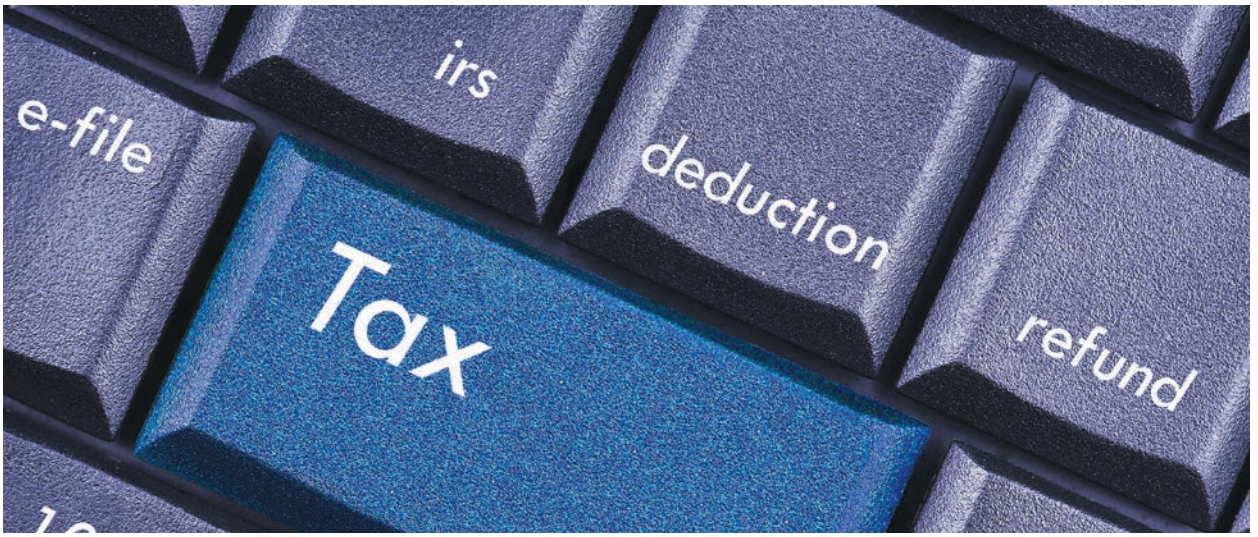
Recent Global Developments in International Taxation[1]



The author quite beautifully introduces issues in international taxation through the matters of Double Tax-Avoidance Treaties and General Anti-Avoidance Rules provisions. She takes help of terms like tax aggression and competition to explain the issues. In this illuminating article, the author discusses the perspectives of both the nation as well as the investors in case. Read on to know and understand the issue...

CA. Bhavna Doshi

(The author is a member of the Institute. She may be contacted at bhavna.doshi@gmail.com)

The taxation of international transactions, in recent times, is characterised by *tax competition* and *tax aggression.*

Let me start with *tax competition.* Businesses today have ample choices in terms of geographies as a result of globalisation and liberalisation policies adopted by the countries across the world over the last three decades. World today is the playground for businesses driving businessmen to choose any destination in the world which gives them maximum post-tax returns. This, besides commercial aspects, means selecting a jurisdiction that is most tax-friendly. Both capital and skilled human resources are far more mobile today than they ever were and, they move to the destinations that give them maximum economic returns.

Nations, as a result, seek to attract investments by offering special incentives and competing among themselves to be more attractive than the other.

[1] *Keynote address delivered at SAFA International Conference on* International Taxation and Transfer Pricing *on 16th September, 2012, in Kathmandu (Nepal).*

We see nations which have raw materials and other resources to engage in production activities offer special incentives in form of low or no tax of specific activities. Special economic zones, free-tax zones, industrial zones are the examples in case. China used them very effectively and India is also using this incentive to promote exports and generate greater employment. In fact, India used this tool very effectively when it introduced *hardware technology* and *software technology parks* with special scheme of taxation which included exemptions from direct and indirect taxation. This enabled India's skilled human resources generate significant foreign exchange earnings and establish itself as a leading player in the global technology space.

At the same time, countries which are smaller and do not have the raw materials, and other resources to effectively take up manufacturing or trading activities, attract businesses to shift tax bases to their nations. This means, business entities carry on operations in one or more countries which may not have tax-friendly jurisdiction but, have their residences in these tax-friendly countries. These countries offer low-tax regime to attract businesses to set up holding companies and generate employment and revenues for the local business entities. Mauritius and Cyprus are examples of such jurisdictions. Mauritius has a very favourable *Double Tax Avoidance Treaty* with India and, as a result, entities investing in India set up SPVs in Mauritius so they do not pay taxes on capital gains arising in India. Another example of such jurisdiction is Singapore which has adopted territorial taxation. They do not tax income accruing or arising to the residents outside Singapore if it is held outside Singapore. It is taxed in Singapore if and when it is brought in Singapore. This has enabled Singapore to develop as a *regional hub* for investing activities and we find many investment banks and merchant banks having their regional hubs in Singapore.

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This *tax competition* from various jurisdictions is bringing in *aggression.* Countries are attempting to protect and retain their own tax bases and also enhancing it. Global recession and shrinking of economies has aggravated this aggression. Fiscal stimulus has led to significant fiscal deficits in many nations including USA, UK and India. China is an exception and they continue to have fiscal surplus. This deficit necessitates augmentation of tax revenue which makes nations aggressive on the tax front.

While, we do see a marginal increase in personal and corporate tax rates as also in the rates of VAT/GST across nations, countries do not increase tax rates substantially in this globalised era due to fear of flight of capital and disincentive to investments and entrepreneurship. Gone are the days when the rates of personal taxation were as high as 80%. In fact, India, in seventies, had personal tax rate as high as 97% and many countries of the world too had fairly high rates. But, these rates have been moderated over the years and currently, we find that average rates of personal taxation are in the range of 40% and, so, also that of corporate taxation which is even lower, in the range of 30%. VAT/GST rates have also moderated and settled around average of 20%.

As nations find it difficult to raise domestic tax rates, we find that nations are looking at ensuring their fair share of taxation in international transactions. Countries are now not satisfied just with the *double tax avoidance* treaties, which have been in place for over 40 years and have worked for avoiding double taxation whichever be the model, e.g. UN, OECD or US model. In fact, most of the countries have a combination of these models, some income being taxed on source basis and some on residence basis; some incomes taxes only one country, either source or residence and some income being taxed by both countries with a cap on the tax rate applicable in the source country. Here again, there have been many disputes and, the developing nations often feel that it is the developed nation which should give credit for taxes paid in developing nation and not, other way round.

These treaties are also being negotiated and renegotiated with developments within and outside a country. Each country, while negotiating tax treaty keeps in mind its specific circumstances and the businesses that it would like to promote. Each country would like its own residents to be spared of taxes in the other country. Treaties relating to taxation of aircraft operations and shipping are such examples which have led Ireland becoming a hub of aircraft ownership.

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Nations, as mentioned earlier, are now looking beyond double *tax avoidance treaties* and looking for ensuring their fair share of taxable income of global transactions. While it is true, as per the economic theory, that a nation should recover taxes from its residents and from activities within the country only as it is for the benefit of its own residents, it is becoming more and more difficult to determine what is the share of revenue of an enterprise from global revenues that a country can legitimately charge to tax. And, here is where we see nations taking aggressive stances to get their fair share of global revenue as tax base and also modifying domestic laws to achieve this objective.

One of the recent examples of this is the case of Vodafone in India, i.e. though the asset that was transferred was located in India, attempts of Indian tax authorities to bring to charge the gain arising from the transaction could not succeed and Supreme Court did not endorse the view of the tax authorities. This case involved holding of the Indian asset/business by a Mauritius entity, say A which, in turn, was held by a Cayman entity, say B, and the transfer of Indian asset/business was achieved by transfer of Cayman entity B. Mauritius and Cayman do not levy tax on capital gains and so the transaction did not attract tax in Mauritius or Cayman. The transaction, in form, was not a transfer of Indian asset/business, so, it did not attract tax in India as well.

Indian tax authorities adopted a fairly aggressive approach and explored every possible way and argument under the law to bring this gain to tax in India. But they realised that their effort was not fruitful since the domestic law in India did not have a provision unlike the countries like UK, to bring such transactions to tax in India.

While on the subject, it is interesting to note observations of the Supreme Court of India in two cases:

1. In the case of *Azadi Bachao Andolan* that challenged the treaty benefits based on residence certificate issued by Mauritian authorities, the Supreme Court[2] observed: *In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital for technology.*
2. More recently, in 2012, in the case of Vodafone[3], Supreme Court observed: *If intention of India at the time of negotiation been to avoid "treaty shopping" an anti-avoidance measure would have been built into the tax treaty.*

These observations of the Supreme Court led to amendment of provisions of domestic law as also the introduction of *General Anti-Avoidance Provisions* (GAAR) in the Budget 2012. These provisions created a flutter especially, among the global investing community, and had a bearing on investments flowing into India. The Government deferred the application of GAAR and has now referred this matter to a Committee headed by the renowned economist Dr. Parthasarathy Shome. The Committee has very recently, on 1st September, 2012, published its draft report for public consultations. The draft report recommends deferment of the GAAR by three years and various safeguards to ensure its smooth implementation arising from concerns expressed by all.

These, anti-avoidance measures, is another area which is attracting global attention in recent times. *Treaty Shopping* and *Treaty Abuse* are being attacked vigorously. Countries used to have specific anti-avoidance provisions for domestic as also international transactions but, with increasing global trade, more and more countries are now looking at introducing provisions to address anti-abuse of double tax avoidance treaties in their laws by way of *general anti-avoidance* provisions. For example, India's domestic law had several specific anti-avoidance provisions like ring fencing short term capital gains so that such gains cannot be set off against business income or salary income as also provisions where privately held entities avoided distribution of dividends to avoid dividend distribution tax but, advanced funds to associated entities. In such cases, advances are deemed to be dividends attracting dividend distribution tax. These specific *anti-avoidance* rules applied mostly to domestic transactions. It is now proposed to address the issue of avoidance of taxation in international transactions through general anti-avoidance provisions.

[2] *2003; 263 ITR 706*
[3] *2012; 204 Taxman 408*

Such provisions exist in other countries like Canada and Australia too. South Africa introduced such provisions in 2006. US does not call it *general anti-avoidance* provisions but, have specific provisions in the law which deal with transactions like transactions considered sham, substance over form test and likes; therefore, it too has, in March 2010, introduced *economic substance* test irrespective of the business purpose of a transaction. UK had commissioned a study to ascertain whether it should have such general anti-avoidance provisions since it also has several anti-avoidance provisions in their current domestic law, commonly referred to as *Targetted Anti-Avoidance Provisions*. A study group headed by Graham Aaronson QC (*Queen's Counsel*) submitted its report in November 2011, and it too recommended an introduction of *general anti-avoidance* provisions with appropriate safeguards.

The interesting question that arises in this context, and which India has constantly faced is: In cases where, under the *Double Tax Avoidance Treaty*, the tax is left to be imposed by a resident country; exclusive taxation by residence country, or for that matter, it could also be source country, and if that country chooses to exempt it, not levy tax on that income or gain leading to no taxation in any country, is it abuse of the treaty? Can it be overridden by the GAAR?

Another significant development related to the aspect of fair share proposition is that of *transfer pricing.* Developed nations have had these provisions for quite some time. India introduced these provisions in 2001, about a decade after it embarked on the journey of globalisation and liberalisation which led to a fair level of increase in cross-border transactions and Indian businesses becoming multinational. Is cost and specified percentage (fairly low percentage say, 3% to 5%) a good model, especially when it comes to outsourcing, and does it ensure a fair allocation of revenues between the nations in case? What is appropriate percentage? Or, does the profit split method a better one?

These issues are engaging attention of global tax stakeholders and countries are seen to be taking a fairly aggressive stance. Litigation has also increased tremendously across the globe. The subject derives significant complexities from the technological advances and new ways of doing business in this space driven world – where there is a person sitting miles away, in another continent, can operate or repair a machine or respond to inquiries, verify documents, carry out tests and so on.

This availability of information at the press of keys has also enabled tax authorities to gather information on worldwide basis. In fact, countries are now posting their officers to foreign jurisdictions to gather information which will enable them to ensure their *fair share* of taxes. TP Week's 2010 rankings of aggressive tax authorities when it comes to transfer pricing shows the rankings:

Japan	1	France	6
India	2	Germany	7
China	3	Australia	8
Canada	4	Korea	9
U.S.A.	5	U.K.	10

We also find tax authorities getting much deeper in the matters. Take the recent issue which is being discussed in India relating to marketing and sales promotion expenses incurred by Indian subsidiary of a foreign multinational where the brand is licensed by the foreign multinational to the Indian subsidiary and for which Indian subsidiary is paying royalty to the foreign multinational. The tax authorities ask as to why a part of the expenditure incurred in India should not be regarded as having been incurred for the benefit of the foreign entity as it enhances the value of brand owned by the foreign associate/holding entity and, why should the foreign multinational not pay a charge for it to the Indian subsidiary? Now, this is not a totally unknown issue. It had arisen in US too where the bright-line test was developed for determining the proportion that can be considered to be enhancing the value of the brand.

This is the power of information availability. Tax Administrators are keeping a watch on litigation and disputes arising in other countries and applying them to the situations in the country. We hear, from informal

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interactions with tax advisors of other countries that number of tax jurisdictions is keeping close tabs on the jurisprudence developing in India in this context. Cross- border training and interactions is now common feature.

Take another example of software industry, where we see tremendous tax disputes. This industry often works on 24*7 model, uses semi-skilled and skilled HR and continuously evolve with emerging change and development. Who takes risk and how much is a fair share for such risk taking and so on are the matters being debated across the globe. Should the mark up for the outsourced activities be 5%, 15%, 25%, or 30% of the costs? What if, as a result, the total top-line/ income of the parent enterprise, adding mark ups in each country, works out to more than 100%?

As a result, a feature impacting taxation of international transactions that we witness in recent times is the approach of foreign investors and their governments where, we find the governments of investing countries are joining hands with businesses and taking up the issues at Government level where their businesses are being impacted or hit with high and often, considered as unfair or unjustified taxation, in general or in specific cases, in other countries.

Mutual agreement mechanism under *Double Tax Avoidance Treaties* is being invoked more and more to resolve such disputes. In India, we have more than 100 cases where mutual agreement procedure (MAP) is invoked. Our experience, at the ground level is that it works in some cases and not in all cases. The success of an MAP depends on the approach of authorities of the countries and if each one takes tough stand and does not take conciliatory approach, it becomes difficult to reach a mutually-acceptable solution; it becomes time consuming. By that time, the matter moves on as per normal procedure under the domestic laws and, often, people get up from the table agreeing to disagree.

Another measure to avoid such disputes and impart certainty to the revenue to be allocated to the activities in the country is *Safe Harbor Rules.* India has enabling provision and detailed rules are being framed to implement this. US has such rules in place and has specified percentages which they would accept as fair and reasonable as mark up e.g. they have specified 7% or so mark up for routine jobs and I believe, mark up generally applied for semi-skilled and jobs is 10% or more.

In fact, this is one of the tools that developing nations are using to attract investment in their countries. Considering the litigations and disputes that the software industry is facing in India, Philippines has announced *Safe Harbor Rules* where they have specified a mark-up 5% or so, which will be accepted for the BPO activities. We, in India, find that this stable and certain regime is leading businesses to shift part of their BPO activities to Philippines. This could also lead to flight of businesses to other developing Asian nations offering similar regimes.

The pre-dispute resolution mechanism of *advance pricing arrangements* is also being used effectively in international transactions. India has very recently introduced this mechanism which is effective from 1st July, 2012. Such mechanisms were informally being used under Customs Laws where also, there are internationally-accepted norms for transfer-pricing determination.

Another tool which is quite effective and rather unique in India is the *Advance Ruling Mechanism.* This mechanism enables businesses to approach the Authority which has persons of high repute and experience, to determine the tax implications of proposed international transaction. Nepal may also consider establishing such an *authority* which brings about certainty and the parties to a transaction know upfront expected tax consequences. The decisions of this Authority are binding on the tax authorities though the applicant has the option to challenge it before High Court and the Supreme Court.

Then, there are various other provisions which are currently prevalent in other countries and India is considering introducing them like the *Controlled Foreign Company Regulations,* to address treaty shopping or treaty abuse, and Group Taxation.

Reforms in tax regimes are continuing world over and it is the cause and effect syndrome. But, one striking feature of the tax reforms as set out in the PWC World Bank Report on *Paying Taxes, 2012* is that there is focus on improving administrative aspects of tax system. Use of electronic filing and payment, reduction of number of taxes and increasing use of self assessment procedures is seen across the world. We can see that all countries are trying to get the maximum share of overall income and tax thereon. They, in fact, need to bear in mind, as in the same World Bank report, that while taxes are essential for economic and social development, it is important that taxes do not hinder the ability of companies to generate sufficient and consistent returns such that the businesses can reinvest and grow. ■