Union Budget 2012-13 – Key Tax Proposals in Respect of International Taxation

Honourable Finance Minister started presenting the Direct Tax Proposals on the floor of the house on 16th March, 2012 with the comments: *"The life of a Finance Minister is not easy. Various players, including policy makers, politicians, agriculturists and business houses, participate in the making of the economy. When everything goes well with the economy, we all share in the joy. However, when things go wrong, it is the Finance Minister who is called upon to administer the medicine. Economic policy, as in medical treatment, often requires us to do something, which, in the short run, may be painful, but is good for us in the long run. As Hamlet, the Prince of Denmark, had said in the Shakerspeare's immortal words, "I must be cruel to be kind".* Thus, he has hinted that some major "cruel" steps are being proposed in his tax proposals. However, he carried on with the speech and declared all goody goody things except certain passing references to the hard steps taken like GAAR etc. He proved the saying *"devil lies in details"*, particularly for the taxation proposals in respect of international transactions. However, he has proposed majority of the amendments with retrospective effects and paved the way for the long drawn litigation instead of providing certainty to the overseas investors. In the above backdrop, this article discusses some major tax proposals which will have far reaching impact on the international tax regime in India.

While introducing Union Budget 2012, the Finance Minister shows his intention to move towards Direct Taxes Code ("DTC"). By incorporating two key proposals of DTC i.e. General Anti Avoidance Rule ("GAAR") and Advanced Pricing Arrangement ("APA"), he has shown his commitment towards tax reforms. However, he has overruled certain important decisions and brought in the retrospective amendments. Unfortunately, he has introduced the "clarificatory" amendments in respect of taxability of transactions akin to "Vodafone's case" and surprised the tax payers by introducing the applicability of transfer pricing provisions to certain domestic transactions. He has tightened the rope on overseas investors by proposing furnishing of Tax Residency Certificate ("TRC") in the specified format in the garb of substance over a form.

In this article, we have discussed certain important tax proposals introduced by the Finance Bill, 2012 ("Finance Bill") in respect of international taxation.

(Contributed by the Committee on International Taxation of the ICAI. Comments can be sent to citax@icai.org)

Key International Tax Proposals

- *Introduction of GAAR;*
- *Taxability of software transactions – definition of royalty;*
- *Taxation of sale of shares/assets outside India;*
- *Taxability of dividend received from overseas subsidiaries;*
- *Requirement of TRC to access tax treaties; and*
- *Certain major amendments in transfer pricing provisions.*

1. Introduction of GAAR

Till date Indian tax laws do not contain any anti abuse provisions. Principles of tax avoidance were thorough judicial opinions. DTC has introduced the concept of GAAR for the first time. Though the future of DTC is still not certain, Finance Minister has adopted the concept of GAAR as an anti tax avoidance measure in the Income-tax Act, 1961 ("Act"). As per the newly introduced Chapter X-A (containing Sections 95 to 102) it is proposed to grant powers to the tax authorities not to allow tax benefits on the transactions/ arrangements which do not have commercial substance or consideration other than solely achieving the tax advantage. As per the proposed amendment, transaction/arrangement will be considered as impermissible if it satisfies any of the following four criteria:

- Not at arm's length;
- Results in misuse or abuse of the provisions of the Act;
- Lacks commercial substance or is deemed to lack commercial substance; and
- It is carried out in a manner, which is normally not employed for bona fide purpose.

Once the transaction/arrangement are considered to be impermissible, the same can be disregarded partly/fully with consequential denial of tax benefits/tax advantages. Further, to keep check on anti abuse on treaty provisions, "treaty override" has been provided when the transactions/arrangements are subject to provisions of GAAR.

While introducing provisions of GAAR, Finance Bill provides that application of GAAR provisions has to be approved by an Approving Panel and thereby giving an assurance to the Tax Payer that opportunity of hearing will be given to them before applying the same. CBDT will formulate the scheme for regulating the condition and manner of application of GAAR provisions.

While introducing GAAR, the Honourable Finance Minister has stated that – *"I propose to introduce GAAR in order to counter aggressive tax avoidance schemes, while ensuring that it is used only in appropriate cases, by enabling a review by GAAR panel."* However, as wide powers have been granted to the tax authorities and tax payers have been burdened with the responsibility to prove that transaction/ arrangement is not guided by the tax avoidance/ escapement, there may be serious doubts in the mind of the tax payers regarding fair implementation of the provisions in view of present day experience of governance, administration and lack of accountability.

Union Budget 2012 has tried to settle the long drawn battle between the Revenue Authorities and the Tax Payers in respect of taxability of sale of software. The Finance Bill proposes to amend provisions of Section 9(1)(vi) with retrospective effect from 1st April 1976 to include payments made for use or right to use of computer software within the purview of royalty.

2. Taxability of Software Transactions – Definition of Royalty

Union Budget 2012 has tried to settle the long drawn battle between the Revenue Authorities and the Tax Payers in respect of taxability of sale of software. The Finance Bill proposes to amend provisions of Section 9(1)(vi) with retrospective effect from 1st April, 1976 to include payments made for use or right to use of computer software within the purview of royalty. As per the proposed amendment "royalty" includes any consideration paid for right, property or information in respect of all or any right for use or right to use a computer software (including granting of a licence) irrespective of such right , property or information being –

(1) In the possession or control of the buyer;
(2) Such right or information used directly by the buyer;
(3) Such right or property or information is located in India

Thus, it is proposed to treat sale of shrink wrapped software or granting of rights to use software as royalty.

Further, The Finance Bill proposes to overrule the decision of Delhi High Court in the case of *Asia Satellite Telecommunication Co* (w.e.f 1st April, 1976) and provides that "process" includes any transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology.

Though, definition of Section 9(1)(vi) has been proposed to be amended, the Tax Payers still have a

window to apply the provisions of tax treaties, if the same is favourable *vis-à-vis* provisions of the Act.

3. Taxation of Sale of Shares/Assets Outside India

Tax professionals have spent last few days in deliberating and discussing the principles laid down by Honourable Supreme Court in the case of *Vodafone International BV*. As we are all aware, the bone of contention in the recent ruling of the Supreme Court in the case of Vodafone has been whether the gains arising to a foreign company from sale of shares of foreign holding company indirectly holding underlying Indian assets (Indian operations) to another foreign company would be subject to tax in India. In this regard, the Supreme Court held that for a transaction of sale of capital asset to be taxable in India, the capital asset ought to be situated in India. The Supreme Court explained that under the scheme of the Act, charge of capital gains in India in the hands of a foreign company requires the following conditions to be fulfilled simultaneously:

(a) Existence of a capital asset;
(b) Situs of such capital asset in India; and
(c) Transfer of the capital asset.

Accordingly, for capital gains to be taxable in India in the hands of the foreign company, the capital asset transferred must be situated in India. Further, Honourable Supreme court has explained the concept of "look at" and "look through" while interpreting the provisions of the law. Court has further discarded the dissecting approach followed by the Revenue Authorities while interpreting the tax provisions.

Provisions proposed under the Finance Bill appear to nullify the key observations made by the highest court of India and proposes to bring to tax all the overseas transactions wherein gain or income can be attributed to the underlying assets in India. Finance Bill has proposed various clarificatory amendments which can be summarised as under:

- Definition of property has been explained and it has been clarified that property includes any rights in or in relation to an Indian company, including rights of management or control or any other rights whatsoever. [Explanation to Section 2(14)]
- Transfer includes disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into India or outside India) or otherwise, not withstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India. Thus, the amended definition will include the transfers irrespective of the fact that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of shares of a company incorporated outside India to the extent said company derives its substantial value of underlying assets situated in India. [Explanation 2 to Section 2(47)]
- Definition of "through" has been provided to include "by means of" or "in consequence of" or "by reason of" transfer of capital asset in India [Explanation 4 to Section 9(1)(i)]
- Any interest/share in a company outside India which derives its value either directly or indirectly or substantially from assets located in India, shall be deemed to have been situated in India. [Explanation 5 to Section 9(1)(i)]
- No regard shall be given to following factors while determining whether an arrangement lacks commercial substance or not:
  - o Period or time for which the arrangement (including operations therein) exists.
  - o Fact of payment of taxes, directly or indirectly, under the arrangement.
  - o Fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

  [Section 97(4)]

A reading of the above amendments proposed in the Finance bill seems to suggest that they have been made in light of the observations made by the Supreme Court in Vodafone's ruling.

To summarise, it appears that in view of the above amendments, any transfer of asset/share/right outside India which has substantial underlying asset/value in India will be subject to tax net in India. Further, language used in the proposed section is "substantial" *vis-à-vis* "50% of assets" used in DTC, the same may lead to litigation.

By amending provisions of Section 90 of the Act, it is now proposed to restrict the grant of benefit of the tax treaties only to the resident of foreign countries who procures the Tax Residency Certificate ("TRC") in prescribed format from respective overseas Governments. The same may be difficult to implement as Foreign Revenue Authorities may not be inclined to give the certificate in the format given by the Indian revenue authorities.

Concept of Advanced Pricing Arrangement has been introduced for the first time in DTC. Finance Minister has introduced the same in the present provisions of the Act to provide certainty to the overseas counterparts and reduce the litigation. Proposed provisions of Section 92CC gives powers to Board with the approval of Central Government to enter into an advanced pricing agreement with any person, determining the arm's length price or specifying manner in which arm's length price to be determined, in respect to the international transactions carried out by that person.

4. Taxability of Dividend Received from Overseas Subsidiaries

The Finance Act, 2011 has introduced the provisions of lower tax rate of 15% (plus applicable surcharge and education cess) on gross basis for the repatriation of dividends by Indian shareholders from their overseas subsidiaries under Section 115DDB. The said benefit is now proposed to be extended for one more year and hence any dividends received during the Financial Year 2012-13 from overseas companies will also be liable to tax @ 15% (plus applicable surcharge and education cess). However, companies subject to Minimum Alternate Tax will be required to pay the same @ 18.5% (plus applicable surcharge and education cess).

5. Requirement of TRC to Access Tax Treaties

By amending provisions of Section 90 of the Act, it is now proposed to restrict the grant of benefit of the tax treaties only to the resident of foreign countries who procures the Tax Residency Certificate ("TRC") in prescribed format from respective overseas Governments. The same may be difficult to implement as Foreign Revenue Authorities may not be inclined to give the certificate in the format given by the Indian revenue authorities.

Memorandum explaining provisions explains that provisions have been amended to recognise the concept of substance over a form. However, it is feared that the same may lead to huge litigation and will raise substantial questions over validity of decision of Honourable Supreme court in the case of *Azadi Bachao Andolan* and CBDT circular No 786, where Government itself was litigating to uphold this circular.

6. Certain Major Amendments in Transfer Pricing Provisions

Transfer pricing provisions has completed a decade of its existence in India. Huge adjustments are being made by the Tax Officers and enormous demands has been raised and being collected. Judiciary is taking different and inconsistent views adding fuel to the litigation. To provide certainty and clarifying certain doubts, Finance Bill has amended various provisions relating to transfer pricing regulations. Further, it proposes to bring certain domestic transaction in its net. Following major amendments has been discussed in detail in the following paragraphs:

- Advanced Pricing Arrangement ("APA")
- Applicability of provisions on certain domestic transactions
- Scope of "international transactions"
- Safe harbor rules
- Penalty provisions

(a) APA:

Concept of Advanced Pricing Arrangement has been introduced for the first time in DTC. Finance Minister has introduced the same in the present provisions of the Act to provide certainty to the overseas counterparts and reduce the litigation. Proposed provisions of Section 92CC gives powers to Board with the approval of Central Government to enter into an advanced pricing agreement with any person, determining the arm's length price or specifying manner in which arm's length price to be determined, in respect to the international transactions carried out by that person. Salient features of APA provisions can be summarised as under:

- The tax payer will approach the Board and arm's length price ("ALP") shall be determined for the proposed international transactions (for which agreement is sought for) by using any method (including prescribed methods) with necessary adjustments or variation. The ALP determined will be deemed to be the ALP for the said international transactions.
- APAs will be binding on the Tax Payer and Commissioner and the income-tax authorities subordinate to him in respect of the said tax payer and said transaction for which APA has been sought for.
- APAs will be valid for maximum period of five year unless there is change in law or facts having bearing on the said agreement.
- Proposed provisions also empower Board to declare any APA as void ab initio, if it finds that the agreement has been obtained by the Tax Payer by fraud to misrepresentation of facts.

It is a welcome move and may go a long way in reducing the transfer pricing litigation provided the same is implemented in intended spirit.

(b) Applicability of provisions on certain domestic transactions:

Surprisingly, the Finance Bill proposes to extend the transfer pricing provisions to certain domestic transactions. Currently, provisions of Section 40A(2)(b) empowers Tax Officer to disallow certain expenses incurred between related parties, if the same are unreasonable or excessive. Further, provisions of Section 10AA/80IA/80IB/80IC, etc. provides that adjustment can be made to the profits derived by the eligible undertakings, if the transactions between eligible and non eligible undertakings of the Tax Payer is not at fair market value. Act does not provide any specific guidance on computation of fair market value of reasonableness of the expenses incurred.

The Finance Bill proposes to extend the applicability of transfer pricing provisions to all the above referred domestic transactions i.e. transactions covered by provisions of Section 40A(2)(b), transactions referred in Section 80A/80IA(8)/80IA(10) and Section 10AA. Further, CBDT has powers to prescribe other transactions which can be covered as "specified domestic transaction" subject to applicability of transfer pricing provisions. The transfer pricing provisions in respect of domestic transactions are applicable only if the aggregate of such transactions are in excess of ₹50 million.

The proposed amendment will cover many more Tax Payers under the purview of transfer pricing provisions and will increase immense compliance burden on them. Further, penalty provisions for non compliance of transfer pricing provisions has been amended and severe penalties has been introduced for failure to comply the provisions. Implementation of the said provisions can be a challenge for Revenue Authorities also due to substantial increase in number of cases subject to transfer pricing.

On a positive note The Finance Bill proposes to remove the cascading effect of Dividend Distribution Tax ("DDT") in a case of holding-subsidiary structure. Earlier provisions were applicable only in the case where the recipient company is not a subsidiary of any other company. Thus, the benefit is available only to single-tier holding structures. The said benefit is now extended and the Finance Bill provides that any dividend distributed by the holding company, irrespective of it being a subsidiary of another company, can reduce the dividend received from its subsidiary which has suffered DDT while computing DDT payable.

The amendment has been proposed in consequence of certain observations made by Honourable Supreme Court in the case of Glaxo Smithkline Asia (P) Limited which suggested Finance Ministry to consider the appropriate provisions for domestic related party transactions.

(c) Scope of "international transactions":

The Finance Bill has amended the definition of "international transactions" with retrospective effect i.e. w.e.f 1st April, 2001 to include following transactions within the purview of "international transactions":

(i) Tangible property transaction

(ii) Intangible property transaction

a. Marketing related assets – trademarks, trade names, brand names, logos, etc.

b. Technology related assets – process, patents, patent applications, technical documentation, technical know-how, etc.

c. Artistic related assets – literary work and copyrights, musical compositions, maps, etc.

d. Data processing related assets – proprietary computer software, software copyrights, automated databases, etc.

e. Engineering related assets – industrial design, product patents, trade secrets, blueprints, etc.

f. Customer related assets – customer lists, customer contracts, customer relationships, etc.

g. Contract related assets – favourable suppliers, contracts, licence agreements, etc.

h. Human capital related assets – trained and organised work force, union contracts, etc.

i. Location related assets – leasehold interest, air rights, water rights, etc.

j. Goodwill related assets – institutional goodwill, professional practice goodwill, celebrity goodwill, etc.

k. Methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data.

l. Any other similar item

(iii) Financial transactions – capital financing including long-term and short-term borrowings, lending or guarantee, etc.

(iv) Provision of Services – market research, market development, marketing management, administration, repairs, etc.

(v) Business restructuring or reorganisation – transaction between Tax Payer and AEs irrespective of facts that it has any bearing on the profit, income, losses or assets of the Tax

Payer at the time of the transaction or at any future date.

This amendment has overruled certain judicial precedents and has far reaching implications on transfer pricing litigation, particularly in view of being retrospective in nature.

(d) Safe harbor rules:

Earlier, provision of Act (before October 2009) provides for safe harbor of +/-5% i.e. when the transaction value falls within +/-5% of the ALP the Tax Payer has a option to substitute the ALP after applying +/- 5% range. To explain the same by way of an example…if X co has entered into a sale transaction with its AE say at ₹96. ALP is determined at say ₹100 and hence range of +/- 5% comes to ₹95 to ₹105. In that event, the Tax Payer was having option to substitute the ALP from ₹100 to ₹96. Controversy was if the transaction has been carried out at ₹94 then adjustment can be made from arithmetic mean of ALP i.e. ₹100 or from lower range i.e. ₹95 and whether +/-5% is a standard deduction or not. There were contradictory rulings by various tribunals on applicability of the said provisions. The Finance Bill has put finality on the litigation and proposed a retrospective clarification that range of +/-5% is not in the nature of standard deduction and once the transaction value falls outside the range, benefit of the same is not available to the tax payer.

The Finance Act 2011 has amended the provisions of safe harbor and provided that instead of a variation on 5% the allowable variation will be a percentage determined by the Central Government. Central Government has yet not notified any percentage of variation. The Finance Bill proposes to further amend the section to provide an upper limit of 3% with respect to the power of Central Government to determine the safe harbor for the calculation of ALP. The amendment is proposed to be effective from 1st April, 2012 and hence will be applicable for the Financial Year 2011-12 also.

(e) Penalty provisions:

Current provisions of the Act provides for penalty of 2% of the transaction value if the Tax Payer fails to maintain the prescribed documents in accordance with provisions of Section 92D of the Act. The said scope has been proposed to be extended by the Finance Bill and it will also cover non reporting of an international transaction as well as maintaining or furnishing of incorrect documentation/information. Thus, if the Tax Payer fails to report certain transaction, the same may attract penalty of 2% of the value of the said transaction.

7. Other Important Provisions:

- On a positive note The Finance Bill proposes to remove the cascading effect of Dividend Distribution Tax ("DDT") in a case of holding-subsidiary structure. Earlier provisions were applicable only in the case where the recipient company is not a subsidiary of any other company. Thus, the benefit is available only to single-tier holding structures. The said benefit is now extended and the Finance Bill provides that any dividend distributed by the holding company, irrespective of it being a subsidiary of another company, can reduce the dividend received from its subsidiary which has suffered DDT while computing DDT payable.
- To boost the infrastructure industry, The Finance Bill has proposed to tax interest payment by certain specified infrastructure companies to Non Resident in respect of borrowings made in foreign currency from a source outside India between 1st July, 2012 and 1st July, 2015 @ 5% as against present rate of 20%.
- The Finance Bill proposes to amend the provisions of Section 139 of the Act and now it would be mandatory for the resident Tax Payer having any asset (including financial interest in any overseas entity) located outside India or signing authority in any account located outside India to file return of income.

Conclusion

It is important to note that one of the objectives of introduction of DTC/several amendments is to provide certainty and reduce the litigation. However, Honourable Finance Minister has overruled following important decisions delivered by Indian courts (and certain on retroactive basis):

- Honourable Supreme Court decision in the case of Vodafone International BV
- Delhi High Court decision in the case of Ericsson Radio Systems AB
- Delhi High Court decision in the case of Asia Satellite Telecommunications
- Certain Tribunal rulings on applicability of Range of +/- 5%
- Bombay High Court decision in the case of Amadeus India

It is pertinent to put in perspective that whether the amendments made are purely in clarifcatory in nature or showing disrespect to judiciary. A question needs to be answered as to whether retrospective amendments provide any certainty to tax payers, particularly to overseas fraternity of investors? ■