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India's 2020 Budget: Implications for Wealthy Families and International Investors

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Mahesh Kumar
PARTNER | SINGAPORE

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India's 2020 Budget, which was announced on February 1, introduces various changes that will significantly impact high net-worth (**HNW**) families and international investors. We have summarized the key takeaways from the Budget as well as some planning opportunities that may be explored.

Implications for HNW families

With effect from April 1, 2020, non-resident Indians (**NRI**) and persons of Indian origin (**PIO**) will be treated as Indian residents if they are in India for at least (i) 182 days in the relevant year or (ii) 120 days in the relevant year and 365 days in the last 4 years. Presently, NRI or PIOs living or working overseas could only be considered resident if they stayed in India for more than 182 days in the relevant year.

NRIs who are not liable to residence or domicile based taxation in any country will now be deemed a resident of India.

The proposed changes are problematic for many HNW families, especially those who have significant assets, business and personal interests in India. The risk extends to both NRIs and foreign citizens whose parents or grandparents were born in India. Certain Indian citizens living in zero tax countries like the UAE may risk becoming Indian resident irrespective of the time spent in India. Resident individuals are subject to worldwide tax and reporting obligations in India, with the maximum tax rate being as high as around 43%.

On a positive note, the category of 'resident who is not ordinarily resident' (**RNOR**) would now be available to any person who is non-resident for 7 out of 10 preceding years. This could provide a 3 year window for certain groups of returning Indians to continue to be taxed as non-residents.

Another change that will impact entrepreneurs and promoters of Indian companies is the abolition of the dividend distribution tax (**DDT**). So far, an Indian company distributing dividends had to pay a DDT of around 21%, with no further tax paid by the shareholders. Going forward, dividends will be taxed in the hands of the shareholders. The maximum dividend tax liability for residents could be around 43% and around 28% for NRIs which may be further reduced under a tax treaty. The Budget also introduces provisions to ensure that distribution of dividends between companies in India is tax neutral.

High tax rates for residents may continue to motivate HNW families to become or remain non-resident. A number of strategies may be explored to mitigate potential risks arising from the 2020 Budget:

- NRIs and PIOs can claim relief under the 'tie-breaker' test of the applicable tax treaty, in order to justify residence in the relevant country outside India. To claim this relief, UAE residents have to be physically present in the UAE for at least 182 days. Countries like Singapore or the UK do not have such a requirement.
- HNW families may be more inclined to seek residence in non-zero tax countries like Singapore or the UK, which have beneficial tax regimes for investment income. One can also consider Italy which has introduced a flat tax scheme (similar to the UK) for certain families who want to shift residence to Italy.
- More Indians are likely to consider getting alternative passports through various citizenship by investment programs in the EU and Caribbean.
- NRIs and PIOs now have a stronger reason to protect income generating assets (both liquid and business holdings) in trust structures. Certain trusts can become tax blockers from an Indian perspective even in a scenario where the relevant individuals are treated as Indian residents.

- The impact of changes to the residency rules may be lesser on NRIs who are employed overseas, since they may still benefit from the 182 day rule. This may motivate more HNW families to establish overseas family office structures which can employ members of the family. Singapore has become a preferred hub for NRIs and PIOs to establish family offices due to the tax incentives for investment management activities.
- The changes in the dividend tax regime may provide opportunities for promoters to take out significant cash flows from their Indian companies. The effective tax can be limited to 10% for residents of Singapore, UAE and the UK or 5% for residents of Hong Kong. Multiple levels of holding companies in India will now not result in additional tax leakages.

Impact on Funds and multinational enterprises (MNEs)

International investors, funds and MNEs will now be subject to a tax of around 22% on dividends received from their Indian portfolio companies or subsidiaries. The rate may be reduced under certain tax treaties- eg. 5% under the Hong Kong and Mauritius treaties and 10% under the Netherlands and Singapore treaties subject to applicable shareholding tests. While claiming lower treaty rates, it is important to consider issues of economic substance, beneficial ownership, the impact of general anti-avoidance rules, the OECD principle purpose test and treaty limitation of benefits criteria.

In certain structures, limited liability partnerships may continue to be the preferred entity to establish a presence in India due to the absence of tax on profit distributions and ease of returning capital. However, the Budget does not extend the lower 25% effective corporate tax rate to partnerships which continue to be effectively taxed at around 35%.

The lower 5% withholding tax rate on interest arising from investment into certain types of rupee denominated bonds will continue till July 2023. In the last few years, MNEs have been provided considerable flexibility in funding their Indian subsidiaries via debt.

Some additional concessions have been given to Indian fund managers to help them establish offshore funds without creating a taxable presence under India domestic law. However, in the interest of certainty fund managers prefer to rely on treaty relief rather than being exposed to domestic law.

The Budget seeks to give a boost to the infrastructure sector. Sovereign wealth funds have been given a tax exemption with respect to income arising from long term investments into infrastructure companies in India between April 2020 and March 2024. There is some ambiguity on whether the exemption can be claimed on a pass-through basis when such funds invest into other infrastructure focused funds rather than directly into the project companies.

The Budget has deferred the application of the significant economic presence test to April 2021. This rule seeks to tax MNEs by virtue of the size of their Indian customer base or revenues even if they do not have a taxable presence in India. The Budget also expands India's taxing powers with respect to income from advertisements targeting customers in India, sale of data from customers in India and sale of goods or services using such data. MNEs will have to seek treaty relief to protect against potential risks arising from these changes.

Advance pricing agreements (APA) have emerged as a useful means of obtaining certainty on pricing related party transactions. Over 300 APAs have been signed covering transactions such as contract manufacturing, software development and IT enabled support services. The Budget allows the tax authorities to enter into APAs and prescribe safe harbors even on matters of profit attributions in the event there is a taxable presence in India.

Authors

Mahesh Kumar

PARTNER | SINGAPORE

Private client and tax

+65 6922 4094

mahesh.kumar@witherskhattarwong.com