TPI Transfer Pricing

August 2009

New Indian tax code – treaty override and anti-avoidance rules

Rahul K Mitra, Anup Seth, Arun Chhabra and Nishant Saini
PricewaterhouseCoopers, India

Ever since India proceeded on the path of economic liberalisation and thus became the favourite destination of MNCs across the world, international taxation and transfer pricing have become the most talked about subjects in Indian taxation and also the largest sources of tax litigation in India in recent times. The much awaited Direct Tax Code Bill, 2009 (Tax Code), which has been recently released, proposes certain fundamental amendments to the provisions of international tax and transfer pricing in the context of Indian taxation, the notable amongst them being:

- a.specific legislation to the effect that the preference of the applicability of a tax treaty or the domestic tax law would depend upon the enactment, which is later in time, as compared to the existing provisions that a taxpayer could choose to be governed by either a tax treaty or the domestic tax laws, depending upon whichever was more favourable to it; and
- b.introduction of general anti avoidance rules (GAAR), which has been referred to in the explanatory statements of the Tax Code, as to also partake of the nature or character of "treaty override".

In essence, both the proposed amendments, which are extremely fundamental and go to the roots of the taxation system of India or for that matter, any country, carry elements of "treaty override", *albeit* in different directions. The scope and amplitude of the aforesaid amendments differ significantly and need to be understood from different perspectives, as analysed below.

I. Preference between tax treaty and the Tax Code, to the one being later in time

As mentioned earlier, the provisions of the existing tax laws of India require that a taxpayer can choose to be governed by either a tax treaty or the domestic tax laws, depending upon whichever is more favourable to it. Several foreign countries have entered into tax treaties with the Indian Government against the background of such a scheme of taxation in India. Incidentally, the Indian Government has signed more than seventy comprehensive tax treaties with various countries to date. The Tax Code now proposes that effective on its enactment, which is destined for April, 2011, the preference of the applicability of a tax treaty or the domestic tax code would depend upon which is later in time.

A very pertinent question arises, namely, whether the proposed legislation would apply only to tax treaties which would be entered into by the Indian Government after enactment of the Tax Code or would the same also apply to more than seventy comprehensive tax treaties already executed by the Indian Government , i.e., under the aegis of the existing enactment of income taxes, which involve all major countries in the world, since literally, the Tax Code would be the one later in time as compared to all the existing tax treaties? There is no express mention of the intent either in the Tax Code or the explanatory statements of the Tax Code.

In case the former proposition is correct, namely that the proposed legislation would apply only to tax treaties which would be entered into by the Indian Government after enactment of the Tax Code, then probably sovereign nations, seeking to negotiate treaties with the Government of India, and also the concerned taxpayers might not raise eyebrows with respect to the validity of the legislation, since it is the prerogative of the Parliament and the Indian Government to legislate and execute tax treaties in any particular manner.

However, in case the latent intention is to apply the proposed legislation to the more than seventy comprehensive tax treaties entered into by the Indian Government to date, i.e., under the aegis of the existing enactment of income taxes, which involve all major countries in the world, then there could be negative implications, including affecting trade relationships between India and the major countries, and also possible questions being raised about the sanctity of the proposed legislation on the touchstone of arbitrariness, which is the conscience keeper of the Indian Constitution for any Parliamentary or State action.

As discussed earlier, there is no express mention of the intent either in the Tax Code or the explanatory statements of the Tax Code of whether the proposed legislation would apply only to the future tax treaties to be entered into by the Indian Government after coming into effect of the Tax Code or even to the existing tax treaties, entered into by the Indian Government under the existing enactment of income taxes.

However, it is possible to take a strong argument, based on the interpretation of the Tax Code that the proposed legislation could be said to apply only to future tax treaties to be entered into by the Indian Government after coming into effect of the Tax Code. Section 282(2)(j) of the Tax Code provides that any tax treaty entered into under the aegis of the existing enactment of income taxes, shall be deemed to have been entered into under the Tax Code and continue in force accordingly, provided the same otherwise meets the parameters of negotiation of tax treaties envisaged under the Tax Code, which are more or less similar to those of the existing enactment of income taxes.

Now, if an existing tax treaty is deemed to have been entered into under the aegis of the Tax Code, one could strongly argue that the said treaty would have been entered into after the Tax Code comes into force, since unless the Tax Code comes into effect, a tax treaty cannot be entered into by the Indian Government under the powers conferred by such Tax Code. Thus, since the existing tax treaties would be deemed to have been entered into after the Tax Code comes into effect, the provisions of even such existing tax treaties, being later in law as compared to the Tax Code, by virtue of the deeming provision or fiction of law, would automatically prevail over the provisions of the Tax Code and would not stand overridden by the Tax Code.

It can also be strongly argued that in any event, the question of overriding of existing tax treaties by the Tax Code on the principle of later in time, would arise only in case of a direct conflict between the provisions of the existing tax treaties and the Tax code through express overriding provisions of tax treaties contained in the Tax Code, and not to general provisions of the existing tax treaties, which are not in express conflict with those of the Tax Code.

However, in case the intention is to apply the proposed legislation even to the existing tax treaties by virtue of the fact that the Tax Code would always be the one later in time as compared to the existing tax treaties, *notwithstanding the favourable interpretations to the contrary, as discussed above*, some of the unfortunate results and consequences that can be conceived of are:

- 1.Majority of the tax treaties executed by the Indian Government with the various countries provide for withholding tax rates of 10 percent or 15 percent on royalties, fees for technical services (FTS), interests, etc, arising out of India to a non-resident taxpayer. The tax code proposes a uniform withholding tax rate of 20 percent for such receipts by non-residents. So taxpayers, who are residents of the relevant countries, who have negotiated such favourable treaties with the Indian Government, could suddenly become impacted.
- 2.Tax treaties provide for the concept of permanent establishment (PE) as a means to create taxable presence in India for non-resident taxpayers. The ambit of PEs under the Indian treaties, though more stringent than the general provisions relating to PEs under the OECD model of tax treaties, are far more relaxed as compared to the Indianised version of "business connection", as a means of creating taxable presence in India under the domestic tax laws. Incidentally, the Tax Code has also proposed the abolition of the savings clause of an independent agent, which insulated non-resident taxpayers from creating a PE or taxable presence in India while dealing with third parties or subsidiary companies in India under an agency model, particularly under the arm's length scenario, which even the existing tax laws of India guarantees to non-resident taxpayers on almost equal footing as the tax treaties. Thus, with the coming into effect of the Tax Code, the favourable concept of PEs, so far as the existing tax treaties with the major countries are concerned, might stand withdrawn and further, non-resident taxpayers, while dealing with even third parties under an agency model, could be dragged into the Indian tax net.
- 3.Some of the existing tax treaties provide for exemption from capital gains taxation in India, particularly in the context of disposal of shares in Indian companies, e.g., Mauritius, Singapore, Netherlands, Cyprus, etc. There have been several instances of litigation, where the Indian Revenue had contended that MNCs had attempted to misuse such tax exemptions through brass-plate or paper companies set up in favourable treaty countries, without any commercial substance in the same. It is submitted that the same is a different matter altogether, however, the point remains that the capital gains tax exemption agreed by the Indian Government in the relevant tax treaties would be denied even for companies of substance. Incidentally, the Indian Singapore tax treaty even contains a "limitation of benefit" clause in the tax treaty, ensuring that only companies of substance get the benefits of the tax treaty. However, if the Tax Code is intended to apply to the existing tax treaties, such benefits enshrined in the relevant tax treaties would be withdrawn even for bona fide and genuine cases.
- 4.All the tax treaties provide a mechanism for settling tax disputes arising in any country through bilateral negotiations in the form of Mutual Agreement Procedure (MAP), where tax authorities of the countries negotiate with each other in order to settle disputes in an amicable manner. The scheme of MAP often provides an easy and effective solution to protracted tax litigation. Now, the Tax Code does not contain provisions for any such bilateral settlement of tax disputes through MAP. Thus, benefits

available under the existing tax treaties signed with the major countries could be lost upon enactment of the Tax Code.

The list given above is only illustrative and by no means exhaustive. There are so many other benefits guaranteed in tax treaties, which various sovereign countries had agreed with the Indian Government at the time of entering into of the tax treaties, by reposing confidence and faith in the tax system of the country existing at the relevant times of execution thereof that tax residents of such countries would be entitled to take recourse to such benefits in case of conflicts between the same and the domestic tax laws of India. However, in case, through an unilateral act, the Indian Government were to suddenly withdraw all such benefits, which it had itself guaranteed through bilateral negotiations with various countries, the same might not be a welcome move.

The issue of whether treaty benefits can be unilaterally overridden by a State through domestic laws is also a vexed one. Tax treaties are governed by the Vienna Convention. Though India is not a signatory to the Vienna Convention yet the principles of the Convention can nonetheless be applied to any Indian tax treaty, a proposition which finds support from the International Fiscal Association. Article 18 of the Convention provides that a State, which is party to a treaty, is obliged to refrain from acts which would defeat the object and purpose of the treaty. Article 26 of the Convention lays down the principles of *pacta sunt servanda*, i.e., "Every treaty in force is binding upon the parties to it and must be performed by them in good faith".

Therefore, any unilateral act on the part of India to override existing tax treaties through the insertion of provisions in domestic tax laws would be in conflict with Articles 18 and 26 of the Vienna Convention. Article 27 of the Convention provides that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. Article 27 of the Convention is without prejudice to Article 46, which provides that a State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance. The said Article further provides that a violation is manifest if it would be objectively evidenced to any State conducting itself in the matter in accordance with the normal practice and in good faith.

When India had negotiated its existing tax treaties, clearly the domestic tax laws did not have any provision to the effect that a tax treaty could be unilaterally overridden by any subsequent amendment made to the domestic tax law, as is contemplated in the Tax Code. Therefore, the present proposal to override even existing tax treaties, if that is intended by the Parliament, would certainly not result in any violation of the internal laws of India, vis-à-vis the existing tax treaties, since the same was not manifest at the time of the negotiation thereof. Further, in any event, such violation would not concern the rule of internal laws of India of fundamental importance, which perhaps are the ones forming the pillars of the Indian constitution, namely, securing to all the citizens of India *justice*, social, economic and political; *liberty* of thought, expression, belief, faith and worship; *equality* of status and of opportunity; and the promotion among all the citizens of India, *fraternity* assuring the dignity of the individual and the unity and integrity of the Nation, as are enshrined in the preamble to the Constitution. Revenue laws are not considered as laws of fundamental importance. These are required as fiscal measurements to support the economy of the country. Therefore, any unilateral act on the part of the Parliament to override existing treaty benefits in the manner referred to above through amendment of domestic tax laws, would again contravene both Articles 27 and 46 of the Vienna Convention.

It is true that the Constitutions of some countries, for example the USA, permit treaty overriding through domestic law, as under such Constitutions, treaties are ranked equal to the domestic law, with the result that they are subject to the rule *"lex posterior derogat legi priori"*, i.e., later law overrides the prior law. Again, there are countries like France, whose Constitutions clearly give treaties a superior position as compared to the domestic law, by virtue of which treaty overriding through amendment of domestic law is not permissible. Though the Indian Constitution does not fall under either of the two extreme categories, yet, there is support and comfort available from at least the Directive Principles of State Policy of the Constitution, in the form of Article 51, which *interalia* requires the State to foster respect for international law and treaty obligations.

In case India would prefer to follow the US path in matters of tax treaties by specifically legislating that the later in law, namely provisions in domestic tax laws or tax treaties, would prevail, then clearly the same can only be made applicable to treaties executed after such legislation, since neither the provisions of the Indian Constitution nor those of the domestic tax laws of India, which existed at the times of execution of the existing tax treaties of India, gave such mandate. *It is expected, based on the interpretation of the provisions of the Tax Code made earlier, that the proposed amendments should apply only to the new tax treaties to be entered into after coming into force of the Tax Code*. However, in case the converse were to happen, i.e., the treaty overriding provisions under the principle of later law to prevail over prior law, would apply even to the existing tax treaties executed by India with various countries, the same may not receive unhindered blessings of the Constitution, quite apart from the fact that it may impact the eco-political relationships with major countries. The matter needs to be handled with care and the Government could do well to bring out necessary clarifications in this regard in order to dispel doubts.

II. General anti avoidance rules (GAAR)

Whenever the topic of tax avoidance comes up for discussion in the context of Indian taxation, the Supreme Court rulings in the cases of *McDowell* and *Azadi Bachaon Andolan* automatically spring to memory. But in actual practice, the issue of tax avoidance, vis-à-vis the introduction of GAAR, actually encompasses a larger area than is covered by the said rulings.

Many people have the wrong notion that while in the case of McDowell, the Supreme Court had held that "substance should rule over form", in the later judgement, i.e., in the case of Azadi Bachaon Andolan, the Supreme Court, while blessing the capital gains tax exemption envisaged in the India-Mauritius tax treaty, had indirectly held that "form overrules substance". The notion is far from reality.

The Supreme Court, even in the case of Azadi Bachaon Andolan, had held that substance in the transaction is the key for tax purposes. However, the fulcrum around which the said ruling of the Supreme Court rotated, was that a transaction, which otherwise was executed in accordance with law, would receive the blessings from the perspective of tax laws, even if the said transaction was entered into solely for the purposes of tax savings. For instance, when the India-Mauritius tax treaty did not contain a limitation of benefit clause, the Supreme Court held that a company incorporated in Mauritius, provided it was a resident of Mauritius under the taxation laws of the said country, would be entitled to the capital gains tax exemption envisaged under the relevant tax treaty on disposal of shares of an Indian company; and the Indian Revenue had no competence, in absence of any anti-avoidance rule embodied in either the tax treaty or the domestic tax laws of India, to question the commercial rationale of the ultimate parent company for routing the investment through Mauritius.

Thus, in view of the Supreme Court ruling in the case of Azadi Bachaon Andolan, so long as a transaction was not sham or prohibited by law, the same would need to receive blessings under taxation laws or treaties, vis-à-vis exemptions envisaged therein, and the Revenue was not competent to question the commercial necessity or justification for the taxpayer in transacting in any particular manner.

Thus, a distinction may be made between the commercial substance and commercial justification/ rationale of a transaction. To satisfy commercial substance, the transaction has to be real, not a sham and also otherwise permissible in law, while to satisfy commercial necessity/ rationale of a transaction, the transaction, which though has commercial substance, has to also satisfy the rationale or need to be entered into, which cannot be solely for the purposes of tax.

It is submitted that GAAR is not necessary or required to ensure commercial substance of a transaction, as the same would have been condemned even within the four corners or parameters of tax treaties or domestic tax laws. The utility of GAAR is really to check the breach or misuse of commercial justification/ rationale. Let us analyse the implications of GAAR in the context of international taxation and transfer pricing through some illustrations :

A. Thin capitalisation

There is a fundamental difference between Article 9 of tax treaties, which enables the international transfer pricing provisions of a country to be applied under the aegis of tax treaties, and the provisions of the international transfer pricing provisions of India.

Article 9 of tax treaties provides that if conditions are made or imposed between two related parties, being tax residents of the respective two contracting states, in their commercial or financial relations, which differ from those, which would be made between third parties, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of the said enterprise and taxed accordingly.

On the other hand, the international transfer pricing provisions of India merely require the computation of any income arising from an international transaction between two related parties to be at arm's length price, where the term arm's length price has been defined to mean the price at which two independent parties would have transacted in uncontrolled conditions.

On a closer reading of the two provisions, it would appear that Article 9 of tax treaties has wider amplitude than the international transfer pricing laws of India. While the international transfer pricing laws of India mandate the arriving at an arm's length price under the given circumstance of happening of any particular transaction between related parties, Article 9 of tax treaties travels one step further in requiring justification of the transaction itself under the yard stick of arm's length principle.

In other words, under the international transfer pricing laws of India, one would only need to prove that the price of transaction between two related parties is at arm's length, while under Article 9 of tax treaties, one would not only need to prove that the price of a transaction is at arm's length, but also that the transaction itself is executed under the principles of arm's length. Since, under the current taxation regime, a taxpayer can choose to be governed by either a tax treaty or the domestic tax laws of India, being more favourable of the two, the larger amplitude envisaged under Article 9 of tax treaties could not be hitherto applied for transfer pricing purposes in India.

Juxtaposing the aforesaid principle on the issue of thin capitalisation, the matter may be analysed as under:

- Let us say that a foreign parent has given a loan of US$500 million to its Indian subsidiary at an interest of three percent per annum.
- Under the international transfer pricing laws of India, it would be sufficient compliance if one were to establish that the rate of interest, i.e., three percent, is at arm's length. The Revenue currently does not have the mandate to question the arm's length nature of the transaction itself, namely whether, given the credit worthiness of the Indian subsidiary, a third party lender would have at all advanced a loan of US$500 million; and accordingly recharacterise the entire amount of US$500 million between loan and equity, by applying judicious transfer pricing methodology.
- On the other hand, Article 9 of tax treaties permit thin capitalisation questions also being asked, in addition to testing the arm's length price of the interest, as borne out by commentaries on the OECD model of tax treaties.
- GAAR now gives the power to the Revenue to challenge the quantum of interest deduction in the hands of the Indian subsidiary not only on the ground of the arm's length price of the interest, but also with reference to thin capitalisation issue, namely whether the entire amount of the loan could be actually held to constitute a loan or whether part of the same was really an equity in disguise.
- In fact, GAAR expressly empowers the Revenue to *interalia* recharacterise loan into equity, which the Revenue was hitherto not authorised to do under the existing international transfer pricing laws of India.

B. Business restructuring

The issue of business restructuring; and the implications of transfer pricing thereto, is a raging one across the world. Germany had already introduced specific legislation on business restructuring, while the OECD and the Australian Tax Office [ATO] had also released draft discussion papers on the relevant subject.

Let us say, that a full fledged marketing distributor operating in India is converted into a limited risk distributor by the foreign principal company. Based on the draft discussion papers issued by the OECD and the ATO, certain questions could crop up from the perspective of transfer pricing, namely:

- Whether the process of business conversion has necessary economic substance and commercial justification? *and*
- Whether the converted entity should receive an arm's length compensation for change in roles?

The two questions, though related, could nonetheless be independent. The first question is aimed to the very substance or acceptance of the business conversion and raises issues relating to the post facto implementation of the business conversion. On the other hand, the second question could operate even in a scenario that the business conversion *per se* has the backing of significant economic and commercial substance, so that transactions entered into post the business conversion between the various entities of the MNC group at arm's length would need to be respected and accepted by the revenue departments of the various countries, however, a taxation event might nonetheless trigger at the stroke of the business conversion in the form of taxability of arm's length compensations in the hands of the converted entities in consideration to their conversion.

Again, merely by paying a compensation for the business conversion, an MNC group might not be able to achieve a valid business conversion, acceptable in the eyes of transfer pricing regulations, in case the business conversion itself lacks economic substance and commercial justification. It is for this reason that one can state that the above questions could co-exist or even operate independently. The issue of whether a compensation needs to be paid to the converted entity and thus taxed in its hands, can be examined by the Indian Revenue under the aegis of the international transfer pricing laws of India, since there might be an actual transaction between the principal and the related party distributor at the time of conversion, in the form of transfer of assets, ideally intangibles, for which an arm's length price might be required to be charged. It is submitted that GAAR does not aim to cover the taxability of such compensation, which is generally referred to as “exit cost” under the parlances of transfer pricing.

What GAAR could cover is the issue of acceptance or otherwise of the business conversion and post facto implementation of the business conversion, in case the business conversion *per se* does not have economic and commercial justification. Simply put, under the current international transfer pricing laws of India, in case the converted distributor can justify that after the business restructuring, all the significant peoples functions are actually carried out by the principal from abroad, such that its status or characterisation as a limited risk distributor is a reality and not sham, then the Revenue cannot question the commercial justification/ rationale of the exercise of business conversion, since as discussed earlier, the existing international transfer pricing laws of India do not permit questioning the arm's length nature of a transaction *per se*.

However, it appears that the Revenue could find such mandate under GAAR, where, while legislating the apathy towards “impressible avoidance arrangement”, for the purposes of *interalia* disregarding the same for tax purposes, the said term has been *interalia* defined to mean a step in, or a part or whole of an arrangement, whose main purpose is to obtain a tax benefit and it creates rights, or obligations, which would not normally be created between persons dealing at arm's length. Thus, GAAR now appears to empower the Revenue to even question the economic and commercial justification/ rationale for participating in the business conversion, which, at the end of the day, is also in line with the draft discussion papers issued by the OECD and the ATO. However, it is submitted that GAAR needs to be applied with care and caution while examining the economic and commercial justification/ rationale for such business conversion in the context of an entity of an MNC group. In this regard, the Revenue would do well to follow the cautious guidance given by the OECD and ATO, namely :

- It is quite possible that an independent entity may agree to operate with limited risks for more stable, *albeit* lower returns, compared to the option of operating with higher risks for a more volatile and potentially higher return. Instances can be found in cases where independent entities work as contract/ toll manufacturers or contract service providers. It has to be borne in mind that an option embedded with risk and correspondingly higher profits is not necessarily a better option for an independent entity, since the entity might not be worse off by selecting a less risky option, though the same reduces the potentiality of higher profits and losses.
- Options available to an entity belonging to an MNC group could be limited, as compared to an independent entrepreneur, standing on its own. For instance, where an entity of an MNC group, works as either a licensed manufacturer or a marketing distributor under license arrangements with the principal company of the MNC group, it cannot straight away refuse to participate in an exercise of business restructuring whereby the entity is converted into either a contract/ toll manufacturer or commissionaire, as the case may be, and continue to operate in its existing capacity, since the principal company could merely terminate the license arrangements, thus rendering the relevant entity into a nullity.
- It would be a different matter altogether that the principal company might be required to pay arm's length compensation to the entity pursuant to conversion in relevant circumstances, however, the point to note is that the concerned entity in the MNC group might not have complete flexibility and liberty to refuse to participate in a business conversion in situations as above, a factor which the Revenue would need to bear in mind, while administering GAAR.

GAAR also appears to empower the Revenue to challenge the economic and commercial justification for interposing intermediaries for availing tax treaty benefits, by nullifying the Supreme Court ruling in the case of Azadi Bachaon Andolan, as stated above. As discussed earlier, while the introduction of anti avoidance measures for treaties to be signed in future might have legislative and rational support, keeping in mind the overall taxation regime of the country, it could be difficult to apply the same to existing tax treaties, which had been executed under the aegis of the current tax laws of India and thus prior to the introduction of GAAR.

Rahul K Mitra is a Partner, *Anup Seth* and *Arun Chhabra* are Senior Managers and *Nishant Saini* is a Manager in the National Transfer Pricing Practice of PricewaterhouseCoopers, India. They may be contacted by email at:
rahul.k.mitra@in.pwc.com
anup.seth@in.pwc.com
arun.chhabra@in.pwc.com
nishant.saini@in.pwc.com

Published by BNA International Inc.