

## International Taxation Proposals in Union Budget 2014-15



*GAAR provisions have been left untouched and not extended in the present Union Budget 2014-15. While it was proposed that all fresh cases involving indirect transfer tax would be pre-approved by a high-level committee, some clarity is required with regard to the interpretation of these provisions per se. However, despite this, Union Finance Minister, Shri Arun Jaitley has done a commendable job through his Budget, by maintaining the fiscal prudence and giving due impetus to growth. The Union Finance Minister says, "The steps that I will announce in this Budget are only the beginning of a journey towards a sustained growth...These steps are only the beginning of our effort to revive the growth spirit of the Indian Economy. They are directional." Overall, the honest efforts of the new Government are admirable while it lives up to its manifesto of encouraging growth by attracting foreign investments, reducing tax uncertainty boosting manufacture and spurring up investments in infrastructure projects. Clearly, the Budget of the new Government aims at a broader horizon. Read on to know the development in international taxation in the Union Budget 2014-15...*

The newly-elected NDA government presented its first Union Budget in the backdrop of huge expectations, given the strong mandate from the people of India. The Budget presented by the Union Finance Minister did not have any big bang reforms but had lot of small fixes in direct taxes and ushered policy statements. Also, several proposals were directionally right aimed at consolidating the economy but the challenge is going to be on implementation. It must be appreciated that the Government inherited and decided to retain the ambitious tax collection target of ₹13.7 lakh crore as set by the previous UPA Government in the interim budget. In the interest of economy at large,



**CA. K. R. Girish &  
CA. Dinesh Daga**

(The authors are members of the Institute who may be contacted at [kalpathi\\_girish@yahoo.co.in](mailto:kalpathi_girish@yahoo.co.in))

# Union Budget 2014-15

the Government very much wanted to increase the tax to GDP ratio but given the limitation the Finance Minister did not attempt to raise any tax revenues during service tax.

On international taxation front, though retro amendments of 2012 in respect of indirect transfer will continue, it is proposed that all fresh cases of indirect transfers coming to the notice of Assessing Officer will be scrutinised by a High Level Committee, to be constituted by the Central Board of Direct Taxes ('CBDT') before initiating any action. Further, it is proposed that the existing tax disputes, arising out of such retrospective amendments, and pending in the Courts, will be allowed to reach their logical conclusions through litigation process.

On the transfer pricing front, those seeking to reduce the transfer pricing litigation, the Union Finance Minister proposed to introduce 'roll back' provisions for APA and 'range concept' for computing arm's length price and this is a very welcome measure considering the litigation in this area.

## Retro-Active Amendments of 2012 in Respect of Indirect Transfer

- The Supreme Court in the case of *Vodafone International Holdings B. V.* held that the transfer by a non-resident to another non-resident, of shares of a foreign company holding an Indian subsidiary Company does not amount to transfer of any capital asset situated in India. Accordingly, the gains arising from the said transaction were not liable to tax in India.
- Subsequently, the Finance Act, 2012 amended the Income-tax provisions and consequently the income deemed to be accruing or arising to non-residents directly or indirectly through the transfer of a capital asset situated in India is to be taxed in India with retrospective effect from 1<sup>st</sup> April, 1962. The widening impact of retro-active amendments are:
  - Retrospective applicability of amendments is a controversial issue and as per international best practices, resort to retrospective amendments in other countries is made only in the rarest of the rare cases.
  - Certainty in taxation is a key driver for India's investment climate. Retro-active amendments have a negative impact on investor confidence.
  - Retrospective overruling of judicial

**There was a widespread expectation that the new Government will do away with the retro-active amendments regarding indirect transfer. But that did not happen, given the legislature implications. The Finance Minister, however, took the middle path to resolve the contentious issue.**

precedents favouring taxpayers potentially undermines rule of law in India.

- Concerns over the impact of retro-active amendments acknowledged by the Prime Minister as well as the Finance Minister in 2012. Circular F. No. 500/111/2009-FTD-I dated 29<sup>th</sup> May, 2012 clarifies that cases where assessment proceedings under Section 143(3) have been completed prior to 1<sup>st</sup> April 2012, will not be reopened on account of the retrospective amendments.
- With the retro-active amendments, tax officers have targeted various companies—who had done any restructuring which has an Indian leg.
- There was a widespread expectation that the new Government will do away with the retro-active amendments regarding indirect transfer. But that did not happen, given the legislature implications. The Finance Minister, however, took the middle path to resolve the contentious issue.
- Though the provisions regarding taxation of indirect transfer of shares would continue, the Finance Minister could have provided certain clarity or relief in respect of the following:
  - Functioning of the Committee—whether the Committee would only implement the law regarding indirect transfer or it can take certain decision like defining 'substantial' interest, *etc.*
  - Indian tax should not be imposed where the shares of the foreign company are listed and traded on a stock exchange outside India.
  - Only *transfer of a controlling interest* in a foreign entity deriving its value substantially from assets located in India should attract tax in India. In this regard, a threshold limit of transfer of more than 50 % beneficial interest in the capital of a foreign entity and/or transfer of more than 50% voting power of a foreign entity could

have been prescribed to define *transfer of a controlling interest*.

- Even in case of a foreign entity deriving its value substantially from assets located in India, only such portion of the gains should be taxable in India as are relatable to Indian assets.
- No taxes to be levied on group restructurings wherein the ultimate parent remains unchanged.
- No tax to be levied on repatriation of funds by the offshore company/entity to its investors on account of buy back, redemption, capital reduction.
- No tax to be levied on liquidation by the offshore company to the extent the repatriation amount relates to the amount realised by the offshore company on sale of Indian assets on which taxes have been duly discharged, or on which no taxes or lower taxes are due on account of tax provisions or treaty benefits available, as may be applicable.
- Transactions which are otherwise not *transfer* as per law, e.g. gift, or transactions, which do not result in any transfer *per se*, e.g. primary infusion in company for acquisition of shares, should not be covered in the deeming fiction created by amending the Section 2(47) of the Act.

## International Practice – Taxation of Indirect Transfers

### Circular issued by Chinese tax authorities

- Circular No. 698, issued by Chinese tax authorities on 10<sup>th</sup> December, 2009, with retrospective effect from 1<sup>st</sup> January, 2008, the date when China's GAAR came into effect, addresses taxability of gains from sale of equity shares, *i.e.*, capital gains, and is aimed at

—   —

**It is proposed to provide roll back mechanism in the APA Scheme for a period of four years preceding the first previous year for which the APA is applied, subject to prescribed conditions. The roll back provisions refer to the applicability of the methodology of determination of ALP, or the ALP, to be applied to the international transactions which had already been entered into, in a period prior to the period covered under an APA.**

—   —

increasing the administration and taxation of direct and indirect capital gains derived by non-residents.

- As per the Circular, in case the tax rate of the country where the overseas transferor is domiciled, is lower than 12.5% or no tax is levied when an overseas investor indirectly transfers the equity of a Chinese resident enterprise, then it should within 30 days upon signing of the equity transfer contract offer certain documents to the competent taxation administration in China.
- In case an overseas investor makes indirect transfer of the equity of a Chinese resident enterprise in the forms including abusing organisation without reasonable commercial purpose to dodge the obligation of paying certain enterprise income tax, the competent taxation administration may reconfirm the quality of the equity transfer trading in accordance with the economic substance, to negate the existence of the overseas holding company serving as taxpayer.

### Taxation of indirect transfer in Brazil

- Supplementary Law No. 104 empowers tax authorities to disregard transactions where the intention is to avoid a tax realisation event.
- This provision is typically employed only where a non-Brazilian company without economic substance/business purpose is interposed to avoid Brazilian capital gains tax.

### Taxation of indirect transfer in Peru

- The tax laws provide for *pro-rata* taxation of gains based on ratio of fair value of the Peruvian company to the value of the foreign company whose shares are being transferred.
- So, if one notices the international experience particularly developing countries they have not gone not go on a confronting approach but in a non adversarial manner. This is where the Indian legislation lacks and the Finance Minister has assured that he would adapt this approach.

## Transfer Pricing

### Roll back provisions in Advanced Pricing Agreements ('APA')

It is proposed to provide roll back mechanism in the APA Scheme for a period of four years preceding the first previous year for which the APA is applied, subject to prescribed conditions. The roll back provisions refer to the applicability of the

# Union Budget 2014-15

**Currently, there is an ambiguity in the characterisation of the gains derived by the FIs from their portfolio investments in India. It is now proposed that the securities held by FIs would be treated as capital asset and accordingly, resulting gain from sale of such assets would be liable to be taxed under the head capital gains.**

methodology of determination of ALP, or the ALP, to be applied to the international transactions which had already been entered into, in a period prior to the period covered under an APA. This amendment shall take effect from 1<sup>st</sup> October, 2014. It is also proposed to strengthen the administrative set up for quick disposal of pending APA applications.

The APA programme at India will be now more successful with this proposal of roll back, as it will give certainty to all stake holders and will reduce the cost of litigation, especially where the normal appeal process is time consuming with uncertain outcomes. However, how the same would get implemented is to be seen, *i.e.*, the date from which this option can be availed. Can it be from the date in which the assessee made his filing request?

### **Use of Inter Quartile Range**

As per the Budget speech of the Finance Minister, the concept of price range for determination of ALP will be introduced in the Income-tax Rules, to align the Indian transfer pricing regulations with international best practices. However, the existing concept of arithmetic mean would continue to apply where the number of available comparables is inadequate.

In India, Arm's Length Price ('ALP') is determined as the arithmetic mean of the range of prices/margins leading to disputes in majority of the cases. It is a fact that no comparable enterprise can operate at the exactly at the identical level of comparability as the taxpayer/comparables so as to transact at the same price or earn the same margin. Moreover, there are constraints of information available of the comparables and some issues regarding the comparability would remain that cannot be identified and adjusted. Computation of arithmetic mean as an average of the prices/margins obviously gets distorted by the extreme values on higher sides and lower sides and accordingly, does not give a true arm's length price/margin.

Tax payers as well as tax administrators have

gained significant understanding and learning in the data analysis and for the benchmarking processes. Adoption of internationally accepted concept of range-which includes a sizable number of comparables of such prices/margin will be a step in the right direction. This will also reduce disputes at the assessment stage itself. Specific rules/guidelines regarding computation and adoption of inter-quartile range are yet to be notified.

### **Use of Multiple year data permitted**

Currently, taxpayers are required to undertake year by year analysis. Prices/Margins in a particular year may be affected due to various economic reasons which can have a material effect on transfer pricing benchmarking. Product and Life cycle of the enterprise also varies from year to year and industry to industry. The Finance Minister, in his budget speech, proposed to amend regulations to allow the use of multiple year data for comparability analysis. Use of multiple year data would now address this issue and will also improve the selection of comparables, for *e.g.* a significant variance in margin from year to year may lead to rejection of that comparable.

### **Definition of Deemed International Transaction**

The deeming transfer pricing provisions contained in Section 92B(2) of the Act are now proposed to be extended to transactions between an enterprise and an independent person where there is a prior arrangement between the independent person and associated enterprise, irrespective of whether such independent person is a non-resident or resident. This provision requires more clarity as what is meant by prior arrangement, as in the absence of the clear definition it can lead to controversy.

### **Levy of Penalty**

It is proposed to extend the authority to levy documentation penalty to the Transfer Pricing Officer. The Transfer Pricing Officer would now have the authority to levy penalty under Section 271G of 2% of the value of international transactions or specified domestic transactions for failure to furnish prescribed information or documentation. This amendment shall take effect from 1<sup>st</sup> October, 2014.

### **Others**

#### **Transfer of Government Security by one non-resident to another non-resident**

Transfer of Government Security, carrying a periodic payment of interest, by a non-resident person to another non-resident which is made outside India

through an intermediary dealing in settlement of securities, would not to be regarded as transfer and accordingly, the same would not liable to capital gains tax.

***Any security held by Foreign Institutional Investor (FIIs) to be a capital asset and liable to be taxed under the head capital gains***

Currently, there is an ambiguity in the characterisation of the gains derived by the FIIs from their portfolio investments in India. It is now proposed that the securities held by FIIs would be treated as capital asset and accordingly, resulting gain from sale of such assets would be liable to be taxed under the head capital gains. Therefore, the FII's would now be eligible to invoke the beneficial provisions of the Capital Gains Article, if any, in the various Double Taxation Avoidance Agreements.

The Government's proposal to treat income generated by foreign portfolio investors as capital gains has been widely welcomed by market participants.

**Conclusion**

There are some disappointments the GAAR provisions were left untouched and not extended. While it is proposed that all fresh cases involving indirect transfer tax will be pre-approved by a high level committee, there is still no clarity on the interpretation of these provisions *per se* which will only fuel uncertainty. Having said this, in his maiden budget the Hon'ble Finance Minister has done a commendable job of managing to maintain prudence at the same time given impetus for growth. As mentioned by the Finance Minister himself he said, people should look at this as a beginning look at me as a marathon runner not as a sprinter!

Overall, we should admire the honest efforts of the new Government to live up to its manifesto of encouraging growth by attracting foreign investments, reducing tax uncertainty boosting manufacture and spurring up investments in infrastructure projects. Clearly, the Government has its eyes on a longer horizon and it will be interesting to watch the next Budget to see some bold measures. ■