Trends in Indian Tax Policy: Practitioner's perspective

Mumbai, 6 December 2013

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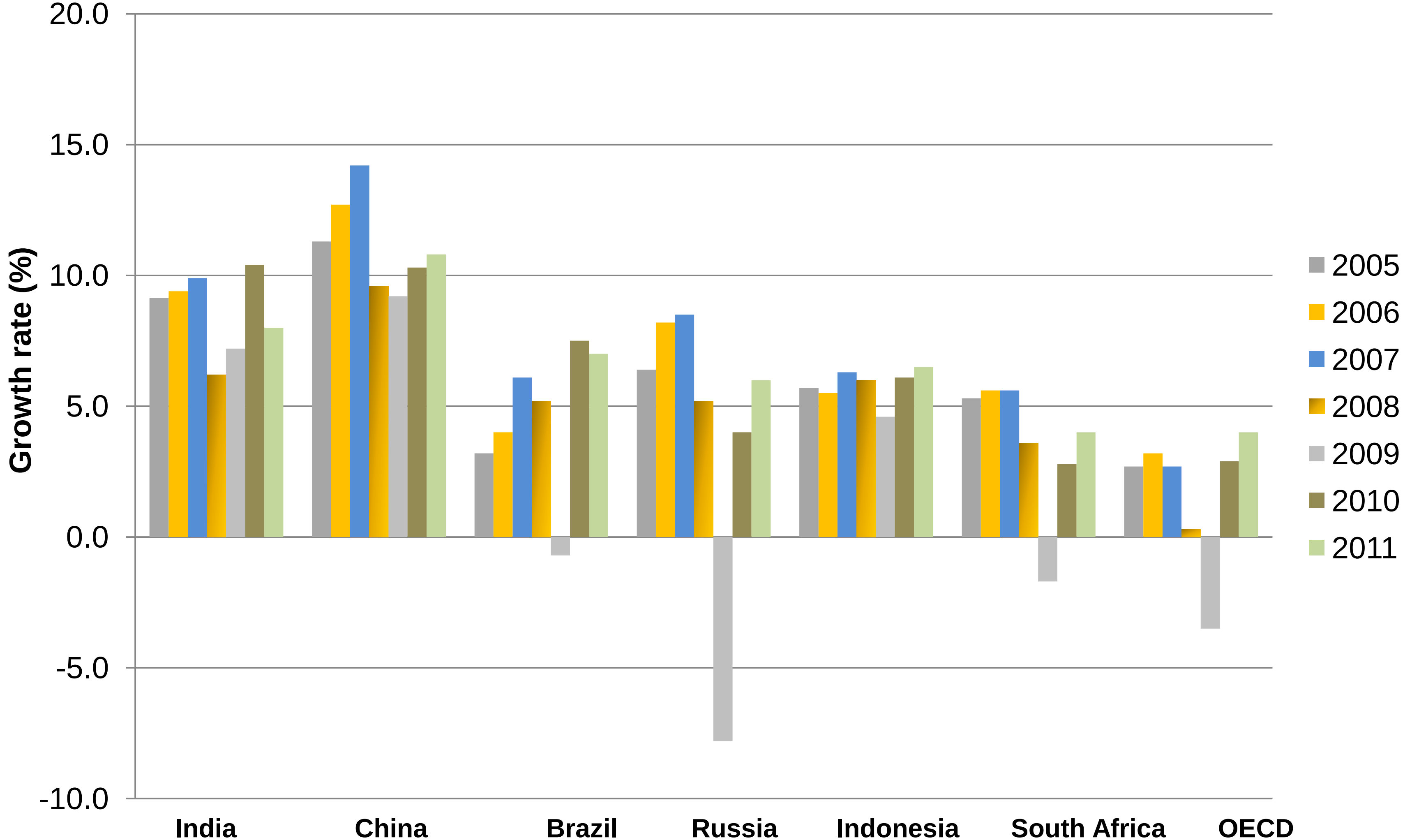
India: A land of opportunities

Demography & Economy: some statistics

- Population: 1.3 Billion (17.31% of the world's population)
- More than 50% of the population below the age of 25 and 65% below the age of 35
- 30% of the population resides in urban areas
- Growing middle class: 30% of the population and growing
- 33% of the population lives below poverty line
- Wide income disparity between 'have' and 'have-nots'
- Wide English speaking population
- World's largest democracy
- Established legal system

India: A land of opportunities

Indian economy is enjoying one of the highest growth rates in the world, more than double the rate of OECD member countries.



Indian tax policies: Inviting global attention

- **India's estimated GDP for 2014 will place it tenth in the world, ahead of 27 OECD members.**
- **The prospects for continued high rates of growth in the Indian economy appear strong.**
- **Speed at which investment flows have been shifting from primarily inward to increasingly outward investment is noteworthy**
  - **Between 2000 and 2011, share of FDI into India increased by five fold, but outbound FDI increased over 16-fold**
- **India's exports of services exceeds all but 8 OECD member countries, and its net exports of services have grown from USD 2.9 billion in 2001 to USD 65 billion in 2012**

With such remarkable achievements, it is clear that India's tax policies are more than ever exposed to international cross-border tax issues

Factors influencing Tax Policy

Tax Policy as a concept implies the implication of the tax structure on macro economy and its impact on economic growth, productivity, distribution, efficiency, equity, stabilization of economy

Tax legislation represents tax policy structure and based to a large extent on economic interest and development needs of the country

Revenue generation is one of the key factors influencing Indian tax policy since:

- India is a developing country and net importer of technology and capital
- As a democratic socialist country, inclusive growth and removal of poverty is high on the political agenda
- Substantial funds required for developmental needs and to finance public welfare schemes – food security, employment guarantee, education health etc

The Indian domestic tax policy also has to address issues of growth of backward areas, foreign exchange earnings, vertical and horizontal equity, as also factor in constants like excluding agricultural income from tax net

India’s Domestic and International Tax Policy

Does India have a domestic and international tax policy?

- Not in public domain; may be discerned from history of tax legislation and negotiated treaties

Domestic Law

- Codified system under Common Law
- Profit linked incentives for various sectors
- Focus on protection and augmentation of tax base
- Emphasis on source based taxation
  - **Section 5: “Income from whatever source derived”**
    - Residents: worldwide income
    - Non-Residents: Income which accrues or arises or which is deemed to accrue or arise in India
  - **Section 9: Incomes deemed to accrue or arise in India through or from:**
    - ‘business connection’ in India
    - property in India
    - any asset or source of income in India
    - through transfer of capital asset situated in India
    - Income by way of interest, dividend, royalty and fees for technical services

…India's Domestic and International Tax Policy

- **Incomes deemed to have source in India include payments in the nature of interest, royalty, fee for technical services by one non-resident to another- if relates to any business carried on or source of income of payer in India**

Ever expanding scope of deemed incomes

2010: Interest, royalties, FTS deemed to have source in India, irrespective of non-resident having any place of business or business connection or place of rendering of services

2012: Indirect transfer of assets

Royalty- Software transmission by satellite, cable, etc.

2013: Rate of tax on royalty/FTS increased to 25% from 10%

Indian tax policy follows 'benefit' principle

E-commerce: High Powered Committee Report, 2001

- Same rules as conventional commerce should be applied
- Concerned about impact on source state taxation with absence of payment establishment- due to lack of physical presence under new communication technology/networks
- Recommended abandoning of PE concepts and advocated taxation of income if expenses claimed in source country ('base erosion' approach)
- Disagreed with OECD's TAG Committee Report on characterization of 13 out of 28 e-commerce transactions- favored taxing of copyrighted article
- Advocated need to ensure equitable sharing of global tax revenues.

International Tax Law: Treaties

OBJECTIVES:

- **Allocation of taxing rights**
- **Assist economic development**
- **Avoidance of double taxation**
- **Equal and equitable treatment of taxpayers**
- **Promotion of international trade**
- **Exchange of information to counter tax avoidance**
- **Accommodating different tax systems**

OECD and UN Model

The OECD Model and subsequently the UN Model, are based on the following principles:

- Source Country should tax local operations, including property or other pertinent matters
- Residual Income should be earned by the country of residence, which provides the knowledge, capital, and global markets for the business
- Presence of an interim holding company should be treated as a Residence country
- Subsidiaries should not be treated as a PE
- TP is to be evaluated on a consistent basis (i.e., One-Sided TP principles)

Indian Tax Treaties

No published Indian Tax Treaty Model or Commentary

Tilt towards UN model with emphasis on source based taxation and capital import neutrality

Influenced by national self interest- social, economical and political goals

Considers domestic taxation system and jurisprudence

Tolerates temporary loss of tax revenues (tax sparing) to promote economic development and capital inflows

Treaty shopping allowed for inflow of foreign investment; though policy shift seen against Treaty misuse in recent times

Overrides domestic law to the extent more beneficial to the non-resident assessee

Trends in Recent treaties:

- Inclusion of limitation of benefit clause (supports source based taxation) – though different versions (eg. USA, UAE, Singapore)
- Strengthening and broad basing exchange of information provisions
- Expanding scope of payments in the nature of royalty (India - Hungary Treaty)

India and OECD

- **June, 2006 - India became observer at Committee of Fiscal Affairs**
- **May, 2007 – OECD offered enhanced engagement with possible membership to Brazil, China, India, Indonesia and South Africa**
- **July 2008 - Indian positions on OECD Model and Commentaries (2008 Update)**
- **OECD is keen on greater Indian participation in future**

…India and OECD

- OECD Commentary referred to by Courts in India as aid in interpreting treaty law [Refer: Vishakhapatnam Port Trust v. CIT (AP); Asia Satellite Telecommunications (Del.); Nokia Networks]
- Several reservations (nearly 75 cases) expressed by India on OECD Commentary:
    - ➢ Treaty benefit to tax transparent entities
    - ➢ Place of effective management
    - ➢ Permanent establishment
    - ➢ Royalty
  - Demonstrates tax base protection approach
  - Provides guide to taxpayers and tax officials on likely approach of Indian tax authorities
- India likely to influence future OECD views towards more source taxation?
- Should India join the OECD?

Source v. Residence Conflicts

Both the OECD and UN Model treaties minimize income that would be allocated to source countries, with the residue allocated to residence countries. (Residual income is what remains out of combined income earned by all parties un cross border transaction, after routine return has been allocated to related parties based on FAR)

Recent changes proposed by OECD in commentary – Give and take policy, source v. residence conflicts continue

BRICS and developed source countries not happy with principles of either OECD or UN

- They feel that categorization of the right to tax income under the OECD/UN Model is not based on any analysis of the relative economic contributions of the various business activities to the actual profits earned in the respective states

Need for allocation of income with reference to country where it is earned

Transfer Pricing policies do not allocate income based on economic reality; based on FAR which is only concerned with the supply side- ignores the size and strength of the economy of the source country, the availability of resources, etc.

…..Source v. Residence Conflicts

Also transactional methods – CUP, Cost Plus ,are one sided methods as testing is limited to income that should have been received by source country on basis of functional comparables, in the source country.

Arms's length standard determined by assuming PE to be a separate entity rejects the global allocation approach

UN Practice Manual on Transfer Pricing for developing countries does not address the above concerns as it does not fundamentally alter the OECD TP model

The principles articulated in Chapter 10 written by select BRIC countries, including India, are however, fundamentally inconsistent with the principles advocated in the Manual

BRIC countries concerned with issues of:

- Location savings
- Comparability analysis and adjustments
- Intangibles
- Risk Allocation
- Cost Allocation and intra-group services

Emerging international tax issues and effect on tax policies

- Increasing concern both among developed and developing countries on 'base erosion and profit shifting', double non-taxation
- Developed countries too now looking at source based taxation- economic downturn, net technology importer, FATCA imposition of withholding taxes on US source investment income
- Concern on Treaty abuse mounting
- Changing economic scenario should force Government to contemplate policy shift
- International taxation and TP controversies today are more than necessary to assure reasonable allocation of taxing jurisdiction among all countries to facilitate global job creation and economic growth
- However consensus required amongst countries for application of common principles- otherwise consequences can be disastrous for business community and economies
- Policy determination needs to balance international economic and taxation goals

Recent Indian Tax Policy Developments

- Introduction of APAs
- Introduction of safe harbor rules
- Direct Taxes Code:
  - GAAR
    - Do we want to close the door on Mauritius?
  - Controlled Foreign Corporations
  - Branch Profit Tax
  - Moving away from profit based incentives to investment based incentives

Whether the tax policy geared to address the concerns of MNEs?

Tax officers (at lower levels) tend to apply domestic tax rules (and approach) unilaterally on international tax issues

Differing and often conflicting views of the authorities, policymakers, judiciary and taxpayer

Tax Administration and Compliance rules may not follow a ‘business’ approach - resulting in tax controversies and tax evasion

Excessive emphasis on form rather than substance

Adversarial attitude of tax administration

Conflicting decisions at various levels of dispute resolution forums adds to the complexity of Indian tax laws

Uncertainty coupled with substantial period in litigation process

Are we on the right path and the way forward

- ❑India's international tax policy is rightly tilted towards source based taxation in sync with the needs of a developing country

- ❑Increase in scope of source based taxation should take into consideration its effect on inflow of technology/capital

- ❑A good tax policy with poor implementation is as good or as bad as wrong tax policy with efficient administration

- ❑Tax policy in the Indian context should also look at the issues of reducing the trust deficit between the taxpayer and tax collector and address issues like simplicity, certainty, accessibility, responsiveness, professionalism, innovation, collaboration and consultation

- ❑Single pursuit of revenue could stifle business growth

- ❑MNEs don't mind fair share of tax on their global revenue and appropriate tax allocation amongst jurisdictions remains a key aspect

Thank You

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