Changing Tax Reforms in India – What Next?

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The Indian Tax Law regime has moved from a complex array of rules and regulations to much simplified arrangement. This transformation is telling in the context of recent set of reforms and the introduction of GAAR as an all encompassing anti avoidance provision. There were several trigger points which initiated these reforms, the most controversial being the famous Vodafone ruling. The author examines the viability of the GAAR in the modern Indian tax law scenario by broadly focussing on the general anti avoidance regulations and the retrospective amendment relating to indirect transfer. The article thoroughly and illustratively examines the various permutations and combinations of instances where GAAR may be applied or withheld and provides for ideal situations where other alternatives may be examined as substitutes for the same.

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I. Introduction

"Nothing endures but changes" - This is equally applicable in the context of the tax forms in India in recent times. There are several trigger points which initiated these reforms, to name a few; The age of the current Indian Tax Law together with the complicated amendments made in the past 50 years, move towards simplification, several controversial tax rulings including the famous Vodafone ruling. Two of the common topics constituting the recent changes in the tax law are the general anti avoidance regulations and the retrospective amendment relating to indirect transfer. This paper briefly analyses these two reforms.

II. General Anti-Avoidance Rules

General Anti-Avoidance Rules ("GAAR") had been introduced by the Finance Act, 2012 to be effective from 1 April 2013. A Committee had been constituted to provide recommendations for formulating the guidelines to be issued for proper implementation of GAAR provisions. The Committee released its recommendations on 28 June 2012. The recommendations of the Committee were perceived to be insufficient or confusing by stakeholders. Subsequently, an Expert Committee under the chairmanship of Dr. Parthasarathi Shome was constituted by the Prime Minister to undertake stakeholder consultations and to finalise the guidelines for GAAR after widespread consultations so that there is a greater clarity on GAAR issues.

On 1 September 2012 the Expert Committee published its draft report which contains various recommendations for amendment of GAAR provisions, for the guidelines to be prescribed and for clarifications and illustrations through circular. It is understood that the Expert Committee has submitted its final report to the Government of India which is largely similar to the draft report. The paper seeks to discuss some of the key recommendations below.

The Shome Committee suggested that the GAAR implementation should be deferred by three years to give time for training tax officers in the application of GAAR provisions and for establishing appropriate procedure / processes and to generate environment of certainty. Tax on gains arising on transfer of listed securities (whether in the nature of capital gains or business income) should be abolished for both residents and non-residents. The Government may consider increasing the rate of Securities Transaction Tax (STT) to make the proposal tax neutral. It is also suggested that the arrangements which have the main purpose of obtaining tax benefit should only be covered under GAAR.

There were major suggestions made in the definitional limits of the words. It was recommended that the term "commercial substance" should be defined under the ITA to mean a change in the economic position by altering the business risks or net cash flows. The definition of "connected person" may be restricted only to "associated person" under section 102 and "associated enterprise" under section 92A. It was suggested that there should be a clarification that the period of the arrangement, tax payments made under the arrangement and provision of an exit route by the arrangement are not sufficient (instead of being totally irrelevant) for an arrangement to be excluded from the commercial substance test but may be relevant in the consideration of other aspects of GAAR. These factors should be considered in forming a holistic assessment to determine whether an arrangement lacks commercial substance.

The recommendations as to that composition of the Approving Panel ("AP") stated that it should constitute five members with a retired High Court judge as Chairman. Two members should be from outside government and persons of eminence drawn from the fields of accountancy, economics or business, with knowledge of matters of income-tax. The other two members should be Chief Commissioners of Income Tax ("CCIT") or one CCIT and one Commissioner of Income Tax ("CIT").

The committee suggested that tax mitigation be distinguished from tax avoidance before invoking GAAR. An illustrative list of tax mitigation or a negative list for the purposes of invoking GAAR should be specified, including *inter alia* selection of one of the options offered in law, amalgamations/demergers as approved by the High Court and intra-group transactions which may result in tax benefit to one person but overall tax revenue is not affected. GAAR should be made applicable only in cases of abusive, contrived and artificial arrangements. A monetary threshold of Rs 3 crore of tax benefit (tax benefit to include only tax and not interest etc.) to a taxpayer in a year should be used for the applicability of GAAR provisions. Tax benefit should be considered separately for each arrangement unless the different arrangements are connected. Tax benefit in case of tax deferral should be determined based on the present value of money. GAAR should not be invoked where SAAR is applicable. Where anti-avoidance rules are provided in a tax treaty in the form of limitation of benefit clause etc., GAAR provisions should not apply to override the treaty. If there is evidence of violations of anti-avoidance provisions in the treaty, such treaty should be revisited, but GAAR should not override the treaty.

All investments (though not arrangements) existing as on the date of commencement of the GAAR provisions should be grandfathered. It should be clarified that where only a part of the arrangement is impermissible, the tax consequences of an "impermissible avoidance arrangement" will be limited to that portion of the arrangement. According to the recommendations it should be considered that while determining tax consequences of an impermissible avoidance arrangement, corresponding adjustment should be allowed in case of the same taxpayer in the same year as well as in different years, if any. However, no relief by way of corresponding adjustment should be allowed in case of any other taxpayer. The tax audit report should be amended to include reporting of tax avoidance schemes above a specific threshold of tax benefit of Rs. 3 crore or above which is considered by the tax auditor as more likely than not to be held as an impermissible avoidance arrangement.

A requirement of detailed reasoning by the Assessing Officer ("AO") in the show cause notice to the taxpayer may be prescribed in the rules. Further, it should also be prescribed that the CIT should make a reference to the AP within 60 days of the receipt of the objection from the taxpayer. In cases of inapplicability of GAAR provisions, CIT should communicate his decision to the AO within 60 days of the receipt of the taxpayer's objection. GAAR cannot be invoked if the CIT fails to act within six months from the end of the month of the reference. When the AO informs the taxpayer in his initial intimation invoking GAAR, he should include how the factors listed in section 97(2) have been considered (after amendment as recommended).

There have been interesting provisions relating to Foreign Institutional Investor (FII) as well. Where an FII chooses to subject itself to tax in accordance with domestic law provisions, then GAAR should not apply to it. Whether an FII chooses or does not choose to take a treaty benefit, GAAR provisions should not be invoked in the case of a non-resident who has invested, directly or indirectly, in the FII. However, this exemption should apply only in respect of investment in listed securities made by the FII in India. Also, GAAR provisions shall not apply to examine the genuineness of the residency of an entity set up in Mauritius where Circular No. 789 of 2000 is applicable.

III. Inapplicability of GAAR

The Committee has also made elaborate recommendations on where GAAR would not be invoked. It has suggested that in cases of tax benefit obtained by the Indian company by not declaring dividend post introduction of Dividend

Distribution Tax ("DDT") and subsequent buy back of shares after accumulating reserves, GAAR would not be invoked irrespective of whether subsidiary company pays tax on capital gains or claims exemption under treaty. Since declaration of dividend is a strategic policy decision, in any case it cannot be questioned.

This restriction on applicability of GAAR would also apply in cases of capital gains on sale of shares of an Indian company V by G and H, where shares of V were acquired by G and H pursuant to liquidation of intermediary Indian holding company X. Another instance would be of Capital gains on sale of shares of an Indian company by A Ltd., resident of F5, where A Limited has satisfied the Limitation of Benefit ("LOB") clause of India – F5 treaty.

GAAR cannot be invoked even in relation to the investment in India routed through F1 country providing exemption from capital gain in source country. The investment based on various criteria such as neutrality of F1's jurisdiction, ease of incorporation and operation of companies in F1, low cost of compliance and ease of migration, no domestic tax liability in F1 and strong treaty network of F1.

As there are no specific provisions dealing with thin-capitalization under the ITA and as it is a case of commercial judgment, GAAR will not be applicable in cases of rising of funds through loan instead of equity.

IV. Tax Liability in Cases of Holding - Subsidiaries

GAAR shall not be applicable in the case of merger which is carried out under the orders of High Court. For instance, an Indian company ("Holdco") borrowing money for acquisition of shares of another company ("Subco") which then becomes subsidiary of Holdco; Holdco and Subco amalgamate so that the interest payable on the monies borrowed to acquire the shares can be deducted in computing the income from the business of the amalgamated company.

It is equally important that the GAAR should not be applicable to an Indian company setting up a holding company in a No Tax Jurisdiction ("NTJ") which accumulates cash and does not repatriate money to India as the declaration/ repatriation continues to be a purely business decision and the ITA does not have anti-deferral provisions like the Controlled Foreign Company rules. A holding company set up by Indian company in a NTJ, accumulating cash / profits for number of years and subsequently merging with Indian company avoiding tax on dividend in India should also be excluded from GAAR as the timing or sequencing an activity is a business choice and is a specific exemption granted under the Act for the merger. Merger of a profit making company into a loss-making one resulting in losses offsetting profits and a lower tax liability for both companies taken together should also be excluded as the merger would be under the High Court order and therefore falling in the negative list for invoking GAAR.

Another instance of exclusion would come from the routing of overseas trading activities by an Indian company Z through an overseas subsidiary located in country A, where such country is a zero/low tax jurisdiction; the director of the said company finalises contracts in India but shows the documentation of trading in country A; and day to day management operations are carried out in India. Such exclusions would be justified as it would either be case of tax evasion by misrepresentation of facts or question of determination of a PE of the subsidiary.

Tax deduction claimed pursuant to setting up a unit in a SEZ area and the production from other units diverted to an exempt unit, with only packaging done in the exempt unit but claimed as manufactured in such exempt unit should be excluded. GAAR cannot be invoked in latter case as it would be a case of tax evasion and not tax avoidance.

Leasing of an asset as against purchase, resulting in higher deduction for lease payments compared to depreciation as it only amounts to selection out of the available options, setting off of losses in the stock market against gains which is aimed at the balancing the portfolio also need to be excluded. GAAR will not be invoked in the case of capital gains on disposal of preferential shares by employee of company R under conditions, where:

(i) The employee is given an option to receive a bonus or salary in the form of shares;

(ii) The employee subscribes to preferential shares;

(iii) Shares are purchased by R's group company or redeemed at a premium which is pre-decided by the employer;

(iv) Gains reflect the employee's annual salary or bonus, after a period of one year resulting in receipt of capital gain instead of bonus or salary

as there is a risk attached to the offer and there is no tax avoidance. However, GAAR may be invoked if every employee's remuneration package comprises a mix of shares and salary in a fixed proportion.

V. Application of The Other Anti-Avoidance Provisions Where GAAR is Not Invoked

There are many instances where a clear cut categorisation of application or non application of GAAR. But there will also be instances where the anti avoidance provisions are applicable even where the GAAR cannot be invoked. The following segment intends to examine these instances.

Production from non-SEZ unit is transferred to SEZ unit at a price lower than the fair market value thus showing higher profits in SEZ unit than in non-SEZ unit and consequently claiming higher deduction in computation of income will be hit by other anti avoidance provisions but not GAAR as they are specifically dealt with through transfer pricing provisions. Shifting / reconstruction of business in such a way that unit located in non-SEZ area offers lower income compared to units located in SEZ area which is specifically dealt with in section 10AA of the Act falls into the same category.

Charges (which include the cost and the mark-up) to group companies by a service company created to manage non-core activities and the transfer pricing provisions for transactions amongst related parties shall be covered by the anti avoidance provisions.

GAAR not to be invoked in all instance where the Short Term Capital loss generated by X set off against short term capital gains from other sources under conditions of:

(i) X borrowed money from Y for buying shares of subsidiaries

(ii) Fair market value of shares was Rs.100 but shares acquired for Rs.600

(iii) Amount received by subsidiaries transferred to a group company of Y

(iv) Shares of subsidiaries sold by X for Rs.100/5 incurring short-term capital loss.

as section 56 of ITA, being a SAAR, is applicable. GAAR may be invoked when SAAR is not applicable.

VI. Cases where GAAR would be Applicable

GAAR shall be applicable where the capital gains on sale of shares of an Indian company by A, A being a "permitted transferee" of its parent Y i.e. although shares are held by it, all rights of voting, management, right to sell, etc. are vested in Y. Unless covered by Circular No. 789 or LOB clause in India-Singapore treaty, GAAR will be applicable as the motive would be to avoid tax and there would be clear lack of commercial substance to make investment through A. Further, GAAR will be invoked for the Capital gains on sale of shares of an Indian company by A, where entire funding for investment by A was done by its parent Y and no other transaction has been carried on.

GAAR shall be applicable in all cases where the Tax benefit is obtained by an Indian company, with no dividends declared by it since 2003 post introduction of DDT, the accumulated reserves pursuant to non-declaration of dividends used to buy-back shares; and the buy-back offer not accepted by other shareholders. This would be acceptable as the arrangement appears to be a dubious method and may or may not be for genuine commercial reasons. GAAR would cover even the Capital Gain on sale of shares of an Indian company where the investment in the Indian company was split between subsidiaries to keep the shareholding below the specified percentage so as to be eligible to claim treaty benefits.

GAAR would be covering certain investment vehicles as well. For instance, it would be applicable to raising of funds through loan instead of equity and rate of interest calculated with reference to annual profit as there would be high likelihood that in substance it is equity investment. Main purpose of the transaction is to obtain tax benefit and the anti avoidance provision would naturally be attracted if the manner in which transaction is carried out is abnormal.

VII. GAAR and The Subsidiary Companies

The subsidiary company located in a low tax jurisdiction ("LTJ"), having reserves, may chose to make a term deposit with a banking company in the LTJ instead of providing loan to the Indian holding company. Such a term deposit provides a back to back loan to the Indian company and GAAR would be applicable here as well as the main purpose is repatriation of funds without payment of due taxes and transaction lacks commercial substance.

A foreign bank's Indian branch arranging loan for Indian borrower from its branch located in third country and if the loan is later assigned to J's subsidiary in F3 to take benefit of India-F3 tax treaty, then too GAAR shall be applicable as it provides for no withholding tax on interest to a bank carrying out bona fide business. A subsidiary in NTJ, having no resources, giving loan to the Indian holding company out of its equity contribution and the Indian company claiming deduction of interest will be covered by GAAR for similar reasons. The subsidiary company remaining idle would also be covered as the purpose of transaction to obtain interest deduction and case of round tripping and therefore deemed to lack commercial substance. Similarly a subsidiary in NTJ (with no resources) giving loan to an Indian company out of its equity contribution subscribed to by another Indian company will be covered. The Indian company claiming deduction of interest would also be covered. In all cases where the subsidiary company has no other activity GAAR would be attracted as the purpose of transaction to avoid tax on interest income in case the loan was provided directly. Even though funds not traced back to the same Indian company, this would be a case of round tripping.

VIII. Services and Forward Contracts

Payment for services/supplies provided by a foreign company to an Indian company for setting up a power plant in India split into offshore design (taxable @ 10% on gross basis), offshore supply (not taxable in absence of any role played by any PE in India), and local supplies/installation (taxable on net basis) such that design services were under invoiced and offshore supplies were over invoiced resulting in significant tax benefit to the foreign company will attract GAAR.

A Forward Contract is entered into by company A Ltd. for sale of some unlisted securities to B Ltd. for a price of Rs. 1000 and A Ltd. purchases the same unlisted securities after one year for Rs. 1100 as agreed in advance. When the forward contract price based on a rate of return of 10% p.a. B Ltd. claiming the gain of Rs. 100 as long term capital gains (which are not taxable at the marginal rate of 30%), GAAR would be invoked since the substance/effect of the arrangement as a whole is inconsistent with the form of its individual steps. However, if B Ltd. has put an option to sell the securities after one year at a pre-determined rate and exercises the said option in view of the lower market price, GAAR cannot be invoked since it is purely a commercial transaction.

An Indian company avoiding Minimum Alternate Tax ("MAT") liability by transferring an investment (the gain on sale of which would be liable to MAT) at cost to a partnership firm (with another person having nominal share) which sells the investment after one year will still attract GAAR. If the partnership firm is dissolved subsequently and the share of the Indian company is transferred back along with profits it would be exempt from tax. A foreign company, engaged in providing architectural design services, forming a partnership firm to claim beneficial provisions of the treaty as regards fees on technical services, which may otherwise not be available will be covered by GAAR. The trained manpower required to provide the services under the agreement entered into by the partnership firm with an Indian company is seconded by the foreign company.

Further, if a company instead of selling property and realizing capital gains transfers the property at book value (below fair market value) to its related company which has a brought forward capital loss GAAR would apply. The related company soon after transfers the property to the third party at fair market value and sets off resulting capital gains against brought forward loss. GAAR may, however, not be invoked if the property is transferred by the related company after a gap of reasonable time as that would reflect that main purpose of the arrangement was not to obtain tax benefit.

IX. Retrospective Amendments relating to Indirect Transfer

The Finance Act, 2012, also introduced retrospective amendments intending to clarify the legislative intent of the source rule of taxation of non-residents in India, particularly in respect of indirect transfer of underlying assets in India. The language and scope of the amendments led to apprehensions about certainty, predictability and stability of tax laws in India, especially in view of the fact that the amendments were perceived to be obviating the Supreme Court decision in the case of Vodafone. An Expert Committee was constituted by the Prime Minister under the chairmanship of Parthasarathi Shome to undertake stakeholder consultations and finalize the guidelines for GAAR. The said Committee, under the Additional Terms of Reference, was asked to examine the applicability of the retrospective amendment on indirect transfer and submit its recommendations to the Government. On 9 October 2012, the Expert Committee published its draft report which contains various recommendations relating to amendment of the provisions on indirect transfer. The recommendations intend to allay the apprehensions of taxpayers and yet protect the tax base from erosion on account of indirect transfer of underlying assets in India cover aspects relating generally to retrospective amendments and clarifications/ suggestions relating to the provisions and their applicability.

X. Some of The Key Recommendations

Retrospective amendments to tax law should be resorted to only in exceptional cases and should not be used to "expand" the tax base; The amendments should be exclusively made to correct apparent mistakes/anomalies in the Statutes, to remove technical defects (particularly in procedure) which had vitiated the substantive law or to "protect" the tax base or be confined to matters that are genuinely clarificatory in nature. It is recommended that under the law of the land, retrospective amendment to a tax law should occur only after exhaustive and transparent consultation with stakeholders who would be affected and in the rarest of rare cases. As a matter of policy, Government should avoid anything which comes as a surprise or unexpected to the taxpayers.

It is suggested that the provisions relating to taxation of indirect transfer as introduced by the Finance Act, 2012 are not clarificatory in nature on account of the following reasons:

(i) The definition of "transfer" in section 2(47)(vi) indicates that the concepts of indirect transfer was restricted to immovable property.

(ii) The computation mechanism under section 48 for non-resident tax payers does not deal with the taxation of indirect transfers.

(iii) Clauses (via) and (vic) of section 47 dealing with exemption in case of amalgamation / demerger of foreign companies do not deal with transfer of shares of a foreign company.

(iv) The provisions, after the incorporation of the recommendations in the Report, should be applied prospectively. This would better reflect global practice, as well as the principle of equity and probity in the formulation and implementation of commonly recognized taxation principles.

(v) No person should be treated as an "assessee in default" under section 201 or as a representative assessee of a non-resident, in respect of a transaction of transfer of shares of a foreign company having underlying assets in India. The Government could apply the provisions only to the taxpayer earning capital gains from indirect transfer.

(vi) CBDT should clarify by way of a circular that where tax demand is raised on account of retrospective amendment relating to indirect transfer, no interest under section 234A, 234B, 234C and 201(1A) would be charged in respect of that demand.

(vii) No penalty proceedings should be initiated in respect of tax demand raised on account of retrospective amendment relating to indirect transfer.

(viii) Transfer of share or interest in a foreign company or entity should not be subject to tax in India even if it derives, directly or indirectly, its value substantially from assets located in India under conditions where:

In case such company or entity is the immediate holding company, the voting power or share capital of the transferor along with its associated enterprises in such company or entity does not exceed 26% of total voting power or share capital of the company or entity during the preceding 12 months; or

In other cases, the voting power or share capital of the transferor in such company or entity along with its associated enterprises during the preceding 12 months does not exceed such percentage which results in 26% of total voting power or share capital of the immediate holding company having underlying assets in India.

(ix) Exemption may be provided in case of transfer of shares of a foreign company which is listed on a recognized stock exchange and where such shares are frequently traded therein.

(x) The terms "frequently traded" and "recognized stock exchange" may be defined as in the SEBI guidelines and RBI regulation on overseas investments by residents respectively.

(xi) Transfer of shares or interest in a foreign company or entity under intra group restructuring may be exempted from taxation subject to the condition that such transfers are not taxable in the jurisdiction where such company is resident. For the purposes of this section Intra group restructuring may be defined as an amalgamation or demerger as defined under the Income-tax Act, 1961 subject to continuity of at least three-fourth ownership or any other form of restructuring within the group (associated enterprises) subject to continuity of 100% ownership.

(xii) In order to avoid double or multiple taxation, it should be clarified that where a non- resident investor has made any investment (directly or indirectly) in an FII or the investment made by an FII in India represents directly or indirectly the underlying assets of the investments by a non- resident, then such non-resident will not be taxable in India in relation to the investments made by the FII in India.

(xiii) PE investors should be kept outside the coverage of taxation of indirect transfer where the non-resident investor's investment in a PE fund is in the form of units which do not result in participation in control and management of the fund and the investor along with its associates does not have more than 26% share in total capital or voting power of the company. Further the investee company or entity does not have more than 50% assets in India as compared to its global assets and should be a listed company on a recognised overseas exchange and its shares are frequently traded. It is also required that the transfer of share or interest in a foreign company or entity results due to reorganization within a group.

(xiv) The phrase "an asset or" should be omitted from Explanation 5 to clause (i) of sub-section (1) of Section 9 since the apparent objective of insertion of Explanation 5 is to bring capital gains arising on transfer of a capital asset having underlying assets in India into the taxable income under the head capital gains. Further, it should be specified that the phrase "the share or interest in a company or entity registered or incorporated outside India" in Explanation 5 means and includes only such share or interest which results in participation in ownership, capital, control or management. Therefore, all other types including mere economic interest should not be contemplated within the ambit of Explanation 5. It is also required that the word "substantially" used in Explanation 5 should be defined as a threshold of 50 per cent of the total value derived from assets of the company or entity, as proposed in Direct Taxes Code (DTC) Bill 2010.

(xv) The phrase "directly or indirectly" may be clarified to represent "look through" approach. For determination of value of a share of a foreign company, all intermediaries between the foreign company and assets in India may be ignored.

(xvi) General provisions of section 2(47) relating to transfer should not be applied on a standalone basis since the provisions of section 9(1)(i) read with Explanation 5 specifically deal with transfer of shares of a foreign company having underlying assets in India.

(xvii) It should be clarified that for the purposes of Explanation 5 to section 9(1)(i)–

- the value refers to fair market value as may be prescribed and can be ascertained based on net assets after taking into account liabilities as well;
- for determination of value, both tangible assets as well as intangible assets are to be considered; and

- the value is to be determined at the time of the last balance sheet date of the foreign company with appropriate adjustments made for significant disposal/ acquisition, if any, between the last balance sheet date and the date of transfer.

(xviii) Capital gains, if taxable on account of indirect transfer of underlying assets in India, should be taxed on a proportionate basis. In other words, the taxable gains in India should be that proportion of the total gains which Indian assets bear to the global assets as proposed in DTC Bill 2010.

(xix) Dividend paid by a foreign company should not be deemed to accrue or arise in India under section 9(1)(i) read with Explanation 5. Similarly, where there is a tax treaty between India and the country of residence of a non-resident, capital gains arising to the non- resident on account of transfer of shares or interest in a foreign company or entity should not be taxable in India under section 9(1)(i) unless the treaty provides right of taxation of capital gains to India based on its domestic law or the treaty specifically provides right of taxation to India on transfer of shares or interest of a foreign company or entity.

XI. Conclusion

The above recommendations of the Expert Committee, if accepted by the government, may substantially dilute the GAAR provisions and provide additional safeguards to protect taxpayers against the arbitrary use of GAAR by tax officers. However, in order to provide greater clarity on application of GAAR provisions, the guidelines should provide more illustrations covering a wide range of scenarios. The taxpayers will need to wait for the final report which is scheduled to be submitted to the government by 30 September 2012.

The recommendations of the Expert Committee have addressed the concerns of the foreign investors to a large extent, particularly the grievance against retrospective application of the amendments relating to indirect transfer. On the recommendations being accepted by the Government, it would not only remove the uncertainty on taxability of transactions already concluded but also provide clarity on applicability of the amended provisions and the interpretation of various terms and phrases. The taxpayers will need to wait for the Expert Committee's final report, after which the Government will form its view on the recommendations. Incontrovertibly, these reforms will go a long way in determining the direction of M&A deals in India.