Nishith Desai Associates

GLOBALIZATION OF INDIA INC.

Key drivers, regulatory overview and various jurisdictional alternatives to structure offshore investments

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GLOBALIZATION OF INDIA INC. - PREFERRED HOLDING COMPANY JURISDICTION FOR OUT-BOUND INVESTMENTS

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I. INTRODUCTION

India has been in recent years, witnessing a spate of overseas investments. While globalization is a key driver, the fundamental that is incentivising India Inc. for their overseas investments, is their quest to grow. Acquisitions, whether domestic or offshore, is the fastest way to growth. A typical demonstration of this was the acquisition of Corus by TATA Steel, which vaulted the combined entity to the fifth position from 56th position it previously held in global steel production capacity.[2] The trend has been asymmetric as far as the sizes of acquisitions are concerned- ranging from early stage opportunities to big-ticket purchases. However, industry classification of the business activities being pursued by an enterprise is a fair indicator of the growth avenues that it may pursue. The total deal valuation for the fourth quarter of financial year 2007-08 for outbound *mergers* & *acquisitions* from India stood at USD 7,197.55 million registering an astounding rise of 216.79% for the same period last year.[3]

Transactions, including mergers and acquisitions are expectedly structured in a manner that should lead to maximum possible cost and tax efficiency. Tax efficiencies to an extent depend on the multinationals' ability to shift profits[4]. Though controversial, it is pertinent that if multinationals are able to shift profits, local tax rates may be less relevant because effective tax payments are small or in certain cases, even zero. The opportunity to shift profits, however, is only available to multinationals that spread across several locations. A company that is active in India and has a subsidiary in one foreign country may not shift profits to the Indian parent, if India has a comparatively higher income tax rates. In contrast, the host tax rate may become especially important if profits of the Indian parent are shifted towards the foreign subsidiary with due deference to applicable transfer pricing norms.

Enterprises that have presence limited to domestic jurisdictions, have various limitations that restrict their ability to react quickly to international market changes. Accordingly, besides tax mitigation, flexibility and speed of operation are the other considerations in devising an offshore structure. 'Structuring' could be either by way of construction or by fracturing. Construction means insertion of one or more layers of structures or routes to make a transaction more efficient, whereas

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[2] The list is compiled from http://www.worldsteel.org/?action=storypages&id=151, but updated below from other sources.
[3] Trends in Mergers & Acquisitions for Q4, 2007-08 from ASSOCHAM Research Bureau. The study report may be accessed at http://www.assocham.org/arb/aep.php
[4] "Who Cares about Corporate Taxation? Asymmetric Tax Effects on Outbound FDI" by Michael Overesch and Georg Wamser.

fracturing could mean breaking up a single transaction into several small parts to make the whole structure more efficient. Factors that are non-economic, typically come into play only with respect to the end jurisdiction where the investment opportunity is sited. Irrespective of its tax regime, no jurisdiction can claim to be the most suitable holding company jurisdiction for outbound investments as that would require confluence of several idealistic characteristics[5] - no withholding tax on dividends, interest or royalty outflows, strong network of investment protection treaties, no levy of local taxes, stamp duty, capital duty or similar taxes, and absence of CFC[6] and similar anti-haven legislations. Further, the ideal location would allow a choice of functional currency, would not tax currency exchange gains, would not have thin capitalisation rules or exchange control limitations and would allow group taxation / fiscal unity. Since such unision of fiscal features have observably, not been achieved within the tax regime of any single jurisdiction, the next best alternative remains structuring investments using a combination of jurisdictional pieces which are brought together to form a picture of tax efficiency. In most cases, an optimized structure will involve multiple layers of holding companies domiciled in one or more jurisdictions to address the tax considerations.

This article seeks to identify the key drivers of structuring foreign investments, considerations for and manner in which a subsidiary for investment holding purposes is being set up and India's offshore investment regime. The last section deals with various jurisdictional alternatives to structure offshore investments with specific references to their domestic tax structure and network of tax avoidance arrangements.

II. EXCHANGE CONTROL STIPULATIONS GOVERNING OUTBOUND INVESTMENTS

Investments, whether inbound or outbound, are governed and regulated by the Foreign Exchange Management Act, 1999 and rules and regulations made thereunder ("**FEMA**") with Foreign Exchange Management (Transfer or Issue of any foreign security) Regulations, 2000 read with all the amendments thereto ("**ODI Regulations**"), being the primary regulations within which framework Indian entities are allowed to make overseas investments.

An *Indian company* can invest in joint ventures or wholly owned subsidiaries ("**JV/WOS**") abroad, which are engaged in a bonafide business activity, up to 400% of the net worth[7] of such investing Indian entity.[8] For the purpose of reckoning net

[5] Fundamentals of International Tax Planning, Raffaele Russo (ed.)

[6] Controlled Foreign Corporation

[7] Limit enhanced by A.P. (Dir Series) Circular No. 11 dated September 26, 2007. The limit of 400% net worth (which is paid up capital and free reserves) is calculated on the basis of the value as per the last audited balance sheet.

[8] The investment may be funded out of one or more of the following sources: (i) out of balance held in Exchange Earner's Foreign Currency Account ("**EEFC**") of the company. If investments abroad were to be funded from such EEFC account which has been maintained in accordance with the Foreign Exchange Management (Foreign Currency Accounts by a Person Resident In India) Regulations, 2000, then the requirement of investment ceiling up to 400% of the net worth (except for investments into financial services sector) will not be required to be complied with; or (ii) drawal of foreign exchange from an authorised dealer in India to the extent of 400% of the company's net worth as on the date of the last

worth of the investing company, the net worth of its holding company (which holds at least 51% in the company) or its subsidiary (in which the company holds at least 51%) may be also taken into account to the extent not availed of by the holding company or the subsidiary independently). Other than direct investment, listed Indian companies can also invest up to 50% of their net worth in shares, bonds/fixed income securities issued by listed overseas companies.[9] Acquisition of an overseas company through equity swap is also permissible, but this would require approval from Reserve Bank of India ("**RBI**") and in certain cases, from Foreign Investment Promotion Board. With respect to overseas investments in the financial services sector, certain additional eligibility criterions would have to be met by an Indian company to invest under the automatic route.[10] It is critical to note that even a step down subsidiary of the JV/WOS investing in a financial services sector is required to comply with the prescribed eligibility conditions. For the purposes of setting up holding companies for structuring outbound investments, the most relevant provision outside those prescribing eligibility criterions is Regulation 13 of the ODI Regulations. The said Regulation is concerned with the post investment / additional changes in existing JV/WOS. While the JV / WOS set up by the Indian party may diversify its activities/ set up step down subsidiary/ alter the shareholding pattern in the overseas entity, however, the Indian party has to report to the Reserve Bank, the details of such decisions taken by the JV / WOS within 30 days of their being approved. These decisions are also to be reflected in the Annual Performance Report required to be forwarded annually to the Reserve Bank in terms of Regulation 15.[11] Accordingly, implementing holding company structures for routing investments may require interacting with the regulators regarding the purpose of setting up of step down subsidiaries, if any, in the concerned offshore jurisdiction.

A *resident individual* on the other hand, may acquire shares of a foreign company by way of issuance under a cashless employee stock option schemes, inheritance from a person whether resident in or outside India or by way of a gift, from a person resident outside India. Separately, an individual resident in India may remit up to US$ 200,000 per financial year for any permitted current or capital account transaction under the Liberalised Remittance Scheme ("**Scheme**").[12] Further,

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audited balance sheet or (iii) out of the proceeds of an ADR / GDR issue without any limits to such outbound investment and without the prior approval of the RBI, subject however to certain conditions.

[9] Regulation 6B of the ODI Regulations.

[10] Regulation 7 of the ODI Regulations prescribes the following prerequisites: 1. net profit during the preceding 3 financial years from the financial services activities; 2. registration with the regulatory authority in India for conducting the financial services activities; 3. obtained approval from the concerned regulatory authorities both in India and abroad for venturing into such financial services activity; 4.fulfilled the prudential norms relating to capital adequacy as prescribed by the concerned regulatory authority in India.

[11] Regulation 15 of the ODI Regulations provides that the Indian party which has made direct investment abroad is under an obligation to: 1. receive share certificates or any other document as an evidence of investment, 2. repatriate to India the dues receivable from foreign entity, and 3. submit the Annual Performance Report to the Reserve Bank every year within 60 days from the date of expiry of the statutory period prescribed by the respective laws of the host country for finalization of the audited accounts of the WOS outside India, or such further period as may be allowed by Reserve Bank.

[12] This is subject to certain restrictions, including that the investment cannot be made directly or indirectly into Mauritius.

general permission is granted by RBI to a resident individual who is a director and shareholder of the foreign company, to acquire qualification shares and rights shares in the foreign company respectively.[13]

RBI has issued a circular[14] whereby such registered *trusts* and *societies* which are engaged in manufacturing / educational sectors, may invest in joint ventures or wholly owned subsidiaries engaged in the same sectors outside India under Regulation 6 of the ODI Regulations. The eligible trusts and societies have to submit their application for making the proposed overseas investments to Reserve Bank of India's for their scrutiny.

Under the Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 ("**VCF Regulations"**), a SEBI registered venture capital fund may invest in equity and equity linked instruments of offshore venture capital undertakings which have an Indian connection (i.e. company which has a front office overseas, while back office operations are in India). Such investments would be upto 10% of the investible funds of a VCF, subject to an overall limit of US$ 500 million. The allocation of investment limits would be done on 'first come- first serve' basis, depending on the availability in the overall limit of US$ 500 million.

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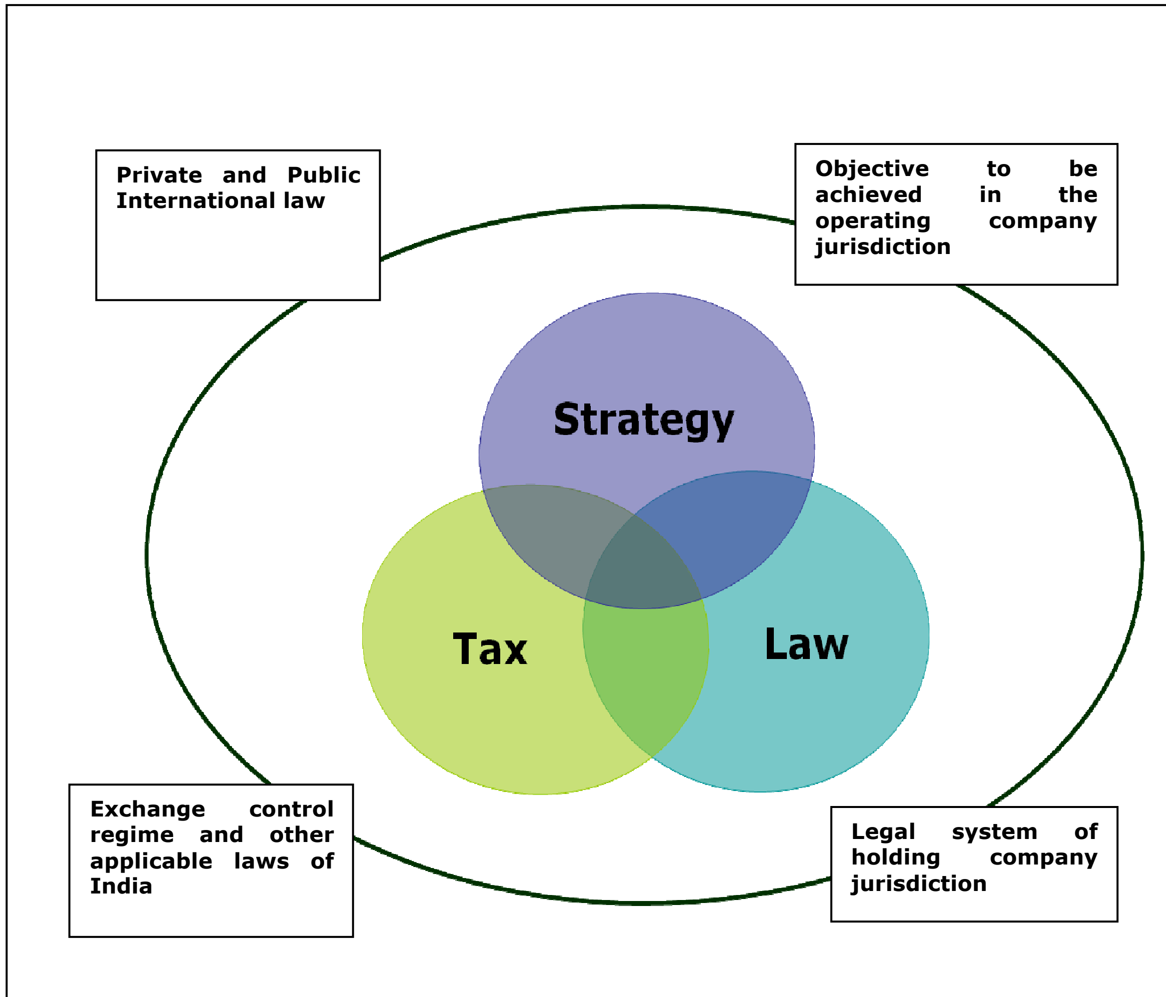
[13] Regulation 24(1) of the ODI Regulations.
[14] RBI/2007-08/387 A.P. (DIR Series) Circular No. 53 dated June 27, 2008.

III. SYSTEM INTEGRATION FOR A TAX EFFICIENT GLOBAL STRUCTURE



The first step for any structuring exercise is to determine the business objectives and strategy of the offshore investment, for example – mergers, acquisitions, intellectual property exploitation, business expansion, exit strategies, etc. Tax, as may get imposed, is sometimes secondary to it. If the enterprise has decided to embark upon a project or has already commenced it, a tax planning exercise has to be undertaken to best mitigate the tax burden on the enterprise accruing from the attending taxable events. The planning for such transaction, as a matter of principle, should ideally be done prior to effecting any transaction or operation geared towards the particular project. Subsequently, tax laws and legal implications need to be analyzed and structured to provide a structure that meets business objectives and assists in compliance with the laws of the local as well as the offshore jurisdiction.

The next issue to be considered is the form in which the transaction would be carried out. From a tax planning perspective, this would include analyzing the nature of the entity to be set up, the different items of tax involved in the project and

computing the tax that would be imposed if the enterprise carries out the transactions in a straight-forward manner.

Having identified the project to be undertaken or the corporate objective to be achieved, it is to be ascertained whether a business presence of the enterprise is required or not. Equity participation, partnership structures work where no local presence is required. Otherwise, a subsidiary or a branch or a liason office[15] of the enterprise company may be set up.

If the enterprise has decided to set up a subsidiary, the next consideration for it would be to determine the manner in which it would finance the subsidiary entity. The decision is crucial, as it is determinative of the nature of its income from the subsidiary. Conceptually, debt has been perceived as a resource not belonging to its holder[16] and accordingly, to the extent debt has been used for the purpose of an enterprise's business, the interest amount paid for servicing the debt is a tax-deductible expense. For similar reasons, remuneration to shareholders by way of dividend payouts is usually, not tax-deductible as it is part of a company's expended resources. The most telling significance of deciding the mix of debt and equity in financing the subsidiary based in a different jurisdiction, is the fact that this determines not only the nature of inflows and its tax characterization and the allocation of taxable profits, but also the very amount of taxable profits for the group as a whole taking all the jurisdictions wherever the group has presence in form or in substance. The differences arise because the interest payments by the subsidiary company can be offset against its operating profits, and accordingly, its taxable income reduces. Whereas, the assessable income of the parent enterprise gets bloated as it receives interest payouts from the subsidiary, an additional stream of taxable income. Understandably, as the extent of use of leverage directly affects the allocation of taxable profits for an enterprise between jurisdictions, tax authorities of various jurisdictions have introduced rules to counter the deductible leverage-linked expenses. Some of these are rules relating to thin capitalisation, application of withholding taxes on interest payouts and strengthening the exchange control regime to regulate the borrowings spread over jurisdictions. Share capital is principally used to finance the foreign subsidiary company as it allows retaining the profits offshore and allows structural flexibility to time the repatriation.[17] Separately, commercial considerations and even the exchange control regime of the subsidiary company may require certain proportion of the financing be done by equity vis-à-vis debt. However, even if the subsidiary has been financed by equity, the repatriation of the profits generated is still not clear of complications.

[15] A liaison office or a project office is set up initially, when the objective is to collect information or marketing and publicity. Most countries do not allow the liason office to carry out commercial activities.

[16] Fundamentals of International Tax Planning, Raffaele Russo (ed.)

[17] Regulation 15 of the ODI Regulations mandates that the Indian party which had acquired foreign security shall receive share certificates or any other document as an evidence of investment in the foreign entity to the satisfaction of the Reserve Bank, it shall repatriate to India, all dues receivable from the foreign entity, like dividend, royalty, technical fees, etc and submit to the Reserve Bank , an annual performance report in respect of each JV/WOS outside India set up or acquired by the Indian party.

Repatriation of equity-financed stake could be by way of dividends and / or capital gains. While dividends are comparatively nominal economic benefits that can be repatriated without disturbing the ownership structure of the subsidiary, capital gains on the other hand leads to erosion of the financing equity itself. Other than debt and equity instruments, a wide range of hybrid instruments could also be used for financing the subsidiary.[18]

Accordingly, most of the planning to achieve tax efficient structures is focused on in what form the profits should be repatriated back.[19] Dividends, interest, royalty receipts and capital gains receive quite different tax treatment both at the domestic and offshore level. It would thus be necessary to consider such differences in deciding, for example, whether an investment should take the form of *dividend-generating equity participation* or an *interest-producing loan*. In the case of industrial and intellectual property, it might be necessary to decide whether the rights should be sold or be exploited by way of a royalty arrangement.

IV. TAXATION AND STRUCTURAL CONSIDERATIONS

Tax considerations remain the key driver in determining the structure adopted for structuring investments, whether inbound or overseas. While exchange control regulations place legal restrictions on outbound investment, taxation places economic restrictions and thus influences the business structure. Investors need to keep in mind the tax regime in their country, the country in which they plan to invest, as well as whether there is a Double Taxation Avoidance Agreement (**"DTAA"**) between the two countries.

Conceptually, while domestic tax is perceived as an obligation, foreign tax is a cost.[20] An obvious consequence of this is that tax payer is expected to use all legal means to organize his affairs in a manner so as to minimize this cost. A double taxation is incidenced when the tax payer is required to pay taxes on the same earnings or assets to two different taxing jurisdictions. Double taxation has been defined as "the imposition of comparable taxes in two (or more) states on the same tax payer in respect of the same subject matter and for identical periods".[21] For these reasons, it becomes essential to use and to ensure that the taxpayer is entitled to the benefits of DTAA between the countries involved in the transaction.

[18] A hybrid instrument is a combination of debt and equity features in varying degree merging the economic benefits of the two. The choice of the hybrid instrument is linked with the nature of the transaction being undertaken. Convertible debt instruments is a typical hybrid instrument which on the one hand allows the issuing subsidiary to take credit of the interest payouts, on the other hand, allows the parent company to receive sufficient equity stake at the time of conversion.
[19] Barry Spitz "International Tax Planning", 2nd edition.
[20] In the words of Mr. Nishith Desai.
[21] OECD Model Convention (1977) and UN Model Convention (1980).

ALTERNATIVE STRUCTURES

There are a wide variety of jurisdictions and entities available for efficient structuring of overseas investments. The overseas *branch* structure allows income earned offshore to be taxed in India on a current year basis, hence, the profits are taxed as and when they arise. Further, losses incurred abroad could be set off against the Indian enterprise. Accordingly, a branch works best for an enterprise that either expects to incur losses initially or enjoys tax holiday, as that would allow to set off the expenditure against the home enterprise's income in India. A branch office however, has to disclose the results of the head office, hence, typically, from a structuring perspective, the home enterprise sets up a subsidiary, which in turn sets up the branch office. A *subsidiary* on the other hand, enjoys the protection of corporate veil and limits the liability of its shareholder – i.e. the parent company. Additionally, a corporate structure allows flexibility in repatriation of profits as either capital gains or interest or dividend. A description of the different types of entities that may be considered for structuring investments is provided below:

1. Offshore Holding Company

One way of effective tax planning could be by way of use of holding companies set up in intermediate jurisdictions for investments in other jurisdictions. An Offshore Holding Company ("**OHC**") is typically set up by corporates incorporated in jurisdictions with comparatively high tax rates due to which the corporate set up a subsidiary entity in an offshore jurisdiction with a tax advantage for minimizing tax liabilities. In general, an OHC may be set up to capture income abroad, achieve tax deferral, and to avail of benefits under DTAAs for the purposes of minimizing global tax incidence and assisting in global tax management. An OHC could also be set up for future restructuring flexibility and for consolidating different ventures under one company while providing oversight functions for the entire group, which could help capture value at one level and could be useful for taking the entity public in a jurisdiction. This could also help the investee company to leverage on the group strength, raise capital and at the same time achieve overall group tax rationalization.

The factors playing an important role in determination of the jurisdiction as to where the offshore holding company should be set up range from the strategy and corporate philosophy of the concerned enterprise, the nature of the revenue stream expected from offshore investment and the regulatory and tax treatment of the country where investment has to be made and the country where the offshore holding company is sought to be set up. If the holding company is intended to play a functional role, then apart from the political and investment climate, the operating corporate laws, ease of administration of the holding company, infrastructure and cost factors also need be taken into consideration. These entire factors however become subsidiary to the domestic tax considerations, which includes the corporate income tax system, and the rates at which stamp duty, service tax, value added tax and other forms of indirect taxes are assessed and taxed.

The Indian context

The Indian Income Tax Act, 1961 ("**ITA**") lays down elaborate provisions with respect to f chargeability to tax, determination of residency, computation of income, et al. Non-residents are taxed only on Indian source income, i.e. income received in India, income that accrues or arises to them in India or is deemed to accrue or arise in India. As per the provisions of the ITA, an OHC should be considered to be a separate legal entity and not be subject to tax in India in respect of its offshore sourced income except if: a) it is a resident in India[22], or b) it has a permanent establishment ('**PE**') in India. Assuming that the OHC would not be resident in India, or have a PE in India, it would not generally be taxed in India. Thus, the Indian corporate / individuals setting up such OHC, would not be taxed in India till the time the OHC declares dividend, or at the time they sell the shares of the OHC at which time, they could be taxed in India on the dividend/capital gain income received from the OHC/accruing from sale of shares of the OHC. On the other hand, if the shares of the portfolio companies held by the OHC were to be transferred by the OHC, the capital gains arising out of such transaction would not be taxed in India and could be retained in the OHC outside India. Thus, the OHC could help achieve the twin objectives of tax deferral[23] and retaining income abroad. Expectedly, OHCs are generally set up in an offshore jurisdiction where there are low to nil taxes then the profits which are accumulated in the tax free climate can be used to fund the requirement of subsidiaries or reinvested for further investment/expansion as required. Separately, from a PE perspective, it is important to note that each entity of the group is to be evaluated separately and accordingly, the group as a whole should not be considered as having a PE.[24] A consequent corollary to this is that while a group entity may have a PE in a jurisdiction, other group entities should not as a matter of natural determination, be perceived to have a PE which has to be decided on a case to case basis for each entity of the concerned group.

To avoid any tax inefficiency arising on account of tax deferrals, (credit for underlying foreign taxes paid on the profits of the paying company may not be available), companies typically try to not repatriate profits accruing to OHCs back home but retain them in the OHC and recycle for overseas investments for financing expansions abroad. India, however, is not alone in having an additional cost on repatriation. US, like India, follows *residence rule* of taxation. Accordingly, till sometime back, a U.S. firm, with overseas operations could indefinitely postpone its U.S. tax on its foreign income by conducting its foreign operations through a foreign-chartered subsidiary corporation which too led to lock up of profits abroad[25].

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[22] The OHC could be considered to be a resident in India if it is *wholly* controlled and managed from India, In such a circumstance, the global income of the OHC could be subject to tax in India.

[23] However, the income would be taxed in India at the time of receipt of dividend income. Further, it may be difficult to claim a tax credit on such income (for the taxes paid in foreign jurisdictions) at that point in time.

[24] Para. 41(1) of the OECD Commentary on Article 5.

[25] In the US, the volume of profits held offshore was so large that a special 'amnesty' was introduced. The American Jobs Creation Act of 2004 ("**Act**") provided a very significant one-time inducement to bring these earnings back to the United States. The Act temporarily reduces the maximum federal income tax rate on such repatriated dividends from 35% to 5.25%. Technically, this reduction is accomplished by allowing the U.S. parent corporation to claim a dividend received

Setting up of a holding company may however not be the answer to all global tax management problems. There has of course been resistance by many jurisdictions including Mexico, where anti-tax haven rules have been implemented to discourage holding companies formed in certain jurisdictions. With a view to curb and to an extent, tax the profits being retained in OHCs, several jurisdictions have formulated legislations which tax OHCs once certain ownership and control is perceived to be in the hands of the resident parent company, and accordingly, such OHCs are deemed, for the purposes of the domestic tax laws of the concerned jurisdiction to be a Controlled Foreign Corporation ("**CFC**").[26] Most countries (example, USA, UK) that have CFC rules, have in place mechanisms such as participation exemptions or underlying tax credits to mitigate the effect of the CFC provisions. Similarly, USA has also implemented anti-inversion rules to prevent abuse of inversions of US corporations into foreign corporations.

The Report of the Working Group on Non-Resident Taxation, chaired by Vijay Mathur and released in January 2003, suggested the introduction of underlying tax credits to boost outbound investments and encourage repatriation of dividends back into India. Simultaneously, it also suggested the introduction of CFC rules. However, it is yet to be seen whether India would follow the footsteps of developed countries like USA and UK and implement these regulations, and also the manner in which these might be implemented.

2. Alternative structures

There are a wide variety of jurisdictions and entities available in the global shopping mall.

As per Indian tax law, a trust is not a separate taxable entity. Taxation of trusts is laid out in section 161-164 of the ITA. Where the trust is specific i.e. the beneficiaries are identifiable with their shares being determinate as on the date of the trust deed, the trustee is assessed as a representative assessee and tax is levied and recovered from him in like manner and to the same extent as it would be

deduction ("**DRD**") equal to 85% of the amount of the cash dividends it receives under this provision from its controlled foreign corporations ("**CFCs**") It is estimated that some USD 350 billion was repatriated under this provision, with one company alone repatriating USD 37 billion.

Source: www.**us**treas.gov/press/releases/reports/finalsecondrepatriationfactsheet.pdf

[26] In general, the rules limiting deferral of offshore income are restricted in scope. Their focus is primarily on 'passive' income (typically those earned out of dividends and certain types of interests and royalties) and income that could be said to have been diverted from domestic taxation without any 'real' activity by the foreign corporation in a 'real' foreign jurisdiction. The Japanese approach to limit such deferral is different to the extent that its legislation instead of focusing on transactions, looks to the location of the principal office or headquarters of the CFC. If the operations are located in a jurisdiction which has no corporate tax or an effective tax rate of 25% or less, then all of the undistributed income, 'passive' or 'active', is taxed **currently** to the Japanese shareholders. 'Currently' signifies that the taxes would be leviable as if it had been remitted to the parent or was the income of the parent, even though there is no actual remittance and the income clearly remains in the legal ownership of the CFC itself.

leviable upon and recoverable from the person represented by him. If the trust is held to be carrying on business, the income of the trust will be assessed at the trust level itself. The income of the trust, once taxed in the hands of the trustee, should not be taxed again in the hands of the investors. However, the nature of transfer from the contributors to the trust, which results in the trust, in the first instance, is also to be understood. If the nature of the transfer is a 'revocable transfer',[27] then in that case, as per section 61 of the ITA, all income arising to any person by virtue of a revocable transfer of assets, shall be chargeable to income tax as the income of the transferor and shall be included in his total income.

Generally, settling a discretionary trust in some offshore jurisdiction would consequent receipt of income from sources outside India and accordingly, there should be no tax implications in India as long as the settlement is not revocable in nature in respect of Indian resident. At the time of receipt of income from the trust, the Indian resident beneficiaries may be subject to tax in India depending on the form and timing of the distribution.

Whether the International investment holding vehicle has been set up as a trust or as an OHC, in both the cases, the investors in their capacity as shareholders of the Company or as beneficiaries of the (discretionary) trust, could be charged to tax depending on the character of the income as received at the time of distribution of the income of the trust. However, it may be difficult to prove that the trust is discretionary in nature, in which situation the income of the trust will be taxed in the hands of the beneficiaries (investor) at the time the trust receives the income. As opposed to a company, a trust is not a separate entity. Since it is envisaged that the trust would be used to hold investments, it may be preferable from a liability perspective, to have a company structure or have a limited liability company to be the trustee of the trust.

At an operating level, a company is usually the preferred structure as compared to a trust. Since it has a separate legal personality, it limits the liability of the investors. It is also effective in establishing residence in a particular country. This is vital for claiming the benefits of a DTAA. A common method is to set up a holding company in a low tax jurisdiction. Low tax jurisdictions, sometimes also known as "tax havens", not only reduce tax liability but also provide investors with an additional shield.

Besides traditional entities such as companies and trusts, recent times have seen a significant growth of partnership structures and other hybrids of partnership structures being used for routing investments abroad. From an investment perspective, the commercial law perception of a partnership is the determinative

[27] A revocable transfer is defined in section 63 of the ITA as follows- "For the purposes of sections 60, 61 and 62 and of this section, (a) a transfer shall be deemed to be revocable if (i) it contains any provision for the re-transfer directly or indirectly of the whole or any part of the income or assets to the transferor, or (ii) it, in any way, gives the transferor a right to re-assume power directly or indirectly over the whole or any part of the income or assets; (b)transfer includes any settlement, trust, covenant, agreement or arrangement."

factor which is the pass-through principles of tax liability being incidence such that the net conclusion is that the profits and losses accruing or arising out of the ventures undertaken by the partnership, is attributed to the partners directly. Regulations 6 and 7 of the ODI Regulations recognize partnerships as being eligible to invest in joint ventures or wholly owned subsidiaries and in financial services respectively. Hybrid structures like Limited Life Companies ("**LLCs**") and Limited Liability Partnerships ("**LLPs**") have also been used globally to setup offshore investments. LLCs are companies, which do not have some of the fundamental characteristics of a company, which are, unlimited life, free transferability of shares, centralized management and limited liability. LLCs are eligible to be treated as partnerships under US tax laws, but they are regarded as companies for corporate purposes-they can enjoy the liability protections of corporations but are not necessarily taxed as corporations. Under the check-the-box rules, businesses can avoid having to carefully structure hybrid entities to realize these benefits. These structures have been marginalized by the 'check-the-box' election regime under the US law.[28] LLPs are essentially partnerships, but all the partners have limited liability. Such entities are popular among law and accounting firms where no single partner may desire unlimited liability and the law would prohibit them from incorporating themselves as companies. Besides these, some other entities that are unique to each legal system. Liechtenstein for example, has *Anstalt* or the establishment, which is a very flexible form of entity. Typically, founders, who may be non-residents, and have a right to appoint beneficiaries, set it up. There is also another entity called *Stiftung* or the Foundation, which is used primarily for the management and investment of family property or for charitable purposes, though it may also have a commercial purpose.

V. OFFSHORE JURISDICTION FOR SETTING UP THE INVESTMENT VEHICLE

There are many business driven motives for setting up holding company structures offshore, which could range from seeking to achieve operational and financial efficiencies and fuctions as a tool for profit, tax and treasury management. Holding company structures may be adopted to consolidate, for management and reporting purposes, the current and future foreign subsidiaries under one foreign holding company structure.

While there is no ideal location for setting up a holding company, there are some jurisdictions whose tax laws provision for special offshore regimes that provide for no or very low statutory rates of tax. DTAAs play an extremely important role in structuring international operations. India has signed over 77 tax treaties. While incorporating a global holding company, the benefits that may be derived from such DTAA should be thoroughly examined. It is important for an outbound investor to

[28] 'Check the box' rules allows a taxpayer to elect to treat an entity as 'disregarded' for US tax purposes. From a CFC point of view, this can lead to a situation whereby the CFC rules will not apply, as the transaction which would have triggered the application of the rules does not itself exist.

keep in mind that some countries (such as the USA) have the concept of "limitation on benefits" or "anti-treaty shopping" under which only residents of the two countries entering into the DTAA can enjoy the benefits of the DTAA. One must bear such anti-abuse provisions in mind before structuring outbound investments.

In identifying the jurisdiction for the location of the OHC, various considerations need to be kept in mind, some of which include *inter alia* political stability of the jurisdiction, ease and expense of administration, availability of reliable administrators, treaty network, exchange controls, domestic tax and legal network and ease of winding up operations. One other very important consideration to be borne in mind is whether there exists an Investment Protection Treaty (IPT). IPTs are agreements between two sovereign nations in order to promote and protect bilateral investments. Typically, such treaties include clauses for fair and equitable treatment, protection from expropriation, insurance coverage and ease in reptriability of proceeds. India has entered into over 24 such agreement with various nations, including, United States, United Kingdom, Netherlands, Mauritius etc.

Some of the popular jurisdictions for setting up offshore holding companies are:

1. **NETHERLANDS**

A Dutch holding company is an efficient structural option as it offers an efficient exit route for profits of subsidiaries. In most cases, a Dutch holding company is set up as a BV, a limited liability company comparable with a LTD, GmbH or SARL.[29]

There are no restrictions for bringing money into the country or repatriating funds from the Netherlands. There are however some reporting requirements.

In Netherlands, corporates are taxed based on the Companies Act of 1969 (CTA, *Wet op de vennootschapsbelasting 1969*). All income earned by companies is deemed to be business income. The corporate tax rate in Netherlands for 2008 is 20% for profits upto € 40,000; 23% tax on taxable profits between € 40,000 to upto € 200,000 and 25.5% on profits beyond € 200,000. In addition, the CTA contains details on *participation exemption* (Articles 13 – 13k CTA), by which the dividends received (which are otherwise chargeable to tax @25%) from a qualifying (resident or non – resident) subsidiary company which is a resident of another EU member state, are exempt from tax in the hands of the parent company. Similarly, capital gains realised on the disposition of shares of such a subsidiary company are exempt (*deelnemingsvrijstelling*). It is relevant to note that effective January 1, 2004, Netherlands has introduced thin-capitalisation norms in reaction to the ruling of the European Court of Justice ("**ECJ**") in the *Bosal case*[30]. By virtue of such rules,

[29] Gesellschaft mit beschränkter Haftung –GmbH; Société à Responsibilité Limité – SARL;

[30] By judgment of 11 April 2001, received at the Court on 19 April 2001, the Supreme Court of the Netherlands referred to ECJ for a preliminary ruling under the EC Treaty on the common system of taxation applicable in the case of parent

expenses incurred as interest payouts to service loans and debts will limit the deductibility of interest paid to related parties if such loan is made to a group entity. The rules thus attempt to limit the tax deduction for interests so paid on loans to group entities. The limiting debt amount is to be determined by the debt/equity ratio, which is set at 3:1. Alternatively, the concerned company may elect for the higher group ratio, which is allowed under certain circumstances if it can be proved that the group as a whole has a higher debt allocation.

The European Union ("**EU**") directives, especially the Parent-Subsidiary directive, effectively reduce withholding taxes upon distribution of dividend to an EU parent. This makes EU OHCs (especially Netherlands) an ideal choice for the acquisition of an EU target. If a Netherlands based company were to own 5% or more of the shares of another EU company, there need not be any withholding taxes leviable on the dividends being remitted by the EU subsidiary, in all other case, the terms and the amount of withholding would be determined by the double taxation treaty. Further, if the subsidiary is a portfolio investment company, there is a *subject-to-tax* test of 10% that must be met instead of the 5% holding. Netherlands has an elaborate network of double taxation treaties that greatly leverages its demand to reduce withholding taxes on incoming dividends. However, it is relevant to note that the ECJ has ruled that national legislation which makes dividends received by a non-resident parent company liable to a withholding tax, while almost fully exempting dividends received by a resident parent company, restricts freedom of establishment.[31] Consequent to the ruling, Netherlands has introduced exemptions from withholding tax for certain non-residents.

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companies and subsidiaries of different member states. Bosal Holding BV (" **Bosal**"), a company established in the Netherlands, where the tax inspector refused to allow the amount of the costs in relation to Bosal's holdings in its subsidiaries in other Member States, to be deducted from the computation of that company's taxable profits for the financial year 1993. ECJ ruled that the costs of a parent company established in one member state incurred in connection with its holding in the capital of its subsidiaries established in other member states is not permissible having regard to Article 52 of the EC Treaty. The ruling may be accessed at: http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&lg=en&numdoc=62001J0168

[31] Denakvit Internationaal BV is a parent company, resident in the Netherlands, which had, at the relevant time, two French subsidiaries, Agro-Finances SARL (which subsequently merged with Denkavit France) and Denkavit France, almost all of the capital of which was under its control. From 1987 to 1989, those two companies paid FRF 14.5 million by way of dividends to their parent company, Denkavit Internationaal. In accordance with the Franco-Netherlands Convention and the French legislation, a withholding tax of 5% of the amount of those dividends was levied, corresponding to FRF 725 000. Denkavit Internationaal and Denkavit France claimed repayment of that sum before the Conseil d'État, which has asked the Court to rule on the compatibility of the French withholding tax system with Community law. Reaffirming the principle that a restriction on the freedom of establishment is prohibited, even if it is of limited scope or minor importance, the Court holds that it follows from the combined application of the Franco-Netherlands Convention and the Netherlands legislation that resident parent companies benefit from a tax regime which allows them to avoid the imposition of a series of charges to tax and that non-resident parent companies are, by contrast, subject to such a form of taxation on dividends paid by their subsidiaries established in France. The Court held that Community law precludes national legislation which imposes, only as regards non-resident parent companies, a withholding tax on dividends paid by resident subsidiaries, even if a tax convention between France and the Netherlands authorises that withholding tax and provides for the tax charged in accordance with French legislation to be set off against the tax due in the Netherlands, whereas a parent company is unable to set off tax in the Netherlands in the manner provided for by that convention. Source: **curia.europa.eu/en/actu/communiques/cp06/aff/cp060102en.pdf**

Other than a BV company, a Dutch co-operative association (coöperatieve vereniging) may also be used as it is not liable for withholding taxes on dividends paid under the domestic tax laws. Further, it has been regarded as a corporate entity that can qualify for the Australian participation exemption[32] on its dividends and on any capital gains arising out of share disposal, provided that the usual qualification rules are satisfied.

Apart from the dividend withholding exemption, the Parent Subsidiary Directive also assists in reducing or eliminating the capital gains tax in Netherlands on account of sale of shares of the EU subsidiary.

Under the India-Netherlands DTAA, the dividends received from a Netherland company would be subject to a withholding tax of 10%, which the recipient Indian company could claim a credit for while offering such dividends for Indian taxation at the rate of 33.99%.

2. AUSTRALIA

Australia has emerged as a jurisdiction of preference when structuring outbound investments from India. As per Article 13(5) of the India-Australia DTAA[33], where an Indian resident receives capital gains income from transfer of shares of an Australian SPV, Australia reserves the right to tax such an asset. Further, as per a capital gains exemption introduced in December 2006, there are no capital gains in Australia on disposal of most Australian assets by a non-resident. This is pursuant to the *Tax Laws Amendment (2006 Measures No.4) Act 2006 (Cth)* which amended *Division 855 Income Tax Assessment Act 1997 (Cth) (ITAA 1997)*, pursuant to which

[32] Australian Tax Office (**ATO**) issued a private binding ruling on treatment of a Dutch co-operative association (coöperatieve vereniging) for Australian corporate income tax purposes. As opposed to other Dutch companies (i.e. a BV or NV), a Dutch co-op is not subject to Dutch dividend withholding tax, provided the co-op is organized in such way that the co-op does not qualify as an entity with its capital divided into shares. Despite the lack of shares, the Australian private ruling concluded that the membership interests in the Dutch co-op met the definition of "shares" for Australian tax purposes, which was a requirement to have the dividends from the Dutch co-op qualify as exempt income. This structure provides a relatively simple way to eliminate or reduce withholding tax on dividends from the subsidiaries in various countries to the parent company in Australia. It should be noted, however, that some EU countries (e.g. Germany) may apply anti-abuse rules negating application of the EC Parent-Subsidiary Directive if the direct parent company has no real substance in the country of residence. The direct parent company should perform an actual economic function within the group; otherwise, this company may not be regarded as eligible for the reduced rate of withholding tax on dividends. As a possible solution, a Dutch operational limited company (BV) could be integrated into the structure between the EU subsidiaries and the Dutch co-op. This could also make the structure more robust, since not all jurisdictions are familiar with a Dutch co-op from a treaty eligibility perspective. Source: http://www.deloitte.com/dtt/alert/0,1002,cid%253D197733,00.html (Australia Tax Alert - March 20, 2008: ATO rules on tax treatment of Dutch co-operative association).

[33] **Article 13(5)** of the India-Australia DTAA: "*Income or gains derived from alienation of shares or comparable interests in a company, other than those referred to in paragraph (4), may be taxed in the Contracting State of which the company is a resident.*"

non-residents of Australia for taxation purposes are not subject to capital gains tax on gains made on disposal of most capital assets[34] disposed on or after December 12, 2006.

Australia presents as a favorable holding company jurisdiction for owning primarily non-Australian assets. Disposal of shares in the Australian holding company is disregarded for capital gains levy if more than half of the holding company's assets, whose shares are being transferred, are not taxable Australian real property[35] or interests in other companies with taxable Australian real property accounting for more than half of their assets. There may be a disregard of the disposal of shares even in select cases where the shares in the holding company is not regarded as an asset used by the non-resident in carrying on a business through a permanent establishment in Australia.

3. MAURITIUS

Mauritius has developed a special regime under which offshore business activities may be carried by companies holding a Global Business License (category 1 or 2) issued by the Financial Services Commission. The company may be set up as a plain vanilla Investment Company or as a PCC.[36]

Companies resident in Mauritius are subject to income tax on their worldwide income at the rate of 15%. Resident companies are companies incorporated in Mauritius or foreign companies with their central management and control in Mauritius. If a non-resident company sets up a branch carrying business in Mauritius, the branch is subject to income tax on income attributable to the branch activities. Capital gains are not subject to tax in Mauritius. However, capital gains tax

[34] Such asset not being any of the following:

(a) A direct interest in taxable Australian real property or an indirect interest by virtue of (i) a non-portfolio interest (10% or more) in the Australian holding company; and (ii) where the intermediating holding company passes the principal asset test, i.e. where over half of the value of it's assets may be attributed to 'taxable Australian real property', however held;
(b) An asset of a non-resident used to carry on business through a permanent establishment in Australia;
(c) An option or right to acquire any of the above assets;
(d) A capital asset owned by an entity when they become a non-resident of Australia for the tax purposes.

[35] Taxable Australian real property is defined by section 855-20 ITAA 1997 as real property situated in Australia or a mining, quarrying or prospecting right (to the extent that it is not real property) if the minerals, petroleum or quarry materials are situated in Australia.

[36] The Protected Cell Companies Act 1999 ("**PCCA**") allows a company to create cells within its capital for segregating the assets within the cells. Consequently, creditors in respect of one particular cell will only be able to claim against the asset of that cell and against the general non-cellular assets of the PCC but not against assets in other protected cells. The PCC structure enables schemes, structured as umbrella funds, to issue a variety of products. A PCC however, to avoid personal liability of its directors, must inform any person with whom it transacts that it is a PCC and identify the particular cell with which that person is transacting.

is imposed on certain gains involving capital gains derived from disposals of land. Dividends paid to residents and non-residents are exempt from tax.

The India-Mauritius DTAA provides for a capital gains tax exemption which regime benefits offshore entities making investment through Mauritius into India. It is thus not surprising that approximately 44.86%[37] of foreign direct investments into India are made through Mauritius. Further, as opposed to several other tax treaties, the India-Mauritius DTAA provides for a credit for the tax payable in Mauritius, rather than a credit for the actual tax paid. Accordingly, residents of Mauritius may claim a foreign tax credit ("**FTC**"), regardless of whether they may claim other credits. The FTC equals the lower of the Mauritian tax liability and the amount of the foreign taxes. In addition, a deemed FTC of 80% is available on foreign sourced income which brings down the effective Mauritius tax rate to 3%. The domestic tax law in Mauritius also does not impose any withholding tax on dividend or interest income.

While Mauritius is widely used as a jurisdiction to invest into India, the benefits of using Mauritius as a jurisdiction for making outbound investments from India are also many. As opposed to several other tax treaties, the India Mauritius tax treaty provides for a credit for the tax *payable* in Mauritius, rather than a credit for the actual tax paid. This could help achieve a lower tax rate in India, since India is a relatively high tax jurisdiction, with corporate tax rate being as high as 33.99%[38]. Mauritius local laws also allow the possibility of an outbound merger, which could help achieve some flexibility in bringing back profits into India.[39]

Recently, Mauritius has tightened its tax residency requirements[40] and formulated strict anti-money laundering laws. In addition, a Memorandum of Understanding ("**MoU**") signed between India and Mauritius provides for effective exchange of information in the detection of fraudulent market practices. Structures have been established for effective implementation of exchange of information, both on request and on a voluntary basis, about suspicious securities dealings between the two countries. The intention behind the MoU is to track down transactions tainted by fraud and financial crime, not to target bona fide legitimate transactions. This combined with Mauritius' strict anti-money laundering law to deter routing money from doubtful origins through Mauritius, making Mauritius a reputable jurisdiction for outbound investments.[41]

4. CYPRUS

Companies resident in Cyprus are subject to income tax on their worldwide income at the rate of 10%. A company is resident in Cyprus if its control and management is

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[37] Source: **FACT SHEET ON FOREIGN DIRECT INVESTMENT (FDI)** (from August, 1991 to March, 2008).

[38] This is however not tried and tested, and could be subject to tax litigation

[39] This methodology could be subject to tax litigation

[40] This is one of the main criteria to be eligible for tax treaty benefits

[41] It may noted that Indian residents may not be permitted to invest into Mauritius from India

located in Cyprus. Non-resident companies are taxed only on income derived from a permanent establishment in Cyprus and on rental income from property located in Cyprus. Tax credit is given as a relief for taxes paid abroad regardless of the existence of a tax treaty with such foreign jurisdiction. Such relief cannot exceed Cyprus tax payable on the same profits or gains.

Capital gains are taxable at the rate of 20%, only insofar as they arise from the transfer of immovable property or from the transfer of shares of a company whose assets include immovable property. Capital gains from transfer of shares of companies however, are not liable to capital gains tax. Companies registered in Cyprus but managed and controlled from abroad will be taxed in Cyprus only on their Cyprus-source income. They will enjoy exemption from tax of foreign dividends and interest and income from any permanent establishment abroad as well as all foreign tax credits and offsets of losses incurred abroad. However, they will not be entitled to benefits under the DTAAs entered into by Cyprus with any other country. Dividends received by a Cyprus Company from its subsidiary or joint venture company abroad will be exempt from tax in Cyprus if the Cyprus Company has more than 1% shareholding in the company paying the dividend.

Once of the benefits of using Cyprus as a jurisdiction are that it is a part of the European Union and may derive benefits relating to other countries within the EU by virtue of the same. Cyprus also has a tax treaty with the US. Thus, in case the Cyprus holding company has any transactions with any US entity, it will be able to claim benefits under the US-Cyprus tax treaty provided it satisfies the *limitation of benefits* clause existing in the treaty.

However, certain factors that make Cyprus a less attractive option are the fact that buyback of shares by a Cyprus company is a process that requires court approval. This results in a reduction in the flexibility of structuring options for routing investments through Cyprus. For example, a Cyprus company could distribute profits to its Indian parent company by way of buy back of shares (the gains from which would be taxed at a rate of 22.66% as opposed to 33.99% in case of dividend distribution). However, such a buy-back could require a court approval in Cyprus.

5. IRELAND

Ireland has, post 2004, emerged as an attractive location for setting up a holding company. The combined effect of recent changes to the Irish tax code in relation to credit relief for foreign taxes and the lowering of tax rates have made Ireland an attractive place to locate intermediate group holding companies.

Some benefits of using Ireland as a holding company jurisdiction are the fact that it offers a reasonably broad exemption from tax on capital gains for disposals of shares and a flexible dividend credit pooling system with the ability to access credit for underlying taxes in a flexible manner and at all lower tiers in the structure; and the abolition of capital duty on share issues.

Ireland has double taxation treaties with quite a large number of countries. Under Ireland's tax treaty network, credit relief for foreign taxes is allowed against Irish tax. Given that Ireland is now a relatively low tax jurisdiction, the foreign effective rate should in many cases exceed the Irish effective rate of tax, in which case no additional Irish tax is payable in respect of the income in question.

At present, corporate income tax rate on trading income in Ireland is 12.5% and on non-trading income is 25%. Dividend received by an Irish company from its foreign subsidiary is subject to tax in Ireland. However, under the Irish local laws underlying tax credit is provided for taxes paid by foreign dividend paying subsidiary. There is no dividend withholding tax on dividends paid to companies not controlled by Irish residents that are resident in a EU member country or a DTAA country. Since India has a DTAA with Ireland there would not be any withholding tax in Ireland on dividends paid to the Indian company. However, in India the dividend income could be subject to tax at the rate of 33.99%. There is a withholding tax of 20% on interest and royalties paid from Ireland, which is applicable to both payments to residents and nonresidents.

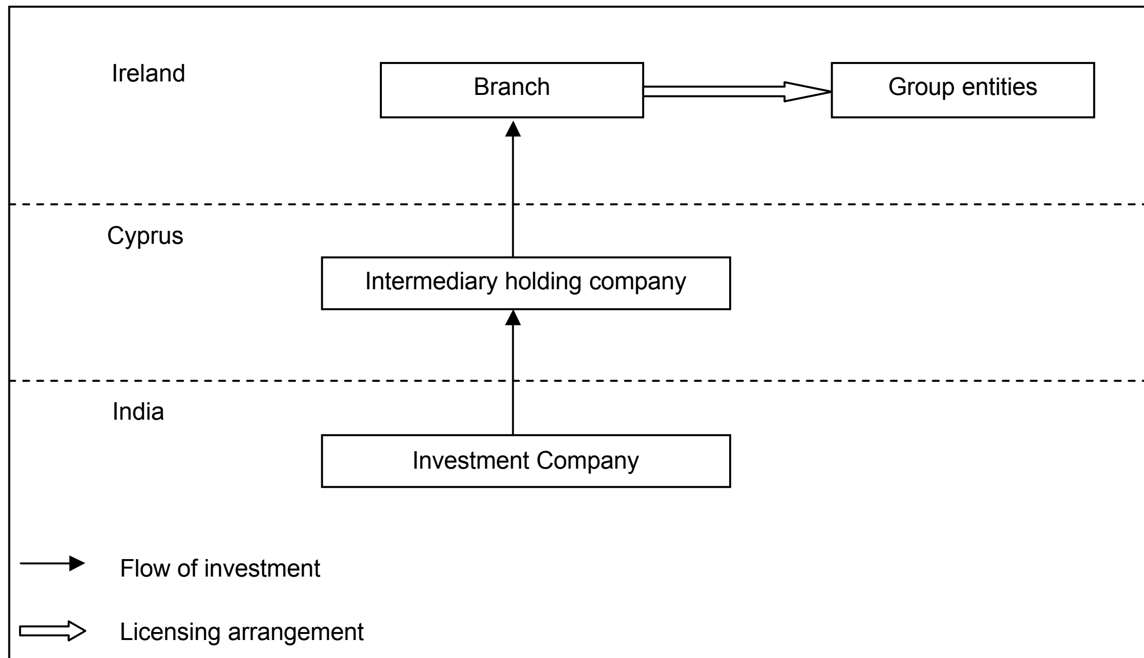
Ireland also benefits from the EU participation exemption rules, and is also considered to be a good jurisdiction for setting up entities for holding intellectual property linked sources of income. Development of Ireland as an efficient holding company jurisdiction for intellectual property based rights (IP) has been brought about due to a combination of both its domestic legal framework providing sufficient legal protection for IP rights and its overall administration. From an international IP perspective, it is relevant to note that Ireland is signatory to the Paris Convention pursuant to which it grants, as regards IP rights, the same protection to nationals of all other convention countries as it grants to its own nationals.

IP is primarily parked in one holding entity to streamline inter-group licensing. Income from IP rights are generally derived by way of royalties, hence the attempt is to maximize the after-tax profit arising therefrom. So while the IP is developed in a jurisdiction where the enterprise has taxable income against which it could offset the IP development related expenditure, the IP itself is subsequently, migrated to a jurisdiction which offers efficient tax rates with respect to IP, so that inflow of royalty-linked income stream is taxed minimally.

Irish resident companies are exempt from patent royalties or other income received where research and development (R&D) work in relation to patented IP has been carried out in Ireland. The income so accrued, can in turn, be paid by a company to its shareholders in the form of dividends, which will be exempt from Irish income tax in the hands of the Irish resident recipient.

Alternatively, branch structure model may be utilised to carry out IP activities. For an Indian enterprise to carry out its IP activities, it could set up a Cyprus based

subsidiary specifically for establishing the branch in Ireland (an interjecting intermediary company is being used as head office because the branch may be required to disclose certain information on its parent entity). If the activities of the banch office set up in Ireland are not characterised as 'trading' in nature, the Irish branch would be exempt from the Irish domestic tax. Based on the Ireland-Cyprus DTAA and subject to certain conditions, the income of the Irish branch may be tax exempt for Cyprus tax purposes. A diagrammatic representation of the proposed structure would be as follows:



A 20% R&D tax credit applies to qualifying expenditure on R&D incurred by companies subject to Irish tax and which is permitted to be carried forward. There is also an exemption from stamp duty on the sale, transfer or other disposition of IP.

6. SINGAPORE

Singapore companies are subject to tax at the rate of 17% effective from assessment year 2010. In addition, 75% of the first SGD 10,000 of chargeable income (excluding Singapore franked dividends) and 50% of the next SGD 290,000 of chargeable income (excluding Singapore franked dividends) are exempt from tax. A new private company may be exempt from tax on the first SGD 100,000 of chargeable income for its first 3 consecutive years of assessment beginning on or after year of assessment 2005, subject to certain conditions.[42]

Singapore adopted a one-tier corporate tax system with effect from Jan 1, 2003. Under the one-tier corporate tax system, tax paid by a company on its chargeable

[42] Source: http://www.deloitte.com/dtt/article/0,1012,sid%253D11410%2526cid%253D184220,00.html

income is a final tax. All dividends paid by a company are exempt from tax in the hands of the shareholders.[43] Dividends received from overseas subsidiaries will also be subject to tax in Singapore. However, dividends received from overseas subsidiaries may not be subject to tax or may be subject to tax at a low rate in Singapore due to the availability of foreign tax credits (including underlying tax credits). Further. capital gains are generally not subject to tax unless the gains are derived from the disposition of real estate that has been owned for less than 3 years or shares of private companies whose assets consist substantially of real estate.

Singapore too has a favourable tax treaty with India. As per Article 25 of the Indo-Singapore DTAA, the Indian company would be able to claim underlying tax credit in India for the *taxes paid* in Singapore on the profits from which such dividends are declared. As discussed above, Indian companies are currently taxed at the rate of 33.99% on dividends received from a foreign company. Thus, as per the provisions of the India-Singapore DTAA, Indian company may be able to claim an underlying tax credit in India for taxes paid in Singapore (i.e. 17%)

Monies can be remitted to Singapore to set up investment holding companies. Upon approval, holding companies are exempt from tax on all disposals of shares in subsidiaries if the percentage of ownership is at least 50% and the shares have been held for at least 18 months. From a tax perspective, such holding companies being resident in Singapore, are subject to income tax on their worldwide income. A company is resident in Singapore if its control and management is located in Singapore. A typical Singapore holding company would derive income under the following heads:

Capital gain income: In order to draw out its share of profits from investee companies, the holding company may redeem the shares held in such companies at a premium. The gains made from the redemption would be classified as capital gains. Currently, Singapore does not tax capital gain income, and these gains would be exempt in Singapore. However, it is possible that as per the domestic laws of Singapore, such gains may be characterised as business income and hence be liable to tax at the rate of 17%.

Dividend income: The dividend income received by the holding company from investee companies shall be exempt from tax in Singapore as per the Singapore local tax laws as Singapore system of taxation is territorial in nature.

Under the Singapore law, the gains made from redemption / buy-back of shares of subsidiary entities may be capital in nature from a corporate law point of view, but not necessarily from a revenue law point of view. Singapore's Income tax Act deems the reduction of share capital, share buy-backs and share redemptions by companies resident in Singapore to be dividends (and hence income in nature) where the payments are not paid out of contributed capital. To safeguard against an

[43] http://www.iras.gov.sg/irasHome/page03.aspx?id=1396

adverse re-characterisation, the proceeds of the redemption or share buy-back could be retained outside Singapore. As Singapore taxes income on a territorial basis (*i.e. accrued in or derived from or received in*) these proceeds would not then be subject to Singapore tax. They can however be declared on to the shareholders of the Singapore cbased company who are outside Singapore, as dividends, without attracting Singapore tax as the comptroller has clarified[44] that such declaration would not constitute constructive remittance[45] of the said proceeds into Singapore.

A non-tax related consideration for using Singapore as a jurisdiction is that it has earned a reputation for a good regional hub for multinational holding companies. Listing on Singapore bourses is becoming more popular by the years. Needless to say, its financial services sector is well developed and suited to the needs and concerns of international companies. Its ease of banking operations assist expatriates to re-locate to Singapore. Further and most importantly, Singapore has also signed a Comprehensive Economic Cooperation Agreement ("**CECA**") with India. This CECA governs trades in goods and services, promotion of bilateral investments and cooperation in various other areas.

7. UNITED KINGDOM

Companies that are resident in the United Kingdom (UK) are subject to corporation tax on their worldwide income. However, a holding company whose primary business consists of making investments and substantial portion of which entity's revenue are derived from such investments, would be treated as an investment company. Further, a UK company will be taxed on the total amount of income earned from all sources including any chargeable capital gains at the rate of 30% which has been reduced to 28% from April 1, 2008. Dividend received by a UK company from its subsidiary will be taxed in UK at normal tax rates. However, if the UK company receives dividend from a foreign company in which it holds at least 10% voting power, in addition to tax credit for taxes withheld on such dividend, it may also obtain tax credit for the underlying taxes paid on the profits out of which such dividends are paid.

Capital gains on chargeable assets are taxed at the normal corporation tax rate in UK. However, a tax exemption for disposals of substantial shareholdings (minimum of 10%) has been introduced from April 1, 2002. Under these provisions, gains realized by a trading company (or member of a trading group) from disposal of substantial shareholding of another trading company (or holding company of a trading group) that has been held at least for a period of 12 months would be exempt from tax. Thus, subject to fulfillment of conditions laid down under these

[44] IRAS Supplementary Circular on One-Tier Corporate Tax System, 27 June 2003

[45] Please note that foreign-sourced income will be deemed to be received into Singapore from outside Singapore where such income is applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore, and when it is applied to purchase any movable property that is brought into Singapore.

rules, gains realized by the UK OHC from sale of investments in subsidiaries would not be subject to tax in UK.

Capital gains tax is generally not levied on non-residents from sale of shares of UK companies. Consequently, no tax would be levied on a gain realized on the sale of shares in a UK subsidiary by the foreign parent company. However, the same will be subject to capital gains tax in India at rates based on the period of holding.

Subject to the thin capitalisation rules, the interest paid by a UK company to a foreign lender may be allowed as a tax-deductible expense. However, the UK company would be liable to deduct withholding tax at the rate of 20% from interest paid to the foreign lender, which gets further reduced as per the provisions of the applicable DTAA. Although thin capitalization rules do not prescribe any specific debt-to-equity ratio, highly leveraged UK subsidiaries of overseas companies having debt-to-equity ratio in excess of 1:1 are usually subject to scrutiny by the Inland Revenue.

UK has developed to be the largest base for non-EU companies setting up operations in Europe. This is a *fair indicatia* of UK's conducive regime for setting up holding company structures in UK. If a UK entity holds an operating subsidiary abroad, then, under either the DTAA with the jurisdiction of the subsidiary company or the EU Parent/Subsidiary directive, it would receive dividends at almost nil to reduced rate of withholding taxes. UK partially follows the imputed system of taxation. That is to say that while the company pays its share of corporate taxes as assessed, the shareholders are allowed to take credit of the proportionate taxes paid on their share of the dividend distributed.

No discussion on UK tax regime can be complete without noting the development of the anti-avoidance doctrines and rules that have been well considered by a series of rulings by the House of Lords. The essence being that circular arrangements and self-cancelling transactions with no commercial purpose are to be looked-through as one single transaction for tax incidence.

Thus, due to its favorable investment holding company regime, UK is a popular jurisdiction for making outbound investments.

8. TAX HAVENS

The term 'tax haven' has not been statutorily defined. Globally, tax authorities recognize certain jurisdictions as a tax haven for applying counteractive measures. This is on account of the fact that typically, tax havens are used to carry out transactions without it being subject to tax consequences. Absence of currency controls and low to nil corporate taxes and lack of tax treaties are the characteristics of a typical tax haven. The revenue authorities may be given the power to examine the transactions in more detail, when it involves a tax haven country. In Australia, wherever a foreign exchange transaction involves a listed country, the transaction

must be referred to the Commissioner of taxation who may cancel or modify such transactions if they appear to involve tax avoidance or evasion, or if they represent a from of capital flight[46]. Some countries have also announced a list of countries which they do not consider as 'tax havens'. This list is known as 'white list'. U.K. has announced a 'grey list' which consists of countries which may be considered as 'tax havens' at some times and not at some other times. OECD has conducted a study of countries and has come out with its own black list of countries that do not have a certain standard rate of tax or has other features which are akin to a tax haven. For the liberal tax regime it offers, a tax haven jurisdiction is what comes closest in being the most preferred holding company jurisdiction for structing investments. The only downside to such structures may be the countervailing measures and restrictions imposed by tax legislations for discouraging their use.

A. BRITISH VIRGIN ISLANDS

British Virgin Islands (BVI) is recognized as a traditional tax haven. Indian enterprises can set up holding companies in BVI for structuring investments. Effective from January 1, 2005, companies that were incorporated under the British Virgin Islands Companies Act (“**BVIC Act**”) were made exempt from taxes under the domestic tax regime and effective from January 1, 2007, no corporate income tax is leviable. Accordingly, there would be no tax implications in BVI on distribution of income (whether in the form of return of capital or dividends) to the parent company. However, from a tax perspective, it is relevant to note that BVI does not have a tax treaty with India, so, for the purposes of examining the tax exposure of the BVI entity in India, determination has to be made of its 'Business Connection' [47]

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[46] Research Report on Tax Havens and Their Uses by Caroline Doggart

[47] Income deemed to accrue or arise in India.

9. (1) The following incomes shall be deemed to accrue or arise in India :

(*i*) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India.

[*Explanation 1*].For the purposes of this clause

(*a*) in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributable to the operations carried out in India ;

(*b*) in the case of a non-resident, no income shall be deemed to accrue or arise in India to him through or from operations which are confined to the purchase of goods in India for the purpose of export ;

[(*c*)in the case of a non-resident, being a person engaged in the business of running a news agency or of publishing newspapers, magazines or journals, no income shall be deemed to accrue or arise in India to him through or from activities which are confined to the collection of news and views in India for transmission out of India ;]

[(*d*)in the case of a non-resident, being

(*1*) an individual who is not a citizen of India ; or

(*2*) a firm which does not have any partner who is a citizen of India or who is resident in India ; or

in India. The general concept is that there should be sufficient territorial connection or nexus between the earning of income by a non-resident outside a country and activities in the country seeking to tax him. A business connection in this context would involve a relation between a business carried on by a non-resident, and some activity in India, which contributes directly or indirectly to the earning of the profits and gains of that non-resident. Thus, a business connection would include a branch, a factory, an agent, or even the seat of management of the non-resident in India. Further, where business connection is said to exist, the income of the non-resident that is taxable in India would be the income attributable to the operations carried out in India. This is also the case if such holding companies are setup in any jurisdiction with which India does not have a tax treaty.

BVI entities are typically used as holding parent for structing carried interest entitlement for co-investment.

B. CAYMAN ISLANDS

Cayman Islands (CI), similar to BVI, imposes no corporate income tax. CI as a jurisdiction, is typically used to set up pooling vehicles for investments by U.S. Tax-Exempt Investors that are tax-exempt under Section 501(a) of the U.S. Internal

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(*3*) a company which does not have any shareholder who is a citizen of India or who is resident in India,

no income shall be deemed to accrue or arise in India to such individual, firm or company through or from operations which are confined to the shooting of any cinematograph film in India.]

[*Explanation 2.*For the removal of doubts, it is hereby declared that business connection shall include any business activity carried out through a person who, acting on behalf of the non-resident,

(*a*) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(*b*) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(*c*) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business :

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.

*Explanation 3.*Where a business is carried on in India through a person referred to in clause (*a*) or clause (*b*) or clause (*c*) of *Explanation 2*, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India;]

Revenue Code of 1986, as amended. U.S. Tax-Exempt Investors, however, are generally subject to U.S. federal income tax on their unrelated business taxable income ("UBTI").[48]

If CI is used as a jurisdiction to set up a holding company for making outbound investments, it is worth noting that dividends, interest and other income received by the Cayman holding company or entities through which it invests from sources within non-U.S. countries may be subject to withholding taxes or other taxes imposed by such countries.

CI allows setting up of ordinary or exempt companies and further classification of resident and or non-resident. The exempt companies are primarily set up for investment holding purposes and have to file an affidavit undertaking that the operations of the entity shall be based exclusively offshore.

CI does not have a tax treaty with India. Accordingly, the general principals of taxation under the ITA shall be applicable as there is no treaty to rely on when profits are repatriated back to India.

V. CONCLUSION

While there is no jurisdiction today in which an Indian company could establish a holding company that would meet all the criterions of an ideal holding company jurisdiction, there are however, certain jurisdictions that could be identified for preference. In fact, the pros and cons of each jurisdiction will need to be weighed against the direct investment route, since in many cases, it may be more beneficial to invest directly into the investee jurisdiction as opposed to investing indirectly through an OHC. Further, apart from the jurisdiction to locate the OHC, it may also be extremely important to structure correctly, the mode of acquisition (whether shares or assets), the mode of financing (through debt or through equity or a hybrid of debt and equity), and to take into account the long-term strategic objectives of the group as a whole.

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[48] UBTI is defined for these purposes as gross income from any unrelated trade or business regularly carried on by the U.S. Tax-Exempt Investor, less applicable deductions. Under Section 513 of the Code, an unrelated trade or business consists of any trade or business, the conduct of which is not substantially related to the U.S. Tax-Exempt Investor's exempt purpose or function. UBTI generally does not include certain enumerated categories of income, such as dividends, gains from the sale of stock in a corporation, interest, real property rentals (subject to certain limitations), royalties and gains from the sale, exchange or other disposition of property other than inventory property.