarity of the term "innovation" and such other reasons. Further, it has not been clarified whether the Notification will cover prior investments, and it appears that investments made by angel investors before the date of the Notification will not be covered.

Equalisation Levy Rules, 2016, notified

With an intention to resolve tax challenges in the digital economy, the Indian government had proposed to incorporate the equalisation levy in the Finance Act, 2016 as per the recommendation under the OECD BEPS initiative. Recently, the CBDT notified the Equalisation Levy Rules, 2016 (the "**EL Rules**") and issued a circular stating that the levy will be applicable from June 1, 2016 at the rate of 6% on the amount

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of consideration for any "specified services" received/receivable by a non-resident person from a person residing in India or from a foreign entity having a permanent establishment in India. The term "specified service" has been defined as online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement, and includes any other service as may be notified by the government in this regard.

Our Comments

This tax has been criticized but is here to stay. Some digital services providers like Google may pass on this tax to the service recipient and some may not. Although this levy is in line with the OECD's BEPS mandate, it seems unlikely that a non-resident service provider will be able to claim a tax credit under an applicable tax treaty for the equalization amount withheld. Further, while the application of the levy is currently restricted to transactions with online advertising companies, the Indian government has reserved the right to expand the scope of the levy to other online services at a future date. Press reports suggest that the Indian government has in effect found an indirect way to tax companies such as Google and Facebook, a development that could set the stage for a cross-border digital transactions tax with the potential to drive up costs for advertisers.

GAAR – investments and arrangements now grandfathered up to April 1, 2017

The IT Act contains provisions that provide wide powers to the tax authorities to deal with impermissible tax avoidance arrangements. The General Anti-Avoidance Rules (GAAR) under the IT Act will be effective from the financial year beginning on April 1, 2017. Under notification 49 dated June 22, 2016 (the "**GAAR Notification**"), the CBDT has amended the IT Rules to provide for the non-applicability of GAAR from investments made before April 1, 2017 and for the grandfathering of income from such investments. Note, however, that GAAR will not apply to: (a) an arrangement where the tax benefit in the relevant assessment year does not exceed a sum of INR3 crores (approx. US$441,176); (b) to a foreign portfolio investor ("**FPI**") who has not taken the benefit of a double taxation avoidance agreement and is registered with the Securities Exchange Board of India; and (c) to a non-resident in relation to investments in offshore derivative instruments in an FPI.

Our Comments

In 2015, GAAR was made effective under the IT Act from April 1, 2017. However, grandfathering provisions under the IT Rules were not suitably modified. This has now been corrected by the GAAR Notification. This is a welcome step, and the IT rules now make it abundantly clear that GAAR will only apply on or after April 1, 2017, irrespective of the date of the original transaction or arrangement.

CBDT amends rules on non-furnishing of PAN by non-residents and prescribes alternative documents

The CBDT has issued notification number 53 /2016, F.No.370 142/16/2016-TPL dated June 24, 2016 (the "**PAN Notification**") to grant a relaxation from withholding of a higher rate of tax for certain payments made to non-residents who do not have a permanent account number (PAN) issued by the Indian tax authorities. As per the PAN Notification, non-reporting of PAN by a non-resident will not attract a higher

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withholding tax rate of 20% plus surcharge in respect of payments in the nature of interest, royalty, fees for technical services and payments on transfer of any capital asset, subject to the non-resident payee furnishing specified details and documents to the payer, such as the name, e-mail id, contact number, address in the country outside India of which the payee is a resident, a tax residency certificate of the payee, and a tax identification number.

Our Comments

Going forward, the withholding tax rigors under the IT Act will not apply where the non-resident does not have a PAN, provided the non-resident furnishes the required information and documents to the payer. All in all, the amended provision is welcome and in line with the larger objective of improving the ease of doing business in India.

CBDT notifies foreign tax credit rules

On June 27, 2016, the CBDT issued notification number 54/2016 notifying the foreign tax credit rules (the "**FTC Rules**") wherein a resident tax payer will be allowed a credit for the amount of foreign tax paid by him in a country outside India, by way of deduction or otherwise, in the year in which the income corresponding to such tax has been offered to tax or assessed to tax in India, in the prescribed manner and subject to providing certain documents such as proof of online payment, bank counter foil or challan (receipt) for evidencing payment of tax. Foreign tax under this notification means those taxes generally covered under a double taxation avoidance agreement, but excludes any sum payable by way of interest, fee or penalty on tax. The notified FTC rules will become effective from April 1, 2017.

Our Comments

The FTC Rules will provide a uniform mechanism to obtain tax credit in India for taxes paid abroad. The tax authorities have accepted the suggestion of stakeholders on: (a) the documentation requirements (self certification supported by proof of payment of foreign tax); and (b) the method for claiming credit in respect of income which is taxed in India over the years and in respect of disputed foreign tax. However, the FTC Rules do fall short in certain respects. The FTC Rules do not provide clarity on the: (a) calculation of underlying tax credit and tax sparing credit as envisaged by certain tax treaties that India has entered into; (b) the eligibility to claim foreign tax credit in case of partnership firms (being fiscally transparent entities, where the partners pay the taxes); or (c) in a case where tax disputes are not resolved within the time available for revising the tax return or completion of assessment. One hopes that these areas are also addressed.

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