Key International Tax Provisions Proposed in Finance Bill, 2013

The Finance Bill ('FB') 2013 was presented on 28th February, 2013 by the Finance Minister Mr. P Chidambaram as a part of Union Budget 2013-14. The purpose of this article is to discuss the key international tax amendments proposed in the FB 2013 pertaining to General Anti Avoidance Rules ('GAAR'), Requirement of Tax Residency Certificate ('TRC'), Increase in the tax rate of royalty/fees for technical services ('FTS') under the Act, and Increase in surcharge on foreign tax payers. Although the number of amendments introduced in FB 2013 pertaining to international tax are much lower compared to amendments introduced in Finance Act 2012, these amendments still are of far reaching nature.

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I. General Anti Avoidance Rules

GAAR was first proposed to be introduced as a part of Direct Tax Code – new legislation envisaged to replace the existing Income-tax Act, 1961. However, through the Finance Act 2012, GAAR provisions in wider form were introduced in the present Income-tax Act, 1961 ('the Act') which were applicable from 1st April, 2013. As per the GAAR provisions introduced in Finance Act, 2012, arrangement entered into an assessee may be declared to be an impermissible avoidance agreement and its effect can be ignored.

Thereafter, the Central Board of Direct Taxes ('CBDT') had formed a Committee to formulate guidelines for implementing the GAAR provisions and

to draft a circular to ensure that GAAR provisions are uniformly applied. The Committee released the draft GAAR guidelines in June 2012.

Subsequently, amidst wide-spread opposition to the sweeping powers granted under GAAR, the Prime Minister constituted an Expert Committee on GAAR on 17th July, 2012 under the chairmanship of Dr. Parthasarathi Shome, to vet and rework the GAAR Guidelines based on comments from various stakeholders, including the general public. The Expert Committee furnished its final report to the Government of India which was published on 14th January, 2013.

In the FB 2013 proposal, some of the recommendations of the report have been included. These amendments in GAAR provisions are explained as under:

GAAR amendments under FB 2013:

1. **Date -** Applicability of GAAR provisions has been postponed to AY 2016-17.

2. **Definition of Impermissible Avoidance Arrangement**

   As per the present provisions, GAAR provisions can apply in an impermissible avoidance arrangement. An impermissible avoidance arrangement was defined as an arrangement, *the main purpose or one of the main purposes* is to obtain a tax benefit.

   This has been amended to clarify that an arrangement can be considered as an impermissible avoidance arrangement only if its *"main purpose"* is to obtain a tax benefit.

   Thus, applicability of GAAR provisions has been limited only in cases where the main purpose is to obtain a tax benefit. Hence, for transactions, where tax benefits are incidental and not main, it may be possible to take a view that such transactions/ arrangement do not fall as impermissible avoidance arrangement.

3. **Onus of proof**

   As per the present provisions of Section 96(2) of the Act, an arrangement was presumed to have been entered into for obtaining a tax benefit, if the main purpose of a step in arrangement is to obtain a tax benefit notwithstanding that fact that main purpose of the whole arrangement is to obtain a tax benefit. As per the amended provision proposed to be inserted by FB 2013, an arrangement shall be presumed, *unless it is proved to the contrary by the assessee* to have been entered into for obtaining a tax benefit.

   Hence, the onus of proof for justifying that the arrangement has not been entered into for obtaining tax benefit would now be on the taxpayer.

4. **Definition of arrangement to lack commercial substance**

   As per the present provisions of Section 97(1) of the Act, an arrangement shall be deemed to lack commercial substance if following conditions are satisfied:

   i) The effect of arrangement as a whole is inconsistent with individual steps or parts; or
   ii) It involves or includes
      a. Round tripping;
      b. An accommodating party;
      c. Elements cancelling each other;
      d. Transaction conducted through one or more persons which disguises the value, location, ownership or control of funds; or
   iii) It involves location of an asset or transaction or place of residence which is without any substantial commercial purpose.

   The above definition is proposed to be amended to include that arrangement would be deemed to lack commercial substance if it does not have significant effect on business risks or net cash flows of any party.

5. **Relevant factors for determining whether an arrangement lacks commercial substance**

   FB 2013 proposes to amend that the following factors may be regarded as relevant but not sufficient for determining whether arrangement lacks commercial substance or not:

   - period or time for which the arrangement had existed;
   - the fact of payment of taxes by the assessee;
   - the fact that an exit route was provided by the arrangement.

6. **Definition of the term 'tax benefit'**

   FB 2013 proposes to amend the definition of 'tax benefit' in an inclusive manner rather than in an exhaustive manner as per existing provisions.

   Hence, the term 'tax benefit' would *include*

   (a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or
   (b) an increase in a refund of tax or other amount under this Act; or
   (c) a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or

(d) an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or
(e) a reduction in total income; or
(f) an increase in loss.

7. Changes in Approving Panel

As per the existing provisions, if the AO at any stage of assessment proceedings considers it necessary to declare an arrangement as an impermissible avoidance arrangement, he would need to make a reference to the Commissioner in this regard. The Commissioner would thereafter and after hearing the assessee, make a reference to the Approving Panel for declaring an arrangement as an impermissible avoidance arrangement.

As per existing provisions, the Approving Panel was to be constituted of not less than three members, being:

i) Income tax authorities not below the rank of Commissioner; and
ii) Officer of the Indian Legal Service not below the rank of Joint Secretary to the Government of India.

Under the existing provisions, as the Approving Panel consisted entirely of the Government officials, a lot of oppositions were raised to ensure that Approving Panel should be independent of Government officials.

Accordingly, as per FB 2013, the Approving Panel is proposed to be reconstituted as under:

i) Chairperson who is or has been a Judge of a High Court;
ii) one Member of the Indian Revenue Service not below the rank of Chief Commissioner of Income-tax;
iii) and one Member who shall be an academic or scholar having special knowledge of matters such as direct taxes, business accounts and international trade practices

Additionally, the term of the Approving Panel has been mentioned as ordinarily one year which may be extended from time to time, up to a period of three years.

Further, the Central Government has the power to constitute one or more Approving Panels as against the existing provisions which grants CBDT the power to constitute an Approving Panel.

Also, under the existing provisions, the directions issued by the Approving Panel were binding on the tax authority. However, the FB 2013 proposes to amend that by providing that directions issued by Approving Panel would be binding on assessee as well as tax authority for which no appeal under the Act would be available.

Further, powers of the approving panel have been enhanced to include the powers of a civil court under the Code of Civil Procedure, 1908.

Irrespective of the above changes, as per the existing provisions, GAAR would still override tax treaty.

Some of the key recommendations of the Expert Committee which were accepted by the Government in January 2013 but have not been proposed by the FB 2013 are as under:

- Grandfathering of investments made before 30th August, 2010;
- The same income not to be taxed twice in the hands of the same taxpayer in the same year or in the different assessment year;
- A monetary threshold (₹30 million of tax benefit) in order to attract the provisions of GAAR; and
- Only one of GAAR and specific anti-avoidance rules to apply when both of them are in force.

Thus, FB 2013 has incorporated certain recommendations made by the Expert Committee on GAAR and it needs to be seen as to how the Government deals with the balance recommendations.

II. Requirement of Tax Residency Certificate ('TRC')

The Supreme Court in the landmark judgment in the case of *Azadi Bachao Andolan (184 CTR SC 450)* had upheld CBDT circular No. 789 dated 13th April, 2000 which had said that TRC will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership of a Mauritian company.

The above observations were followed in a number of judicial rulings thereafter and were accepted as a settled principle. However, tax officers were often raising the issue that TRC by itself is not sufficient proof of residential status of an assessee.

As per the present provisions, GAAR provisions can apply in an impermissible avoidance arrangement. An impermissible avoidance arrangement was defined as an arrangement, the main purpose or one of the main purposes is to obtain a tax benefit. This has been amended to clarify that an arrangement can be considered as an impermissible avoidance arrangement only if its "main purpose" is to obtain a tax benefit.

Subsequently, Finance Act 2012 introduced sub-section 4 to Section 90 and 90A which provided for mandatory furnishing of TRC as per the prescribed format in order to avail DTAA benefits. Further, the Memorandum explaining the provisions of FB 2012 provided that furnishing of TRC was not a sufficient proof in order to claim DTAA benefits.

Consequently, FB 2013 has now proposed to introduce sub-section 5 to Section 90 and 90A with retrospective effect from Assessment Year ('AY') 2013-14 to provide as below:

"(5) The certificate of being a resident in a specified territory outside India referred to in sub-section 4, shall be necessary but not a sufficient condition for claiming any relief under the agreement referred to therein."

A literal reading of the proposed amendment would suggest that TRC cannot be regarded as a sufficient proof to claim DTAA benefits.

Due to this proposed amendment, various stakeholders had raised their apprehensions, as it would mean that the TRC produced by a resident of a contracting state could be questioned by the tax authorities in India.

Pursuant to this, the Finance Ministry has clarified that proposed amendment does not intend to dilute the legal position as existing today on acceptance of TRC as a valid proof for treaty residency. Hence, the TRC produced by a resident of a contracting state will be accepted as evidence that he is a resident of that contracting state and the Indian tax authorities will not go behind the TRC and question his resident status. Thus, Finance Ministry confirmed that in the case of Mauritius, Circular no. 789 dated 13-04-2000 continues to be in force by issuing a clarification.

However, the Finance Minster has clarified in the press that for the purpose of examining beneficial ownership of recipient in the matter of interest, royalty, etc. the tax authorities can look beyond TRC to determine their compliance. The above statement has however, not been incorporated in the clarification issued by the Finance Ministry.

The Finance Ministry has clarified that when the FB 2013 is taken up for consideration, the concerns if any for the above sub-section would be suitably addressed.

Thus, based on the amendment to be made by FB 2013, proposed to be applied retrospectively from AY 2013-14, it appears that the TRC will now only be one of the necessary conditions for claiming the treaty benefits. However, the condition of beneficial ownership will have to be independently verified and hence tax authorities may go beyond the valid TRC for looking for beneficial ownership. The tax department in the past and the judiciary have also challenged the concept of beneficial ownership while claiming treaty benefits.

III. Increase in Tax Rate of Royalty/Fees for Technical Services under the Act

Section 115A of the Act deals with the tax rate on dividends, royalty and FTS in case of foreign companies. As per the existing provisions, the gross amount of royalty/FTS received by the foreign company from an India concern from an agreement entered on or after 1st June, 2005 is taxable at the rate of 10% (plus applicable surcharge and cess).

FB 2013 has proposed to increase this rate from 10% to 25% (plus applicable surcharge and cess). This enhanced tax rate of royalty/FTS would apply to all the payments made from the tax year 2013-14.

The Honourable Finance Minister, in his budget speech on 28th February, 2013 gave the following justification for the proposed amendment:

"Another case is the distribution of profits by a subsidiary to a foreign parent company in the form of royalty. Besides, the rate of tax on royalty in the Income-tax Act is lower than the rates provided in the number of Double Tax Avoidance Agreements. This is an anomaly that must be corrected. Hence, I propose to increase the rate of tax on payments by way of royalty/ fees for technical services to non residents from 10% to 25%. However, the applicable rate will be the rate stipulated in the DTAA."

The Honourable Finance Minister has made an inaccurate assumption that the rate of royalty in the Act is lower than the rates provided in the number of

DTAA's. The rate of royalties/FTS under the current DTAA's has been summarised in the following table:

Royalty		FTS	
Rate of withholding	**No. of countries***	**Rate of withholding**	**No. of countries***
10%	52	10%	46
15%	14	15%	7
20%	5	17.5%	1
22.50%	2	20%	5
10%/15%/20%	4	22.5%	2
10%/20%	1	10%/15%/20%	4
15%/20%	1	15%/10%	1
25%/15%	1	25%/15%	1
30%	1	30%	1
As per domestic law	3	Doesn't Exist	15
Total	**84**	**Total**	**84**

** The numbers are tentative and without considering impact of MFN Clause*

The impact of the proposed increase in the rate would be substantial in cases where:

- There is no treaty with the country of the recipient;
- Treaty benefit is denied for any reason;
- There is unintended coverage due to the wide scope of definition of royalty/FTS under the Act;
- Where the contract is net of tax;
- TDS default could also lead to disallowance under Section 40(a).

The proposed amendment also makes the punitive rate prescribed under Section 206AA smaller. As per Section 206AA of the Act, where any person who is entitled to receive any sum or income or amount on which the tax is deductible under chapter XVIIB of the Act and he fails to furnish his Permanent Account Number, the tax shall be deducted at the higher of the following rates:

i. At the rate specified in the relevant provision of the Act or
ii. At the rate or rates in force or
iii. At the rate of 20%

Accordingly, in case the foreign company receiving royalty/FTS fails to furnish the Permanent Account Number, the tax to be deducted would be 25% (and not punitive rate of 20%).

However, the proposed amendment would not have its impact on the following:

- If the recipient is entitled to DTAA benefit in terms of coverage or rate;
- If the treaty is governed by Fees for included services concept;
- If the payment is made by a non Indian concern (as Section 115A is limited to application of payments by Indian concern).

In the existing scenario, where the Indian companies are reliant on foreign technology for setting up of various operations and joint ventures, transfer of technology is bound to become expensive and prohibitive. Further, it may also affect technology transfers and joint collaboration agreements and in the process, limiting the growth of Indian companies in the competitive global scenario.

The Finance Ministry has clarified that proposed amendment does not intend to dilute the legal position as existing today on acceptance of TRC as a valid proof for treaty residency. Hence, the TRC produced by a resident of a contracting state will be accepted as evidence that he is a resident of that contracting state and the Indian tax authorities will not go behind the TRC and question his resident status.

IV. Increase in Surcharge on Foreign Tax Payers

There is a marginal increase in the rate of surcharge on foreign tax payers. Presently, the rate of surcharge on the foreign tax payers where the income exceeds ₹10 crore is 2%. The said rate is proposed to increase to 5%. Hence, the resulting effective corporate rate tax of foreign tax payers having income in excess of ₹10 crore would be 43.26% for the tax year 2013-14.

Conclusion

Thus, although a number of amendments introduced in FB 2013 pertaining to international tax are much lower compared to amendment introduced in Finance Act 2012, these amendments still are of far-reaching nature and their impact would need to be adequately analysed before undertaking any international transaction. ■