Impact of Domestic Tax Changes in India on its Tax Treaty Policy

Panel Discussion: Guidance points

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December 6, 2013

Building a better working world

Basic framework for taxation of domestic and international incomes

Introductory Observations

- India has witnessed a sea change in tax policy over the past two decades.
- The last two decades have seen India globalizing at a rapid pace and integrating with the world economy – resulting in substantial increase in cross-border transactions
- India's domestic tax policy is aimed at lowering the tax rates while at the same time broadening the base to increase its tax-GDP ratio. Promotion of investment and growth is also an important objective of the policy. With these objectives in mind, India has introduced many changes in its domestic policy in the recent years. Many of these changes have been related to, and impacted, directly or indirectly, taxation of cross-border transactions.
- India's treaties were made at a time when India was still a closed economy, and the value and volume of cross-border transactions very limited. With the changing environment and India now being a more open economy, there is a fundamental debate on the changes in the domestic tax policy and their impact on the treaty policy.
- The basic principles underlying India's treaties are similar to those for other treaties. Their primary purpose is to avoid double taxation of income from cross-border transactions. They reflect the primacy of the country to tax its residents on their worldwide income, taxation of nonresidents on business income derived from the country, and taxation of other incomes at negotiated rates.
- Without altering this basic framework, changes in domestic policy have had an impact on taxation of nonresidents in India, in some cases negating the benefits provided in the treaties, and in other cases limiting or narrowing the scope of the benefits through aggressive interpretation or enforcement of the provisions. There have also been provisions which have gone in the opposite direction, i.e., extended benefits to nonresidents (and also residents) through incentive provisions which are beyond the treaty provisions.

Introductory Observations

- Examples of domestic changes which have impacted taxation of nonresidents
  - Substitution of dividend distribution tax for taxation of dividends in the hands of shareholders
  - Introduction of Transfer Pricing provisions and their aggressive enforcement
  - Exemption of long-term capital gains from listed securities and the introduction of the securities transaction tax
  - Taxation of capital gains from indirect transfers
  - Introduction of GAAR and other Anti avoidance provisions
  - Exchange of information provisions
  - Introduction of CFC provisions
  - Repeal of profit-linked incentives for exports, exemption for external corporate borrowings (ECB)
  - Strengthening tax administration and better tax payer services
- As can be seen, these changes are motivated by diverse considerations, including
  - Evolving views on corporate-shareholder tax integration
  - Need for incentives for savings and investments, and exports
  - Concern of the government about tax avoidance through shifting of profits/incomes to low tax jurisdictions and
  - Concerns about misuse of the treaty provisions, especially recognizing the political hurdles in renegotiating the treaties

Questions for discussion by panelists

- What is the nature of interplay between the domestic policy and treaty policy in other jurisdictions? Examples of domestic policy changes (already implemented or contemplated) impacting treaty policy?
- What have been the motivating factors for these changes? e.g.,
  - Creating a competitive regime for investments in the country (e.g., move to territorial taxation, reduction in statutory tax rates)
  - Ensuring enhanced international capital flows
  - Capital export/import neutrality
  - Evolving views about source- or residence-based taxation of incomes (e.g., capital gains from real property)
- Have these changes been considered/implemented as part of a coherent and balanced framework, or in an ad-hoc / arbitrary manner?

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Domestic tax changes in India impacting treaties

Treaty impact or treaty concessions diluted or regulated by Indian Domestic Law （ITL）

Provisions which may deny, or restrict access to treaty	▶ Override by GAAR ▶ Non-production of TRC / specified particulars
Treaty concessions rendered ineffective by ITA	▶ Indian company liable to tax on dividend distribution or buy-back ▶ Shift to investment linked incentives
Effectiveness of treaty entitlement regulated by ITA mechanism	Stiff withholding rates ▶ Absent PAN ▶ If from non-co-operative jurisdiction
More favourable domestic law provision dilutes treaty impact	▶ Specified interest tax @5% ▶ No capital gains tax on listed shares ▶ FOA dispensed in India-Australia DTAA

Alignment of Indian treaties and ITL

Limitations on benefits

- In absence of TRC
- In case of GAAR

Challenges of digital economy

- Expansive definition of "royalty"
- Coverage of software, transmission transaction
- Stiff domestic WHT rate

ITL Scope

Treaty Scope

- Trend towards strictly worded LOB

- India's position is that Website constitutes PE

Alignment of Indian treaties and ITL

	Capital gain on indirect transfer of shares	Exchange of information
ITL Scope	▶ Capital gains on indirect transfer of shares	▶ Right to notify a jurisdiction to be non-cooperative ▶ Foreign asset reporting ▶ Extended limit of 16 years for audit
Treaty Scope	▶ Treaties with UK, USA, aligned to India Domestic Law ▶ Most treaties protect indirect transfer	▶ Trend of liberally worded EOI Article in Indian recent treaties

Alignment of Indian treaties and ITL

Profit Attribution

ITL Scope

- Locational savings, talent pool, market offering, value creation of intangibles and goodwill.
- Wide definition of capital asset to include any rights

Treaty Scope

- Open to insertion of Article 9(2) to facilitate bilateral APA

India Landscape : Recent policy changes

Transfer Pricing Rules	▶ Interpretation of intangibles and location saving factor
Taxation of capital gains	▶ 'Indirect transfer' worse than direct India transfer?
Taxing dividend and buy-back	▶ Inundates negotiated DTAA relief ? ▶ Tax credit in home jurisdiction of shareholder / alienator?
Defining "Royalties"	▶ Blurs distinction between service and royalty? ▶ Plausible answer to digital economy issues?
GAAR Override	▶ Not all arrangements are grandfathered

Description of Domestic Policy Changes impacting Treaty Policy

India has introduced many changes in the domestic law which have made the treaty almost ineffective – the provisions include those which:

- Check, restrict or deny access to treaty, e.g., GAAR, TRC, taxation of royalties & FTS, TP rules
- Clarify treaty intent, e.g. taxing FC at higher rate is not discrimination
- Render treaty exemptions ineffective, e.g., Dividend distribution tax
- Demand discipline, e.g., furnishing ROI
- Dilute the treaty impact favorably, e.g. reduce WHT from 20 % to 5% on interest paid on money borrowed in foreign currency from outside India

Some changes have been introduced with the aim of aligning the treaty with domestic law – these include:

- Exchange of information
- LOB Concept
- Secondary source rule expansion
- Indirect transfer rules
- Force of attraction rule

Review / Analysis of select domestic changes

Analysis of select changes in domestic law

- **Identified changes in domestic law in India**
  - Transfer pricing rules
  - Taxation of capital gains
  - Taxation of dividends
  - Taxation of royalties and Fee for Technical Services
  - GAAR to override treaty benefits
- **Questions for intervention by the Panelists**
  - What is the impact of these changes on the treaty policy? Do they amount to a significant deviations from the basic principles guiding the treaty policy?
  - Are the changes made in response to the changing economic priorities of rapid-growth economy of India, and/or to protect the tax base of India from BEPS activities of MNCs?
  - Is there a precedence of introducing such changes in other jurisdictions or is India alone in doing so?
  - Are these changes reasonable and cohesive, conforming to the international norms or is there a significant conflict between the domestic and international policies?
  - Have these changes been in an ad hoc and arbitrary manner or should they have been introduced in a constructive and collaborative manner?

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Way forward and key takeaways

Way forward and key takeaways,

►OECD Observations

- Important to ensure effectiveness and fairness of tax rules and provide a certain and predictable environment for business
- Coordinated efforts, as against unilateral actions, are needed, otherwise changes could be disruptive and create greater uncertainty
- Unilateral actions may not be successful in achieving the desired outcome (e.g, if the country is seeking Exchange of Information)
- The crux of the issue is not source vs residence taxation, but collective avoidance and double non-taxation of income
- A new thinking is needed on issues such as the new global value chains and the treatment of intangibles