India Tax; another googly

Over recent days there has been coverage in domestic Indian and international press with regard to the potential unexpected imposition of a retrospective tax on foreign companies, whom have long believed were exempted. This negative publicity comes at a time when the Modi-led Government has been at pains to impress on potential investors that the Government is committed to ensuring a consistent and predictable tax regime in the country, and thus appears both contradictory and “off message”.

We have had a number of discussions with experts including accountants (big 4) and market practitioners, and attempt below to document a “current view”. We stress that Ocean Dial is not an India tax expert. We are seeking to clarify an issue that is causing some confusion and uncertainty on the basis of what we have learnt. We hope the situation will be clarified as soon as possible, but in India that is not always the case.

What is MAT?

Minimum Alternate Tax (MAT) has been in existence in India in its current format since 2001, but on the statute books since 1997. It is a tax on book profit of a company, and is levied at 18.5%. It was introduced to ensure that companies in India who were paying zero (or low) tax, despite showing profits and paying dividends, (owing to multifarious exemptions) were brought into the tax net. The liability is calculated on both short and long term profits (net of any losses), and deductions are not claimable. Any interest income accrued on government securities is subject to MAT, whilst share dividends are not as a dividend distribution tax has been previously deducted at source.

As defined by Indian law, a company can be either Indian or foreign. However, in calculating the potential MAT liability as per the Company’s Act 1956, the law states that a company’s books must be prepared according to recognised Indian accounting standards. Owing to this requirement, the rules have historically been interpreted to imply that MAT was taxable only on Indian companies, and which might also include foreign companies with a permanent establishment (PE) in India.

What has changed?

In late 2012 the Authority of Advance Ruling or ARR, (http://www.aarrulings.in/) decreed that Castleton, a Mauritius entity (though not an investment company), which had sold the shares of an Indian company was deemed liable for MAT on the capital gain. The ruling has been challenged by Castleton and the case is due to be heard by the Supreme Court. An outcome is expected in the next 4-6 months.

Subsequent to the AAR ruling, the internal audit functionaries of the India Revenue Service (IRS) launched an “audit objection”, arguing that since the Castleton case had adjudicated in favour of the IRS, tax assessors should be now issuing MAT claims against foreign companies retrospectively. We understand that the IRS requested interpretation from the Government before proceeding, but no clarity was forthcoming. Consequently tax assessors are now calling for foreign companies to “show cause”, and have in some cases, issued tax notices for the year 2012/13. Historic claims for the years back to 2009/10 are expected.

Currently, we understand that these notices have only been issued specifically to those Foreign Portfolio Investors (FPIs) who have invested into India from countries where no double taxation treaty (DTT) with India exists. It appears that the IRS has consciously disregarded those entities that invest through Mauritius or Singapore or other countries where a DTT, providing STT (securities transaction tax) has been paid. Hence these entities are not expected to receive retrospective tax claims for unpaid MAT, and this is in spite of the fact that Castleton is thought to be registered as a company in Mauritius.

Acknowledging the likely reaction from FPIs, the Finance Minister issued an amendment to the current MAT section in the 2015 India budget, confirming that foreign entities would not be subject to MAT from 2015 onwards (providing STT was paid). On account of the fact that the case against Castleton is effectively “sub judice” the Government insists that it is constrained in providing any retrospective amendment, arguing that the matter remains with the courts, highlighting that all FPIs have the right to appeal.

A figure of US$6.5bn has been "bandied" around by the press and the Finance Ministry in India as the potential outstanding liability that could potentially be due. We understand that this number is likely to have been provided by the IRS to the Finance Ministry as its assessment of the potential liability. It may also explain why the Government has held back from providing retrospective clarity, in spite of the damage to India's credibility as an investment destination.

Conclusion

Uncertainty will pervade until the Supreme Court decrees on the Castleton ruling which, if delayed beyond the end of this tax year, could result in further notices being issued for 2014/15. However, evidence to date suggests that funds such as those currently managed by Ocean Dial Asset Management, which invest through Mauritius, should not currently expect to receive a request to "show cause" or indeed a retrospective tax claim for unpaid MAT.

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