Corporate Finance-Debt vs Equity Controlled Foreign Corporation

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Corporate financing

- Debt vs Equity
- Debt and equity financing are two very different ways of financing your business.
- Debt involves borrowing money directly, whereas equity means selling a stake in your company in the hopes of securing financial backing.
- Both have pros and cons, and many businesses choose to use a combination of the two financing solutions.

Corporate Financing

- Payments made under the **equity** instruments are usually classified as **dividends** whereas payments made under **debt** instruments are usually classified as interest.
- From the company's view point, debt is always preferred over equity as a high debt-equity ratio can reduce the tax on business profits:

Particulars	Cost of debt	Cost of equity
Nature of return	Interest paid on debt	Dividend paid on equity
Max tax rate as per OECD Model	10%	5%/ 15%
Deductible as expense to company	Yes	No

Debt Financing

- Borrow funds
- a fixed rate of interest
- a fixed duration
- Collateral or some form of security given

- **Short-term debt financing** gives the company access to quick loans for a short duration. The company might require short-term debt financing to fulfill a temporary financial emergency. Short term loans usually carry a high interest rate.
- In **Long-term debt financing**, companies borrow for multi-year periods i.e. 10 years, 20 years and more. While long-term loans carry low interest rates, over the course of the loan tenure, they incur a huge interest obligation.

Types of debt financing

- Types of Debt Financing can be :
  - Bank Loans
  - Bonds- A bond is a fixed-income instrument that represents a loan made by an investor to a borrower (typically corporate or governmental)
  - Debentures- A debenture is a type of long-term business debt not secured by any collateral. It is a funding option for companies with solid finances that want to avoid issuing shares and diluting their equity.
  - Bearer Bonds- A bearer bond is a fixed-income security that is owned by the holder, or bearer, rather than by a registered owner. The coupons for interest payments are physically attached to the security.
- **Debt Financing via Bank Loans**: Bank loan is the most common type of debt financing. Bank loans can be:
  - Secured Loans
  - Unsecured Loans

Advantages of Debt

1. **Retain ownership of the company**: In debt financing, you are only taking a loan from the lender. The lender has no right to interfere in the working or decision-making aspect of the company. You are the owner of the company. The lender-borrower relationship ends once the loan is paid back.
2. **Tax Advantage**: The interest payable by the company on the loan is **deductible from the company's taxable profit**. This reduces the overall tax liability and cost of debt financing for the company.
3. **Easy Financial Planning:** Since the **rate of interest is fixed**, the company knows exactly how much interest is to be paid each month. It also **becomes easier for the company to forecast its future expenses** and engage in efficient financial planning and budgeting.

Disadvantages of Debt

1. **Compulsory Repayment:** A loan or debt is an expense which needs to be compulsorily repaid to the lenders. If the company goes bankrupt, the lenders have to be paid first, even before the equity shareholders.
2. **Collaterals**: Lenders require collateral assets to be maintained against the loan. If the company's assets are not sufficient, lenders might demand even personal assets to be attached as collaterals.
3. **Credit Rating**: Large debt financing can affect your credit rating. A cut in the company's credit rating can increase the cost of borrowing, due to increased risk to the lenders. Even a small delay in interest payment can adversely affect the company's reputation and credit ratings.

Equity Financing

- Equity financing means selling a stake in your company to investors who hope to share in the future profits of your business.
- Several ways to obtain equity financing- venture capitalist or equity crowdfunding. Business owners who go this route won't have to repay in regular installments or deal with steep interest rates.
- Investors are partial owners who are entitled to a portion of company profits, perhaps even a voting stake in company decisions depending on the terms of the sale.

Types of Equity

- **Seed capital-** Owners money
- **Friends and family-** Money raised from known people
- **Angel investors.** An angel investor is a wealthy individual who gives a business a large cash infusion. The angel investor gets equity – a share in the company – or convertible debt for their money.
- **Venture capitalists.** A venture capitalist is an entity, whether a group or an individual, that invests money into companies, usually high-risk startups. In most cases, the startup's growth potential offsets the investor's risk. In the long run, the venture capitalist may look to buy the company or, if it's public, a substantial portion of its shares.
- **Equity crowdfunding.** Equity crowdfunding is when you sell small shares of the company to numerous investors via crowdfunding platforms. These campaigns usually require immense marketing efforts and a great deal of groundwork to hit the goal and get funding.

Advantages of Equity

- **No repayment until the company is profitable.** Whereas debt financing requires repayment no matter your business situation, angel investors and venture capitalists wait until you make a profit before recouping their investment. If your company fails, you never need to repay your equity financing, whereas debt financing will still require repayment
- **No fixed interest payments-** Unlike Debt, in equity only profits need to be shared, there is no fixed cost involved.
- **Well suited for startups in high-growth industries.** Especially in the case of venture capitalists, a business that's primed for rapid growth is an ideal candidate for equity financing.
- **Rapid scaling.** With the amount of capital a company can obtain through equity financing, rapid upscaling is far easier to achieve.

Disadvantages of Equity

- **Hard to obtain.** Unlike debt financing, equity financing is hard to obtain for most businesses. It requires a strong personal network, an attractive business plan and the foundation to back it all up.
- **Investor involvement in company operations.** Since equity financers invest own money, they get decision making rights and get involved in business operations. That also means less control of owner on the company and the risk of removal from a management position if the other shareholders decide to change leadership.

DEBT VS EQUITY

DEBT VS EQUITY CONUNDRUM

- Business owners decision
- Availability
- Corporate laws
- Tax laws
- Cost benefit analysis

Many companies use a mix of both types of financing

The Companies Act, 2013

Debt	Equity
Debenture-Redeemable, Unredeemable, Secured, unsecured, Convertible etc	Equity Shares
Bond- Included in definition of Debenture	Preference Shares
Loan	Bonus Shares

Tax Treatment

Particulars	Debt	Equity
Return	Interest	Dividend
Tax deductibility for the corporate from Taxable profits	Yes	No

Debt/Interest-Income Tax Act,1961

- Indian tax law does not specifically define the terms "debt" or "loan". In the ordinary sense, it means something that is owed and creates an obligation to pay, generally money or money's worth. In terms of financing, it connotes a temporary provision of money usually with interest payable on the amount.
- "interest" defined u/s 2(28A) in the ITA "*interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized…*"
- The ITA allows tax deduction of interest u/s 37 in respect of capital borrowed **for the purposes of a business or profession**.
- **The interpretation of "*business purpose*" is largely a question of fact whereby the borrowed funds should be utilized for the purposes of the existing business and not a new project or independent venture which is unconnected with the business.**

Article 11-OECD DTC

INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

ARTICLE 12

ROYALTIES

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is

Dividend-Income Tax Act, 1961

- 1997-Withholding Tax
- 2002-DDT
- 2003-Withholding Tax
- 2019-DDT

2020- Withholding tax

Resident shareholder

- Domestic companies shall be liable to deduct tax under Section 194 at the rate of 10%;
- If aggregate amount of dividend distributed or paid during the financial year to a shareholder exceeds Rs. 5,000;
- Dividend received during the financial year 2020-21 and onwards shall now be taxable in the hands of the shareholders

Non-Resident shareholder

- The dividend income shall be taxable in India as per provisions of the Act or as per relevant DTAA, whichever is more beneficial;
- A non-resident generally invests in India either directly as private equity investors or as Foreign Portfolio Investors (FPIs);
- The dividend is payable to a non-resident or a foreign company, the tax shall be deducted under Section 195 in accordance with relevant DTAA
- Tax Rate: FPIs & NRIs- 20% and Offshore banking unit-10%

Withholding rate under DTAAs

- Croatia
- France*
- HongKong
- Lithuania
- Malaysia
- Mauritius
- Nepal
- Netherlands*
- Saudi Arabia
- Sweden*
- Switzerland*

5% withholding

- Botswana
- Ethiopia
- Mozambique
- Sri Lanka

7.5% withholding

- Austria
- Bangladesh
- China
- Cyprus
- Czech Republic
- Germany
- Indonesia
- Ireland

10% withholding

*By virtue of MFN clause

Article 10-OECD

DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);

   b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Dividend – Article 10- Overview

	Article 10	Content
Sharing of taxing rights	Article 10(1)	Taxability of dividend in resident country
	Article 10(2)	Taxability of dividend in source country
Definition	Article 10(3)	Meaning of 'dividend'
PE scenario	Article 10(4)	PE scenario
Extraterritorial taxation	Article 10(5)	Extraterritorial taxation

Debt-Equity ratio

Debt-to-Equity ratio

- Investors rely on the **debt-to-equity ratio** to measure and compare the percentage of a company's capital financed by debt.
- **Debt to equity ratio or (D/E) ratio = Total Debt (short-term + long-term) / Total Equity**

Total Short term debt	**INR 10 Lakh**
Total long term debt	INR 40 Lakh
Total equity	INR 1.2 Cr
Debt-Equity Ratio	0.42

- For example, ABC Ltd has a total short-term debt of Rs 10 Lakhs, long-term debt of Rs 40 Lakhs and the total shareholder's equity is Rs 1.20 Crores. The debt-to-equity ratio of ABC Ltd is 0.42
- A debt-to-equity ratio of 0.42 means that for every rupee in equity, ABC has 42 paise financed by debt.
- A good debt-to-equity ratio is between 1 – 1.5 but varies with industry type as some industries work on high debt like Infrastructure and construction industry.

Thin Capitalisation

- Thin capitalization refers to the situation in which a company is financed through a relatively high level of debt compared to equity.
- Thinly capitalized companies are sometimes referred to as —highly leveraged or —highly geared.
- The OECD has expressed that multinationals may have certain thinly capitalized entities achieving favourable tax results, which is now a global concern.
- BEPS Action 4 Report titled "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" tries to counter the issue of Thin capitalisation.

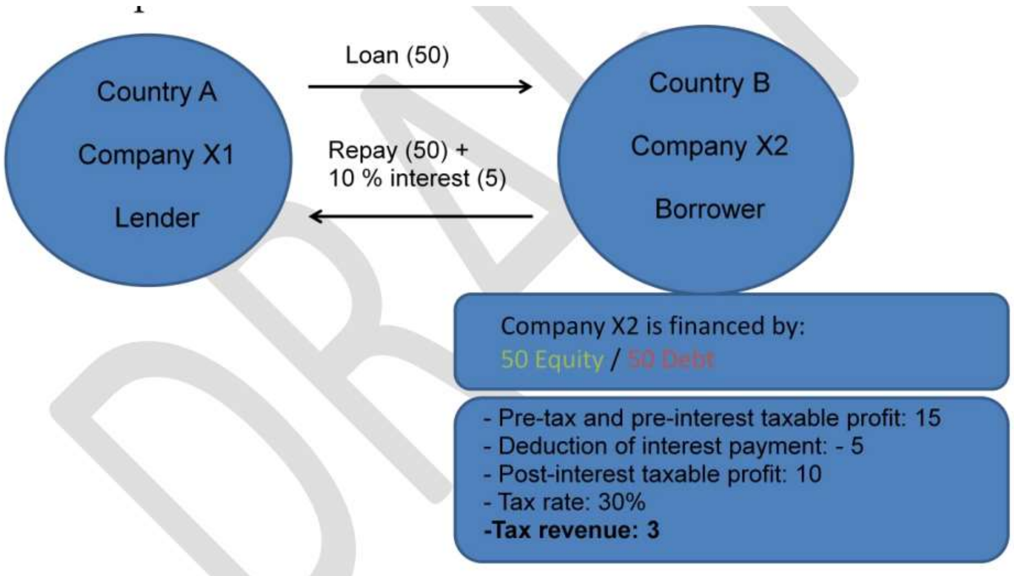
Why is thin capitalisation significant?

- The way a company is capitalized will often have a significant impact on the amount of profit it reports for tax purposes.
- Country tax rules typically allow a deduction for interest paid or payable in arriving at the tax measure of profit.
- The higher the level of debt in a company, and thus amount of interest it pays, the lower will be its taxable profit.
- For this reason, debt is often a more tax efficient method of finance than equity.

EXAMPLE 1 Thin Capitalisation

Example 1: Debt to equity investment of 1 to 1.

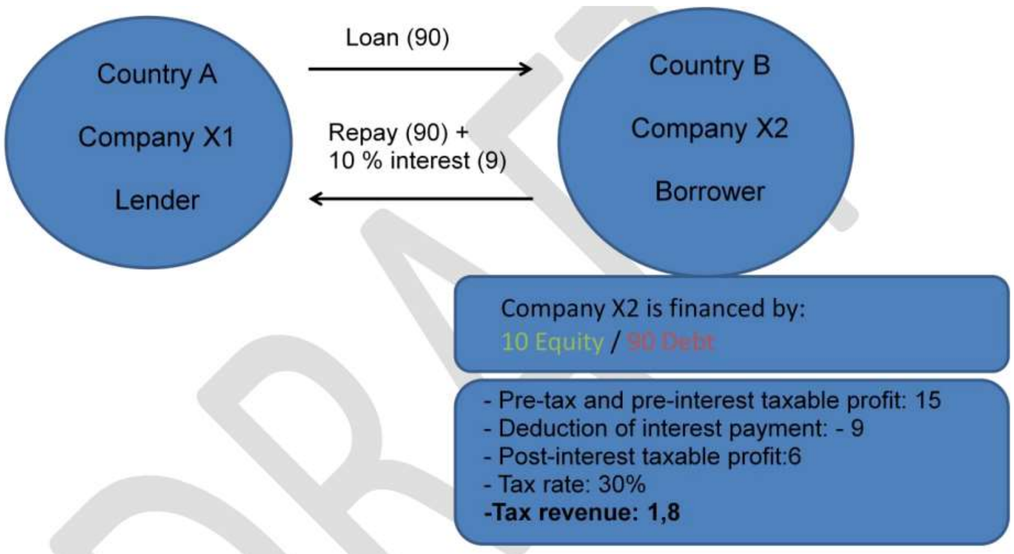
Company X, a corporation from Country A, establishes group affiliate Company Y in Country B with an investment of 50 in equity capital and a loan of 50 from Company X at a 10% interest rate. Company Y generates pre-tax and pre-interest operating income of 15 for year 20XX, and pays interest to Company X at 10% i.e. an interest payment of 5. The post-interest taxable profit of Company Y is 10 and, taxed at a 30% tax rate, generates tax revenue of 3 for Country B



Source: https://www.oecd.org/ctp/tax-global/5.%20thin_capitalization_background.pdf

EXAMPLE 2 Thin Capitalisation

- Example 2: A debt to equity investment of 9 to 1.
- Company X, a corporation from Country A, establishes a group affiliate Company Y in Country B with an investment of 10 in equity capital and a loan of 90 from Company X at a 10% interest rate. Company Y generates pre-tax and pre-interest income of 15 for year 20XX, and must pay interest to Company X at 10% i.e. a total interest payment of 9. The remaining taxable profit of Company Y is 6 and taxed at a 30% tax rate, which generates tax revenue of 1.8 for Country B .



Source: https://www.oecd.org/ctp/tax-global/5.%20thin_capitalization_background.pdf

BEPS Action 4

As seen in the example the thin capitalization can lead to base erosion for the country taxes.

The Action 4 Report specifically addresses the BEPS risk arising from three different types of situations wherein MNE Groups:

i) place higher levels of third-party debt in high-tax countries,

ii) generate interest deductions in excess of the group's actual third-party interest expense by using intra-group loans, and

iii) use third party or intra-group financing to fund the generation of tax-exempt income.

BEPS Action 4-Limit interest deduction

OECD recommended that tax jurisdictions should implement a mechanical rule to limit interest deductions, which may have been undertaken as an instrument for excessive tax deductions. Three broad practices have been suggested to tackle the issue of thin capitalization.

- First, the **fixed ratio rule**, which limits the interest costs benchmarked as a percentage of earnings before interest, taxes, depreciation, and amortization (Ebitda). This restricts an entity's net interest deductions to a fixed percentage (say, between 10 to 30%) of its Ebitda calculated using tax principles.
- Second, the **group ratio rule**, which allows an entity to deduct interest expense limited to the ratio of interest/Ebitda of its worldwide group.
- Third, **the targeted rules**, to address specific risks not addressed by the fixed and group ratio rules.

India-Thin capitalisation

- The Government of India, through Finance Act, 2017, introduced anti-abuse provisions in the Indian tax laws that provides for limitation on interest deduction in certain cases;
- This is broadly in line with the recommendations as per BEPS Action 4 Report.

Section 94B

- It is applicable to an Indian company, or a permanent establishment (PE) of a foreign company, which pays interest or incurs an expenditure of a similar nature, for payment to a non-resident associated enterprise
- in excess of Rs 1 crore.
- Applicable also where debts are issued by third-party lenders but AE provides guarantee or the AE deposits a corresponding and matching amount of funds with the lender.
- **An exception** from the applicability of provisions has been carved out for Indian companies or permanent establishments of a foreign company engaged in the business of banking or insurance.
- The provisions limits the deductibility of the payment of interest by an entity to its non-resident associated enterprise to 30% of Ebitda.
- Interest amounts exceeding such threshold are allowed to be carried forward for a period of eight succeeding years, subject to maximum allowable interest expenditure of 30% of Ebitda for each such period.

Example of 94B

EBITDA	Rs 1000 cr
Interest payment to AE	Rs 400 cr
Section 94B limits interest deduction to 30% of EBITDA	1000*30% = Rs 300 cr
Rs 100 cr can be carried forward for 8 years	

Case Study-Section 94B

EBITDA	Rs 1 crore
Interest payment to AE	Rs 50 Lakh
Section 94B limits interest deduction to 30% of EBITDA	

- What are the section 94B implications?

Controlled Foreign Company

Controlled Foreign Corporations (“CFC”)

- CFC’s are corporate entities incorporated in an overseas low tax jurisdiction and controlled directly or indirectly by residents of a higher tax jurisdiction (Parent State).

- Since each corporate entity is treated as a separate legal entity, the profits earned by such CFC’s are not taxed at the owner level until they are distributed. CFCs tend to earn passive income; such income is not distributed, thereby resulting in tax deferral in the parent state.

CFC rules are anti-avoidance rules to stop MNE from setting up subsidiaries with little substance in low tax jurisdictions, to divert profits from higher tax jurisdictions.

Controlled Foreign Corporations ("CFC")

International Bureau of Fiscal Documentation (IBFD):

- "The term is generally used in the context of tax avoidance rules designed to combat the **diversion by resident taxpayers of income to companies they control and which are typically resident in countries imposing low-or-no taxation.** Under these rules income of the controlled company is typically either deemed to be realized directly by the shareholders or deemed to be distributed to them by way of dividend. Often only part of the controlled company's income is dealt with in this way, typically passive income such as dividends, interest and royalties (tainted income). Many but not all controlled foreign company regimes apply only to corporate shareholders."

Controlled Foreign Corporations ("CFC")

- CFC's are incorporated in low tax jurisdictions or Tax Havens- Bermuda, Singapore and many more with an intention to evade and avoid payment of tax in high tax jurisdiction
- The income accrued or earned is diverted to low tax jurisdiction by incorporating entities in that jurisdictions which is ultimately controlled by person resident in high tax jurisdiction.
- This lead to tax evasion which is completely unlawful and bad in the eyes of law and also the high tax jurisdictions like India suffered huge loss of tax revenues which ultimately results in unfair tax collection from honest taxpayers.
- Such income can only be taxed in India after it has been repatriate to India in the form of distributable profits like dividend, which is usually not done so as to avoid tax liability.

CFCs-India-Introduction

- Unlike most OECD member countries, India does not have CFC provisions in its domestic tax legislation.
- CFC provisions were included in the Direct Taxes Code Bill, 2010, new legislation proposed to replace the current Income Tax Act, 1961, that was presented to parliament in August 2010 but lapsed without being passed.
- The implementation of the Pillar Two GloBE proposal would focus policy choices in India that consider the prevailing framework for Indian-headquartered MNEs.

BEPS-Action 3

- 1998 Harmful Tax Competition Report, the OECD has encouraged the use of CFC legislation, including recently as part of the BEPS Project (Action Point 3).;
- Action Point 3 of the BEPS Project is concerned with CFC and with providing a best practice blueprint for a set of CFC rules.
- In addition the EU has included CFC rules in their 2016 Anti-Tax Avoidance Directive.
- **BEPS Action 3-** The report identifies six ‘building blocks’ as the design principles for CFC rules. The report notes that these are not minimum standards but are a guide to ensure that jurisdictions that choose to implement such provisions will have a set of effective CFC rules that will prevent the diversion of profits to foreign subsidiaries.

Main features of BEPS Action-3

- **Control Test-** The main test that defines a CFC is the level of control that relevant persons (ie those that have a connection through residence or presence) in a territory have over a foreign company. {Most jurisdictions provide for 50% control threshold}
- **Lower Level of Taxation**- Many countries have a lower level of taxation test in their CFC provisions. This may mean ascertaining what the taxable income or gains of the foreign company are under domestic provisions and comparing the actual overseas tax incurred with that taxable income.
- **Identification of Income-** The focus of most countries that have CFC provisions is then to identify specific types of income or gains earned by the foreign company which are regarded as abusive. Eg Investment or passive incomes which sometimes remain untaxed

Worldwide Control test

- In the US & Japan CFC regs- the threshold is 10% voting stock control per shareholder, where shareholders hold more than 50% of the voting power.
- In Germany there is no minimum where there is passive portfolio income – otherwise 50% of the voting rights.
- In some circumstances 'control' under the UK system can refer to a UK-resident company having a 40% or more interest in another foreign company; with a minimum 25% interest required for the CFC charge to apply.
- In Canada control is defined by a 10% shareholding, together with related persons, with at least 1% held by the Canadian entity itself.

Identification of income

Once the offending income is identified there are two different approaches that can be taken by jurisdictions:

- **the transactional approach**, is to identify purely the offending income from underlying transactions undertaken and to tax those transactions as though they had arisen in the country applying the CFC provisions (eg this broadly applies in Australia, Canada, France, Germany, the US, the UK and new (2017) Japan approach).
- **the jurisdictional approach**, is to look at the activities of the foreign company as a whole to decide whether the offending income or activities represent the major part of the foreign company's activities. If they do, all of the income/gains earned by the foreign company are subject to tax under the CFC provisions (eg this broadly applies in Sweden, and under the old rule in Japan).
- Some countries have both transactional and jurisdictional approaches to their CFC provisions, such as the current UK approach.

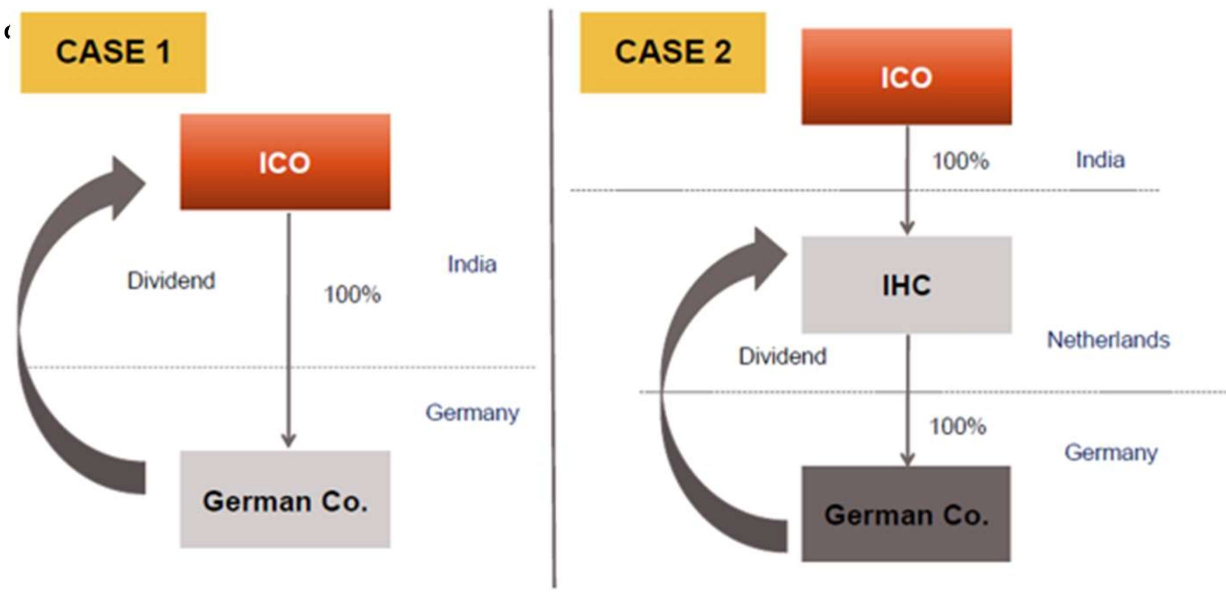
BEPS Action 3-CFC

The suggested 6 building blocks of CFC regulations are:

- *Definition of a CFC (including control)*;
- *Threshold requirements and exemptions*
- *Definition of CFC income;*
- *Rules for computing income;*
- *Rules for attributing income;*
- *Rules to prevent or eliminate double taxation*

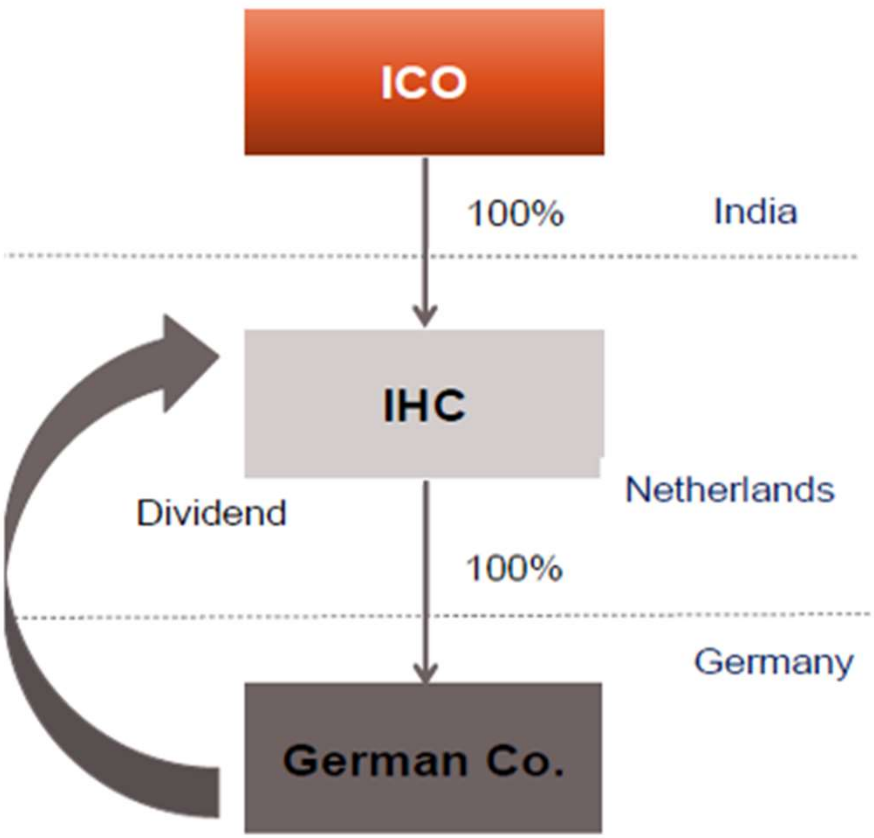
CFC concept-India

- An Indian resident assessee is taxed on his / its world wide income. However, the income is liable to tax only if the assessee has either received the income or earned it.
- When an Indian resident invests outside India, he may get foreign income. When those investments yield incomes – say interest, dividend etc., they will be taxable in India. These incomes will also be liable to Indian FEMA (Foreign Exchange Management Act) discipline.
- In case, the Indian investor wants to earn foreign income but does not want to pay the Indian taxes on the same; or does not want the Indian FEMA discipline for the same then he may invest through an intermediary company. The intermediary company – being a foreign company will not be liable to Indian tax, and the FEMA discipline will be much less



While Dividend in Case 1 was taxable in hands of ICO, in Case 2, Dividend is exempt in hands of IHC under tax rules

Need for CFC rules



CFC -India

RESIDENT RULE OF TAXATION

Many countries, including India, follow the “Resident rule of taxation”, wherein, if a person is a tax resident of India, their global income is subject to tax in India (country of residence). These taxation are triggered at the point, when the income accrues or is received by the resident.

- In the earlier example, the income accrues to ICO, when the German Co. declares dividend. Secondly, if the German Co also pays royalty, and it is received by ICO, it shall be taxable.
- In order to defer/avoid taxes in India in the above case, many taxpayers set up corporations outside India (resident state) in a jurisdiction (Netherlands) which would levy no tax or lower tax on the foreign sourced incomes (Refer Case 2). In this case, if the German Co. declares dividend, it would be exempt from tax in Netherlands as there is no tax on dividend in Netherlands under their local laws/ under European Union Directives.
- Secondly, if the German Co pays royalty, there would be no tax in Netherlands, as these may be exempt under the European Union regulations, relating to free movement of income in EU without any taxation

CFC -India

- Where income are diverted to the CFC, such income would either not be brought back to the country of residence (say India), or brought in a manner where tax levied would be lower in the country of residence .
- In order to provide the country of residence (India), the right to tax such income, CFC regulations are introduced, whereby, if a foreign corporation is used as a mere tool to defer/not pay taxes in the country of residence, the country of residence gets the right to tax such income.
- In the above example, if the CFC provisions are present in the domestic taxation system of the parent's Country of Residence (India) and if the Netherland Co, qualifies as a CFC, parent company would be liable to pay tax on certain passive income of Netherland Co., even though these are not accrued/remitted to the parent's jurisdiction.
- Some countries may provide for a levy of penalty for concealment of income, in cases where the income is kept in a CFC, and not repatriated to the Country of Residence.

Conditions

- The degree of control exercised over a particular corporation, would result in such organization being classified, as a CFC ("IHC" in the example). A foreign entity would be regarded as Controlled Foreign Company, if all the following conditions are fulfilled : –
  - Person(s) in the State of residence (India), individually or collectively exercise control over the CFC;
  - CFC is not engaged in active trade or business;
  - Shares of the CFC entity are not listed on recognized stock exchange of the country of residence (Netherlands);
  - Entity is resident of territory with low rate of taxation
  - Specified income of the entity exceeds a given threshold (INR 2.5 million in the case of limits specified under DTC 2010).

Control ownership criteria

- Control, in general, for the purpose of CFC may have different parlance in different countries. Control is generally said to exist if there is a control over voting power, to influence the business of a CFC, and/or simply having a significant stake in the CFC's assets, profits or liquidation proceeds (i.e., controlling ownership). However, the most common criterion, where a control is said to exist in the case of CFC are as under : –

a) More than 50% equity or voting power

Many countries consider a company as a CFC of another person, when a particular company or group of companies, along with individuals, owns equity or have voting power, directly or indirectly, in excess of 50% in the other company.

b) Equal to or less than 50% of equity or voting power

Some countries, deem that even a control of less than 50% of equity or voting power may be sufficient to possess the ability to reduce the overall tax liability of the company. In these cases, even when a particular company owns equity or has voting power, directly or indirectly, equal to or less than 50%, control is deemed to exist so as to constitute one company as a CFC of the other.

Active trade or business test

- In order to qualify as being engaged in active trade or business , a CFC has to satisfy the following two cumulative conditions : –
- It should actively participate in industrial, commercial or financial activities, undertaken through employees other personnel in economic life of the CFC country; and
- Specified income (mainly include passive income like interest, dividend and royalties, and income from certain related party transactions) should be less than 50% of the income for the year. In order to compute the 50% limit, the comparison has to be done at gross level. For example, if an entity is engaged in trading and investment activity, sale value of goods, would be compared with interest / dividend income .

CFC rules -India

WOULD CFC RULES BE VALID CONSTITUTIONALLY IN INDIA -ARTICLE 245 OF INDIAN CONSTITUTION

Under the Indian law, the power to make laws for the Parliament, and the Legislatures of States are as under : –

•Subject to the provisions of this Constitution, Parliament may make laws for the whole or any part of the territory of India, and the Legislature of a State may make laws for the whole or any part of the State

•**No law made by Parliament shall be deemed to be invalid on the ground that it would have extra territorial operation**. (Emphasis supplied)

If the CFC Rules are brought into legislature, the intention would be to protect the Indian tax base, in respect of income that has nexus with India. In such a case, any provision in Income Tax Act, 1961 cannot be regarded as unconstitutional, merely because it has extra territorial operation.

Case Study

- ICO, an Indian company is evaluating whether, IHC, a company incorporated in Netherlands is a CFC. The income of CFC is given as under. You are required to confirm if IHC would qualify as a CFC of ICO ?

Interest	**5 lakh**
Dividend	2 lakh
Royalty	3 lakh
Income from sale of good to related party	8 lakh

- What would be your answer, if the income from Sale of Goods was Rs.12,00,000 ?

Case Study-Answer

- Passive Income of ICO = Rs. 10,00,000 (Rs. 5,00,000 + Rs. 2,00,000 + Rs. 3,00,000)
- Active income from Sale of Goods = Rs. 8,00,000
- % of Passive Income vis a vis total income =10,00,000/18,00,000 = 55.56%
- Since Passive Income > 50%, IHC is a CFC of ICO, assuming other tests are satisfied
- If the income from Sale of Goods is Rs. 12,00,000
- % of Passive Income vis a vis total income = 10,00,000/22,00,000 = 45.45%
- Since Passive Income < 50%, IHC is not a CFC of ICO, assuming other tests are satisfied

Thank you!!

Any Questions?

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