Patterson Belknap Webb & Tyler LLP

Foreign Holding Companies and Domestic Taxes: US, Canada and India

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About the Author

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Patterson Belknap Webb & Tyler LLP

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Look-Through Rules for Indirect Transfers of Real Estate and Other Domestic Assets

Look-Through Rules for Foreign Holding Companies

- The US, Canada and India each tax nonresidents on the sale of domestic real property and other domestic situs assets. However, their rules differ markedly when it comes to the treatment of foreign companies that (directly or indirectly) own domestic real property and other domestic situs assets.
- The US and Canada will both tax the gains on the sale of stock in a domestic corporation if a sufficient proportion of the corporation's assets is comprised of domestic real property (including resource property and other domestic situs assets). However, the US generally does not tax the sale of stock in a foreign corporation by a nonresident seller and Canada does so only under limited circumstances.
- In contrast, India appears to tax nonresidents on the sale of stock in foreign companies with Indian subsidiaries without any apparent threshold for indirect ownership of Indian real property or other tangible assets in India (although the law may be in flux).

US Rules on Dispositions of US Real Property Interests

- General Rule: Nonresident aliens and foreign corporations generally are not subject to federal income taxes on gains from the sale of capital assets, including stock in US corporations, unless such assets are US real property interests.
- Dispositions of US real property interests:
  - Under the Foreign Investment in Real Property Tax Act ("FIRPTA"), foreign corporations and nonresident aliens who directly or indirectly sell interests in US real property (including leaseholds and resource properties) are taxed on the gains.
    - This can include the sale of interests in partnerships and certain US corporations that own US real property interests.
    - Foreign corporations are taxed at a 34-35% rate, while nonresident aliens are taxed at a 20% rate if the asset has been held for more than one year.
  - *Withholding obligations.* A purchaser who buys U.S. real property from a non-U.S. person generally is required to withhold 10% of the amount realized upon the sale.
    - Depending on the amount of appreciation, this may be more or less than the foreign seller's tax liability (i.e., the seller may have to apply for a refund).

US Rules on Dispositions of US Real Property Interests

- US Real Property Holding Corporations: The sale of stock in a US corporation may be subject to the FIRPTA tax and applicable withholding if the corporation has been a *US real property holding corporation* ("USRPHC) at any time during the previous five years.
  - *Definition.* A USRPHC is any US corporation if the fair market value of its US real property interests equals or exceeds 50% of the sum of (1) its US real property interests, (2) interests in real property located outside the US and (3) other assets held for use in a trade or business (such as inventory, depreciable property, patents and other IP).
    - This rule excludes many other US assets – i.e., it is targeted at US real property.
  - The sale of a foreign corporation generally is not subject to FIRPTA no matter how much US real property it owns. (The foreign corporation ultimately may have to pay taxes on gains from the sale of the underlying US real property interests.)
  - *Notice requirements.* Certifications and IRS notices are required to establish that a US corporation is not a USRPHC. Purchase and sale agreements involving US targets often require these certifications (or certifications that the seller is not foreign) as a closing condition.
  - *Exceptions.* There are exceptions for companies that are publicly traded (if the foreign shareholder owns no more than 5%), as well as for certain real estate investment trusts.

US Rules on Dispositions of US Real Property Interests

- FIRPTA overrides nonrecognition treatment for nonrecognition transactions involving transfers of US real property interests (including shares of USRPHCs), except in certain circumstances, such as where the transferor receives a US real property interest that would be subject to FIRPTA in the exchange (e.g., a "like kind" exchange for other US real property interests or a capital contribution or reorganization in which the transferor receives stock in a USRPHC).
  - Transfers in which the foreign transferor receives stock in a foreign corporation are eligible for nonrecognition treatment only under limited circumstances.
  - The parties to the transaction must satisfy the IRS notice requirements.
- In some cases, taxpayers may apply for a withholding exemption from the IRS (for example, based on a Code or treaty exemption or because the taxpayer demonstrates that no gain would be recognized).

Taxable Canadian Property

- Nonresidents generally are not subject to income taxes in Canada on the sale of stock in a corporation (Canadian or otherwise) unless the stock is "taxable Canadian property."
- *Taxable Canadian property* includes, among other things:
  - Real property situated in Canada;
  - Certain assets (such as equipment) used in a trade or business carried on in Canada;
  - Certain oil, gas, timber and other resources properties; and
  - Shares of a corporation or interests in a partnership or trust if, at any time during the five year period immediately preceding the disposition, more than 50% of its fair market value was derived from real or immovable property situated in Canada or certain resource properties.
    - *This can include shares of a nonresident corporation that satisfies the above fair market value tests.*

Taxable Canadian Property

- Exceptions to Rules Characterizing Shares as Taxable Canadian Property:
  - Shares of publicly traded stock and mutual funds generally are not considered taxable Canadian property regardless of their real estate holdings during the previous five years so long as neither the taxpayer nor any person not dealing with the taxpayer on an non-arm's basis owned 25% or more of any class of shares during that five-year period.
  - Many treaties, including the US-Canada income tax treaty, limit application of the tax to sales of resident corporations that own the requisite amount of real property (and also shorten the lookback period).
  - As with the US, certain tax filings may be required with the Canada Revenue Agency.
- Comparison with US: Overall look-through rules for companies are similar to those in the US (including a five-year look-book period), but in certain non-treaty contexts can include nonresident corporations.

India and the Vodafone Case

- General Rule: Nonresidents (including nonresident companies) are subject to income taxes on gains from the sale of assets situated in India.
  - Stock of an Indian company is considered to be "situated" in India for this purpose.
  - A buyer may be responsible for withholding taxes from the proceeds.
  - Recent legislation following the Vodafone decision extended this rule to cover transfers of interests in nonresident companies that own assets situated in India (including Indian subsidiaries). The new rules are not well defined, but appear to be far broader in scope than the rules for taxable Canadian property.
- Vodafone Acquisition: In 2007, Vodafone International Holdings B.V. ("Vodafone"), a Dutch subsidiary of Vodafone PLC, acquired the stock of CGP Investments (Holdings) Ltd. ("CGP"), a Cayman Islands subsidiary of another Cayman Islands holding company owned by the Hong Kong-based Hutchinson Group. CGP indirectly owned a 67% interest in Hutch Essar Ltd. ("Hutch"), an Indian cellular communications company with licenses throughout India, through multiple tiers of Mauritius and Indian subsidiaries. Total consideration for the share purchase and ancillary transactions topped $11 billion.

India and the Vodafone Case

- Position of Indian Tax Authority: The government attempted to impose a $2.5 billion tax liability on Vodafone for failure to withhold income taxes from the proceeds. Although Indian tax law only addressed withholding obligations with respect to direct sales of assets located in India (including shares of companies incorporated in India), the government took the position that it had jurisdiction to tax the transaction because it involved an indirect transfer of an Indian company.
- Decision in Favor of Vodafone: The Supreme Court ruled in favor of Vodafone, concluding that Indian tax law at the time did not extend the government's jurisdiction to such indirect transfers.
  - The court acknowledged that while the tax authorities could ignore the form of a "sham" transaction, this did not preclude legitimate tax planning. The Indian tax authorities could not read an indirect transfer rule into the tax law or a limitation-on-benefits provision into the India-Mauritius tax treaty.
  - The court also stressed that the holding company structures of both the buyer and seller had been in place for some time – i.e., they had not been created to avoid taxes in India.

India and the Vodafone Case

- Change in Law Regarding Indirect Transfers: The Finance Act 2012 extends India's tax jurisdiction retroactively to transfers of interests in nonresident companies by nonresidents if the shares of such companies derive their value "substantially" from assets located in India. This legislation was enacted to reverse the Supreme Court's decision in Vodafone.
  - There is no guidance as to what "substantially" means (e.g., more than 50%?).
  - Proposals have been floated to scale back the indirect transfer provisions to allow for certain corporate reorganizations, but nothing has been enacted and key terms have yet to be defined.
  - If an Indian subsidiary is owned by a holding company in Mauritius or certain other treaty jurisdictions it may actually be better for Indian tax purposes for the holding company to sell the Indian subsidiary directly.

India and the Vodafone Case

- Final Comparison Points:
  - The US generally would not tax the sale by a nonresident of a foreign corporation owning US real property interests. The sale of a US corporation is taxable only if a sufficient proportion of its holdings is comprised of US real property interests.
  - Canada may tax the sale of a nonresident corporation under limited circumstances (in the absence of a treaty), but there would need to be significant real estate holdings (e.g., more than 50%).
  - Pending further guidance from the Indian tax authorities, there does not appear to be any minimum real estate holding threshold in order for the sale of stock of the foreign parent of an Indian subsidiary to be taxable in India.