


# Indo-UK Patrika



Welcome to the summer issue of Kingston Smith's Indo-UK Patrika quarterly newsletter. This edition of the newsletter looks at the recent budget announcements in India and its implications on the taxation of foreign dividends, the trend for employers to move away from the net salary model, an update on immigration matters, comments on the recent consultation announced on the UK residence and domicile rules and the secret to having a successful joint venture in the UK.

## Taxing Foreign Dividends

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Geetika Mehra, Partner, at KS international's New Delhi firm, Mehra Goel & Co, reviews the changes to tax rates on foreign dividends and its effect on Indian companies preferred structure for their presence in the UK.

The recent announcement that the rate of Indian Corporation Tax on foreign dividends would be reduced to 15% may have caused some Indian businesses with operations in the UK to question the common wisdom of operating in the UK through a branch instead of a subsidiary. The branch model has typically been used to avoid the problem of double taxation with no relief on UK profits paid to India as dividends and also to maximize the benefit of SEZ and STPI exemptions. However, with the benefit of STPI exemptions coming to an end and the SEZ exemptions limited to operations undertaken within the SEZ areas; the 15% Indian rate of tax on dividends could have made converting branches to subsidiaries a compelling proposition. Unfortunately, the 15% tax rate is not as attractive as it first seemed once the detail of how and when it applies is understood.

At present, when Indian corporates declare dividends, a dividend distribution tax (DDT) is applied at a rate of 15%. Adding corporate surcharges and Cess, the effective rate becomes a little higher at around 16.6%. However, the hands of the recipient, promoters or individual shareholders, there is no DDT. With a view to provide an impetus to outbound investment by Indian Multinationals, and to bring foreign dividends closer in-line with their domestic counterparts, the rate of tax on dividends received by an Indian company from its foreign subsidiary has been lowered to 15 % plus surcharge for the Financial Year 2011-12. While this is a welcome move for India Inc, the proposed tax relief has thrown open a few issues which will limit its impact during this one year window.

The reduced tax rate will be offered where the Indian company has a minimum 50% stake in the foreign subsidiary. Does 50% stake in the foreign company by an Indian company mean direct holding or also through conduits? It is common for a clutch of investment companies coming under a group to invest abroad and together they may account for a minimum 50% stake.

Indian companies under the Minimum Alternate Tax (MAT) regime may not be able to rely on a 15% basic tax after all on the dividend income from foreign companies. The current MAT rate is 18.5%. Accordingly wherever MAT becomes payable, the dividend income from foreign companies built into the book profits would suffer tax not at 15%, but at 18.5%.

A dividend received by an Indian company from its foreign subsidiary will form the part of the base for calculating DDT because as per Section 115-O, DDT is not payable on dividend received by a parent from its subsidiary if the subsidiary has paid DDT. A foreign subsidiary obviously would not have paid DDT. In this case, the tax charge on dividends received from foreign subsidiaries could be much more than 15%. It will be in the range of 30/33.5 % plus.

The limitation of the one-year window, is predominantly due to the imminent Direct Taxes Code (DTC) regime that has a specific tax clause related to Control Foreign Corporations (CFC). If there are overseas companies controlled by Indians and if these companies earn passive income in the form of dividends, royalty, rent or interests, then according to DTC guidelines, the income of these companies will be taxable in India at 30% to the shareholders, who control the company in the year of accrual.

Lastly and very importantly, in the absence of a unified credit regime on foreign dividends, no tax credit or exemption is available in India on Foreign corporation tax paid on the income on which dividends are declared, unless the subsidiary is located in Singapore or Mauritius.

The double taxation treaty between India and the United Kingdom offers credit on Indian income taxes to the UK parent company but not vice versa. The DTC is also not clear on the credit mechanism. This makes the tax cost on overseas income extremely high and continues to serve as a disincentive to bring back the dividends to service Indian shareholders.

While the reduced taxation offers relief for those companies who have cash lying idle overseas and want to avail of this window and bring the cash back into India, to make this measure truly effective, introduction of fiscal benefits in the form of tax credits on foreign Income will provide the desired incentive to outbound investment and for Indian holding companies to bring back the passive Income in the form of dividends to service Indian shareholders.

### A change in the way expats are paid in the UK – moving from net to gross

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**Tim Stovold, Tax Partner at Kingston Smith LLP, considers the implications of the recent change to tax and immigration laws in the UK and how it has made Indian employers in the UK to review the Expat salary structure model.**

It has long been the trend that Indian employers seconding their employees to the UK have paid salaries on a net basis so the tax and National Insurance liability is met by the employer. This way of paying employees is usually operated under a Modified PAYE Scheme (or TDS scheme) which is agreed in advance with HM Revenue & Customs (“HMRC”). Whilst this scheme has many advantages, recent changes to tax and immigration laws have caused some employers to question whether the disadvantages of this scheme are starting to outweigh the advantages.

The Modified PAYE Scheme allows employers to estimate their annual PAYE liability at the start of the tax year and, in the course of the year, to review their estimates and recalculate the liability based on the actual amounts paid. In practice, most employers operated this scheme so that the recalculation is performed at or near the end of the tax year so that the actual tax and National Insurance paid to HMRC is close to the final liability for the year.

In performing this calculation, certain concessions are granted by HMRC such as being able to apply a normal tax code giving the personal allowance instead of relying on codes issued by them, giving provisional relief for non-UK work days and, in some cases, allowing credit for foreign tax paid that would normally only be given after a claim is made in a personal tax return.

The intention of the Modified PAYE Scheme rules is that the correct amount of tax and National Insurance is collected through the PAYE system instead of an over-deduction being made through the operation of the normal PAYE rules which would subsequently need to be reclaimed by the employee.

As the Modified rules envisage that the calculation of the tax and NI liability can be on an estimated basis, to ensure that the correct amount of tax is collected, there is a requirement that each employee completes a personal tax return to declare the actual amounts they have been paid and therefore they may be due a refund or have an additional liability to pay.

The difference between the tax deducted at source under the Modified rules and the normal rules can be significant as the normal PAYE rules would only give 1/12ths of the tax free allowance and tax slabs each month so if an employee is only working in the UK for six months, they would only have been given half of their entitlement to allowances through the payroll under normal PAYE whereas the Modified PAYE scheme would give the entire year's allowances.

Where the employer operates a net scheme, this reduction in tax and National Insurance burden would often equate to a cost saving for them as the net scheme requires that the employer meets the cost of the tax and National Insurance.

There are two problems that companies operating Modified PAYE Schemes now face. The first is that the estimated nature of the Modified PAYE Scheme and the fact that the grossed up salary payable to the employees can change dramatically depending on the number of months an employee spends in the UK during a tax year mean that satisfying the UK Border Agency that the gross salary reported on a Certificate of Sponsorship has been paid may be difficult.

There needs to be a dialogue between HM Revenue & Customs and the UK Border Agency on this issue but as yet, little progress appears to have been made.

The second issue relates to the filing of employee tax returns. For any tax returns up to and including those relating to the 2009/10 tax year, a late tax return would incur a penalty of £100 which is subsequently reduced when the tax return is filed to the lower of £100 or the tax liability shown on the return. As most Modified PAYE calculations are re-run at the end of the tax year to capture the actual liability of the employee, this means that the tax returns subsequently filed showed no liability and therefore there is no penalty exposure.

However, from the 2010/11 tax year onwards (returns due to be filed on or before 31 January 2012), there is no mitigation of tax return penalties and they can now escalate where the failure to submit the return continues beyond three months.

Even though the penalty is a liability of the employee, employer's are expecting that that as the requirement to file the tax return only exists as a consequence of the way in which they calculate their PAYE, the employee's will expect their employer's to cover any penalties assessed.

For these reasons and others, some employers operating net schemes are considering moving to a gross PAYE scheme. This move comes with a cost increase to the employer which can only be mitigated if employees continue to file tax returns and mandate tax refunds back to the employer but most employers acknowledge that this will be difficult in practice to achieve as employees will understandably refuse to mandate the refund to the employer.

A net payroll scheme can still be advantageous to employers but additional steps need to be put in place to ensure that the UKBA requirements can be satisfied and that there is a robust system in place for completion of employee tax returns.

## The UK Immigration Scenario

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Rita Shah, Partner at immigration law firm JSK Law, discusses the new changes to immigration rules and regulations in the UK.

Building on the Government's policy that "Britain needs to attract the brightest and the best to fill jobs gaps" the first major change to reduce immigration into the UK came into effect on 6 April 2011. Under the annual limit, employers are able to bring only 20,700 people from outside the EU to work in skilled professions under Tier 2 (General) of the points-based system. A further 1,000 visas are made available to people of 'exceptional talent'.

Prospective workers need to have a graduate-level job offer, speak an intermediate level of English and meet specific salary and employment requirements. Those earning a salary of £150,000 or more will not be subject to the limit. Immigration Minister Damian Green said: "The annual limit will not only help reduce immigration down to sustainable levels but will protect those businesses and institutions that are vital to our economy."

There are also changes to the Intra Company Transfer route (ICT), which is exempt from the annual limit:

- The job will have to be in an occupation on the graduate occupation list;
- Only those paid £40,000 or more will be able to stay for more than a year - they will be given permission to stay for 3 years, with the possibility of extending for a further 2 years; and
- Those paid between £24,000 and £40,000 will be allowed to come to the UK for no longer than 12 months, at which point they must leave the UK and will not be able to re-apply for 12 months.

Also, Tier 1 of the points-based system is restricted to all but entrepreneurs, investors and people of exceptional talent. The 'Exceptional Talent' route will be open to current and prospective leaders in the fields of science, engineering and the arts.

However, the Government has "rolled out the red carpet" for Entrepreneurs and Investors. Under the new visa rules for Investors, those who invest substantial sums of money will be fast tracked to settlement in the UK. Those who invest £5 million will be allowed to settle here after 3 years, and those investing £10 million or more will be allowed to settle after 2 years in comparison with the minimum 5 year requirement that is currently in place. Entrepreneurs will also be able to settle in the UK after 3 years if they create 10 jobs or commence a business with turn over greater than £5 million.

As part of continuing efforts to reduce migration further a Consultation on employment-related settlement was announced by the government on 9th June that seek to prevent foreign professionals from settling here permanently. The proposals seek to break this link between working and automatic permanent settlement, except for a limited number of high net worth individuals.

The tighter rules will also affect diplomats from India and other non-EU countries posted here who bring along their domestic help.

The Summary of the Proposals is:

- Clearly define temporary and permanent migration routes
- Allowing only the brightest and best workers to stay permanently
- Consider capping the maximum period of Tier 1 temporary leave at 5 years and restricting the number of exceptional talent migrants granted settlement
- Define Tier 2 as temporary and thereby end the assumption that settlement will be available for those who enter on this route
- Consider whether certain categories of Tier 2 migrant (for example ministers of religion, elite sportspeople, those earning over £150,000) should retain an automatic route to settlement

- Create a new category into which, after 3 years in the UK, the most exceptional Tier 2 migrants can switch and go on to apply for settlement
- Apply robust selection criteria to those Tier 2 migrants who wish to switch and possibly a limit on the total number of migrants allowed to switch
- Allow those Tier 2 migrants who do not switch into a settlement route to stay for a maximum of 5 years with the expectation that they and any dependants will leave at the end of their leave
- Apply these changes to those entering the Points Based System from April 2011
- English language requirement for dependants of Tier 2 migrants applying for a route to settlement
- Introduce an English language requirement for adult dependants of Tier 2 migrants applying to switch into a route to settlement

The consultation on employment-related settlement will run for 12 weeks until 9 September and the UKBA will announce their firm plans in due course.

In the government's pledge of cutting net immigration to UK, the impact on UK businesses could prove to be disadvantageous as skilled workers not allowed to settle here permanently could consider migrating to countries such as Canada and Australia.

There is also a drive to encourage Investors and Entrepreneurs to come to the UK under the new enhanced visa procedures. However, the proposal to remove visas for domestic workers could impact their decision to settle in the UK, as accompanying Domestic staffs are also a critical factor for Investors and Entrepreneurs when considering relocation.

### HMRC Consultations on Domicile and Residence

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Tim Stovold, Tax Partner at Kingston Smith LLP, reviews the newly released consultation document on Domicile and Residence and the associated tax treatment for Non-Domiciled individuals in the UK.

Last month, HM Revenue & Customs released Consultation Documents on a statutory test for residence and the reform of the taxation basis for non domiciled individuals. The introduction of a statutory test for residence in the UK would be welcome as the current regime is based on a combination of HMRC guidance and case law which has led to some unpredictable results.

However, a change to the residency rules will have minimal impact for many Indian employees on secondment to the UK as their employment income is normally taxable from arrival on the basis that is a UK source of income and therefore taxable in much the same way for UK residents and non-residents. Where it will have implications is on the taxation of income arising outside of the UK as, if the new rules are implemented as announced in the consultation, employees on secondment to work full time in the UK will become tax resident (and therefore taxable on worldwide income and gains) potentially sooner than they would under the existing rules.

The key points are:

- Residence – a test based on a combination of days in the UK and the number of specified connecting factors with the UK.
- Non-domiciled individuals – a new £50,000 charge for those residents here for 12 of the last 14 years. Also some simplification of parts of the existing rules. There is a proposed relaxation of rules on remittances for investment in UK businesses.
- Statutory Residence Test - A simple day counting approach alone has been ruled out. Instead the proposals look at a mix of time spent in the UK and other ties through family, accommodation, work etc. To some extent the tests look to reflect the factors that are taken in to consideration under the present rules.

There is to be a 3 part test:

**Part A** – if any one of the following three tests are satisfied, the person is always non resident.

- Not resident in previous 3 years and less than 45 days in the UK in the year
- Resident in one or more of previous 3 years and less than 10 days in the year
- Full time working abroad with less than 90 days in UK and, of those 90 days, less than 20 working days in UK

**Part B** – if any one of the following three tests are satisfied, the person is always resident.

- In UK for more than 182 days in the year
- Only home (or homes) is/are in the UK
- Full time work in the UK

If the person exceptionally satisfies some tests in both A and B, then A will take precedence.

**Part C** – for the less clear cut cases a rather mechanical consideration of a mix of time spent in the UK and other specific factors including location of family, accommodation, etc... are suggested.

The new statutory test is proposed to apply from 6 April 2012 and will supersede the existing case law tests for Income Tax, Capital Gains Tax and Inheritance Tax. No transitional rules are proposed, although this will mean that initially some parts of the new statutory test will depend on residence for earlier years determined under the current non statutory rules.

### Tax treatment of non domiciled individuals

The existing £30,000 Remittance Basis Charge (RBC) will remain for those resident in UK in 7 of previous 9 years and opting for the remittance basis. For longer term residents there will be a £50,000 charge as the cost of opting for the remittance basis where someone has been resident for 12 of the previous 14 years. It is estimated that may be 3,500 taxpayers will pay this new higher charge and the additional revenue to be raised is estimated at £80 million per year.

No changes are proposed to the current de minimis rules or the ability to opt in and out of the remittance basis from year to year.

A new relief is proposed for remittances from abroad for the purpose of investing in a qualifying UK business. Funds used for this purpose will not count as remittances, so enabling overseas income or gains to be remitted to the UK without further tax cost.

The relief appears wide ranging. The investment may be in the form of shares or loans, there are few restrictions on the type of business including all trading activity (other than some leasing) and also including commercial letting (but not residential). It is though intended that investment must be in a company rather than alternative business structures. No size limit is intended, no restrictions on the investor's connection with the company and only limited restrictions on the territorial extent of the business (although investment overseas would normally be possible without worrying about the remittance basis rules anyway).

The Consultations are open until mid September with the intention of legislating in Finance Bill 2012 for introduction from 6 April 2012.

### The secret to a successful Indo-UK JV – it's all about the planning

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Rishi Malliwal, Partner at Sprecher Grier Halberstam LLP examines the Joint Venture as another feasible structure for Indian companies to do business in the UK and the associated factors to be considered for a successful JV.

With successful and established Indian businesses increasingly looking to establish an international presence, particularly in the UK market, we take look at why searching out a UK joint venture partner can be a rewarding commercial option as well as outlining some the key considerations to bear in mind when establishing a joint venture in the UK.

## Why a joint venture?

There are many reasons why you might wish to establish a joint venture in the UK – for example, to secure a closer working relationship with a key supplier or customer in the UK potentially on a profit sharing basis, or to benefit from the combined commercial strengths, financial resources and expertise by forming a strategic alliance with a competitor in a foreign market such as the UK. Whatever the reason, you should ensure that the commercial objectives and responsibilities of each potential joint venture participant are clear and well understood by each other party.

## Preliminary considerations

There is no “one size fits all” approach to establishing a joint venture in the UK, but several factors will ultimately influence the nature of the commercial venture, the structure and operation of the joint venture. Some of the key preliminary considerations include:

- The commercial viability of the potential business relationship, including cultural differences and divergences in attitudes toward the business and the interaction between the JV partners.
- The structure of the JV: contractual, limited partnerships, partnerships of corporate vehicles or direct ownership of shares in a special purpose JV company.
- Where the JV entity should be located – which may, to a large extent, be driven by the location of the significant business assets.
- The tax efficiency of the proposed structure.
- The legal and regulatory framework affecting the establishment and operation of the JV as well as the potential interaction between the laws of India and the laws of the UK and any potential effect this may have on the JV.
- How the JV will be managed and controlled and how this responsibility will be shared.
- How the JV entity will be funded and how this responsibility will be shared.

## The importance of expert advice

Establishing a JV in the UK can be an exciting and rewarding step in expanding or strengthening your commercial interests here, however this process can be complicated and very costly if appropriate expert advice is not obtained, particularly where legal and tax issues are not properly considered at the outset.

Its important to give due consideration to not only the legal aspects of creating a JV in the UK, but also the cultural and other non-legal factors which are unique to creating a successful Indo-UK business partnership.

## Kingston Smith News

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Chandru Iyer, International Business Development Director at Kingston Smith LLP will be travelling to India between 21 July - 9 August for his annual visit to meet clients, prospects and business associates in the market. Covering Delhi, Mumbai Pune and Bangalore, Chandru's visits are representative of the firm's commitment to the India UK business corridor.

We hope you find the first edition of the Indo-UK Patrika an interesting and informative read, and we welcome your feedback.

Please email our India Desk with your thoughts, ideas and suggestions.

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