Section 94 A
Black Listing of Tax Havens

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This section is a collection of anti avoidance provisions. The memorandum explaining the provisions of Finance Bill refers to this section as "Tool box of counter measures". A very simple description of the section would be: It authorises the Government of India to black-list non-cooperative jurisdictions; and to penalise both – Indian assessee as well as the concerned non-resident. It seeks to cover: (i) Tax Base erosion by way of Transfer Pricing and (ii) Round Tripping.

Direct Taxes Code with its provisions of GAAR & CFC, and now Finance Bill 2011 with Tool Box is a concerted attack on tax avoidance by using international facilities. This branch of law has yet to develop in India. One may consider the provisions carefully & not jump to conclusions.

This is a complex provision. To make the issues clear the article is divided into a few parts.

I. A simple statement of the provision is given in paragraph I.

II Some charts & illustrations are given for explaining the tax planning which some people do.

III Specific in depth issues on the section.

I. Simple statement of provision:

It is well known that tax evasion takes place through offshore centers (also known as tax havens). The offshore centers not only help in tax evasion, but also in avoiding other laws. Their laws are designed to thwart any enquiries from other countries. The Indian government has so far been ineffective in getting the required information from the offshore centers.

In order to discourage Indian residents from undertaking transactions with persons in such centers, the finance bill has provided for several measures. The provisions are explained below.

I.1 **Sub Section (1):** The Indian Government is trying to enter into agreements so that the offshore centers provide the necessary information. However **despite** such **agreements**, the information may not be forthcoming. In such situations, the Indian government can notify such a country or a territory as "notified jurisdictional area" (NJA). (Or in simple words, black list a jurisdiction.)

I.2 **S.s (2):** If an Indian assessee enters into a transaction with a person in NJA, it will have some consequences as stated below. Note that the **assessee may be an Indian resident or a non-resident**. There can be several situations where a non-resident will be an Indian assessee. If that non-resident tries to reduce Indian tax liability by transacting with tax haven companies, its attempt can be curbed U/s. 94A.

i) The transaction will be considered as an "**International Transaction**".

(ii) Even if just any one party to the transaction is located in an NJA, all the parties to the transaction shall be treated as "**Associated Parties**".

(iii) All provisions of "**Transfer Pricing"** will apply. Assessee will have to get the accounts audited for Transfer Pricing (TP) and submit the same with Income-tax return. It will also have to maintain complete records as required under TP rules. This can become a time consuming and costly exercise for the Indian assessee. The 5% safe harbour margin will not be available in such cases.

I.3 **S.s (3):** (i) If any **payment is made to a financial institution** in an NJA, the assessee will have to provide an **authorisation** to the Central Board of Direct Taxes to seek relevant information from the said financial institution. If an authorisation is not given, no deduction will be allowed for the payment made to the financial institution. Say a loan is taken from a bank in Cyprus, (and assume that Cyprus is notified as an NJA), then no deduction for interest paid to the Cypriot bank will be allowed unless the assessee gives an authorisation.

iii) If any **expenditure or depreciation allowance** is claimed for a transaction with a person in an NJA, no deduction will be allowed unless the assessee maintains documents and furnishes information as may be prescribed.

I.4 **S.s (4):** If the assessee has **received any amount** from a person in an NJA, he will have to provide explanation for the **source of amount in the hands of the payer**. Thus if an Indian resident has received a loan from a company in British Virgin Islands (BVI) (and assuming that BVI is an NJA), the assessee will have to provide the source of amount in the hands of the BVI company. If the explanation is not provided, or the explanation is unsatisfactory, whole of the loan will be added as the income of the Indian assessee.

I.5 **S.s (5):** If any payment is made to a person in an NJA, and the NJA is liable to tax in India, then the **tax has to be deducted** at the highest of:

- rate in force (including the rate in a DTA),
- rate specified in the relevant provisions of the Income-tax Act,
- rate of 30%.

Apparently, the non-resident may not pay such taxes. Then Indian assessee will have to pay the taxes. In such a case, the Indian Assessee will have to gross up the tax. This will be an additional cost.

I.6 **Summary so far:** Consequences of applicability of S.94A can be summarised as under:

I.6A **Compliance with procedures:**

(i) Once a territory is black listed, all Indian assessees dealing with all parties located in the NJA will be liable to TP procedures. (S.s 2)

(ii) If a financial institution is involved, Indian assessee will have to give an authorisation to the CBDT to seek relevant information from the institution. (S.s 3a)

(iii) In addition to the TP records, CBDT may prescribe additional records to be maintained and information to be furnished. (S.s 3b)

Once the above referred procedures and authorisations are complied with, the assessing officer will make assessment. If the information justifies, he may make additions to the income of the assessee.

I.6B **Tax Consequences: For the Indian assessee:**

If the procedure is not complied with, the consequences for the Indian Assessee will be as under:

(i) Payments to Financial Institutions will be disallowed as expenses. (S.s 3a)
(ii) Expenses paid to a person located in an NJA will be disallowed.

(iii) Loan etc. received from the person located in an NJA will be treated as the income of the Indian Assessee.

Tax Consequences: For the Non-Resident party:

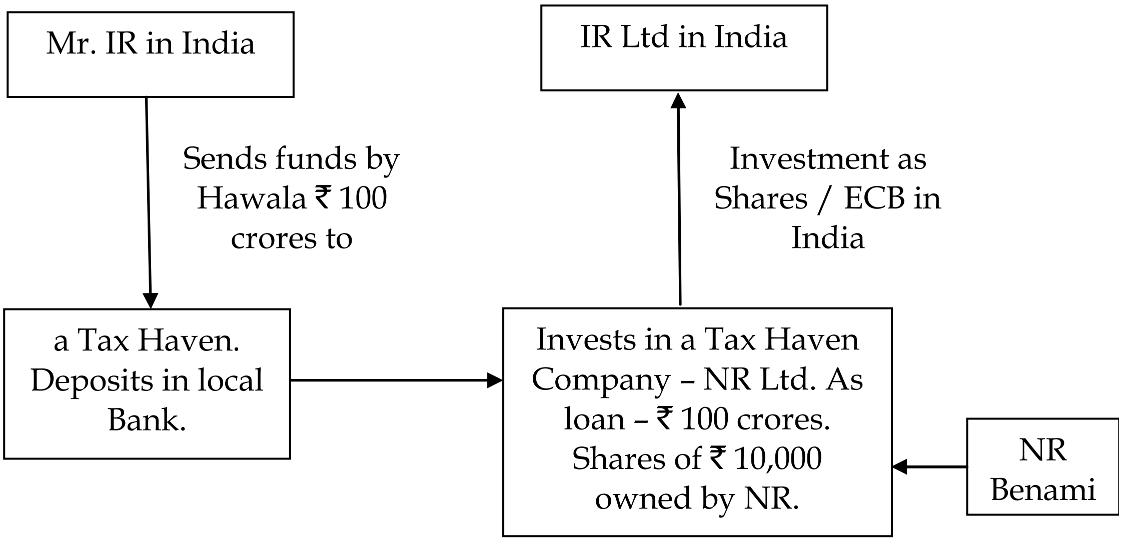
Where any payments are made to persons located in an NJA, and such payments amount to taxable income in the hands of the NJA person, then tax shall be levied at the highest rate.

II. Charts & Illustrations:

In this paragraph, three charts are given explaining how round tripping is done. While the charts show round tripping of black money, there can be many more transactions of genuine loans. To weed out round tripping from genuine loans & investments is a difficult task. And unless round tripping is established, tax department cannot make additions to returned income.

Round Tripping - Chart 1
Sub Section 4

Using tax havens and Benami Non-Residents



This is a simple chart explaining "Round Tripping".

Mr. IR sends his black money by hawala to a tax haven. There he incorporates a company – NR Ltd. Equity shares of the company are held by a non-resident friend or relative. IR's funds are given to the company as loan. NR Ltd. then complies with RBI / FEMA requirements and invests in IR Ltd.

When Indian CIT enquires about the source of funds with NR Ltd., There are two probabilities:

(i) No one gives proper information. Parties try to hide behind secrecy laws etc. Such transactions will be covered U/s. 94A(4). Consequences as stated earlier will follow.

(ii) The non-residents come forward & give their identity, establish their capability to give loans. The loan would be given through banking channel. In such cases, tax department may write to the income-tax department of the NR. This threat itself will be a tremendous threat reducing the number of Benami loans.

Benefit of S. 94A will be that rampant use of round tripping will be curtailed. However, where ever strong benamis are willing to support the transaction, and do not mind enquiry with their own tax departments, Indian tax department cannot do much.

Round Tripping - Chart 2.
Sub Section 4

Using tax havens and Benami banks and FIIs.

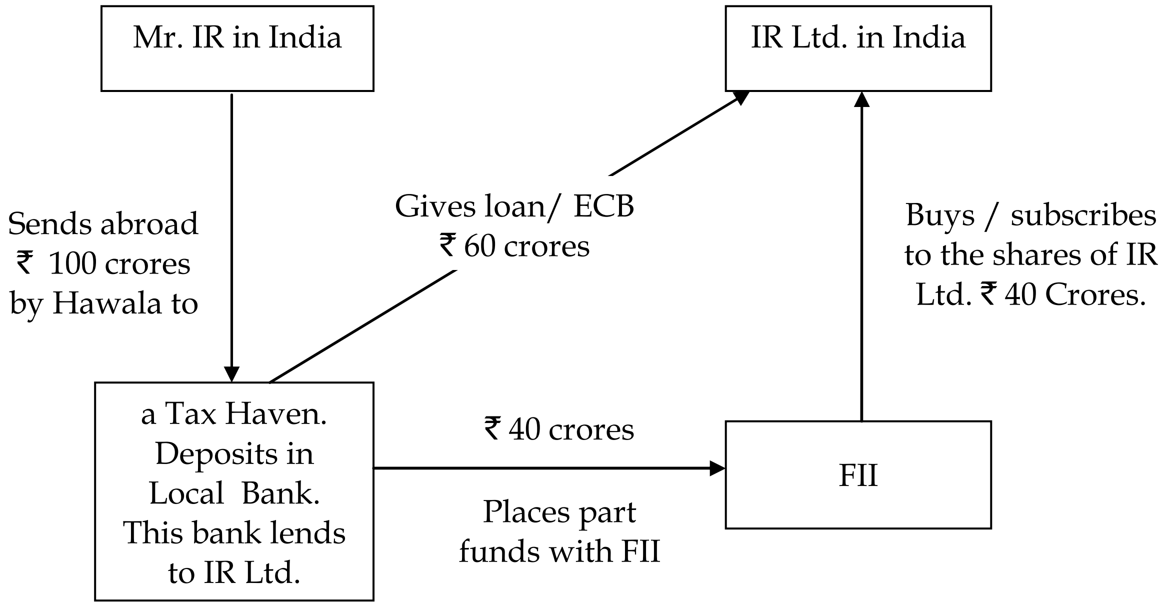


Chart 2 plan is improved (from assessee's view point) over Chart 1. IR does not use names of any NRI or tax haven companies. The multinational bank and FII may act as Benami for a fee.

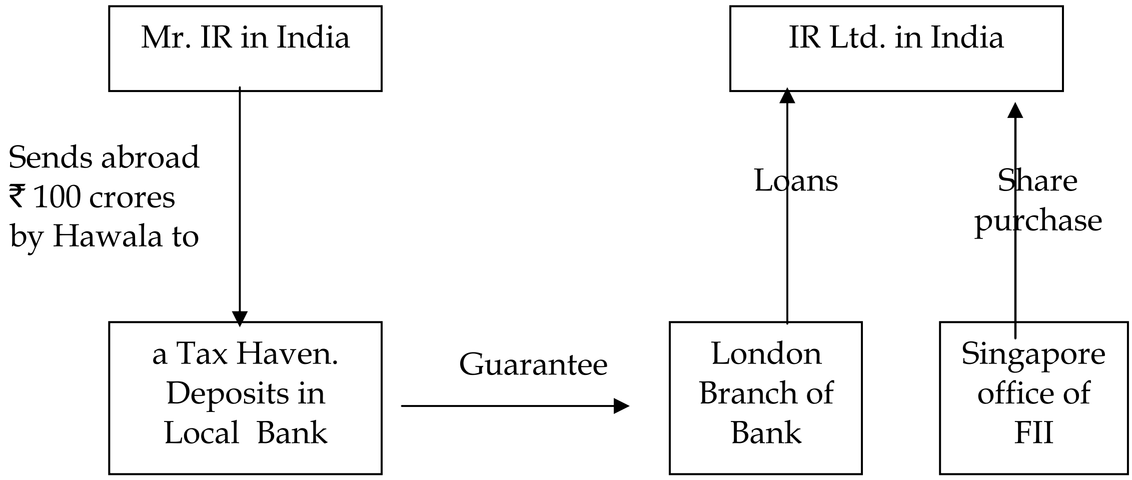
Identity and capability of these banks to make such investment will be clearly established. Hence S.68 investigation will fail.

They will not tell real source of funds. In this case, Indian CIT can ask queries. He will get replies. But not real information. Hence even S.94A will fail.

When tax havens, international banks & FIIs form a cartel & act as Benami, Indian anti avoidance law fails in catching the culprit. These are the serious limitations to what the Government can do .. though entire mechanism may be known.

Round Tripping - Chart 3

Using reputed Country Bank branches.



MNC banks and FIIs have branches in several countries. They will provide funds through the branch "located" in a "Reputed" country.

Here provisions of S.94A will fail.
U/s. 68, CIT can enquire. But the enquiry will fail.

When the international banks & FIIs act through "reputed" countries, Indian laws fail.

Section 94A targets: (i) tax base erosion by transfer pricing arrangements and (ii) round tripping. Transfer Pricing (TP) provisions are on Indian Statute books for ten years. Hence these are not explained by charts. Relevant discussion of legal issues is covered for both kinds of violations.

Part III. Details:

III.1 Compare & Contrast Sections 68 & 94A.

1.1 Almost 25 years back a big scandal of money laundering through **hundis** had broken out. Income-tax department learnt that assessees with black money were showing loans from others. These loans were documented in the form of promissory notes or hundis. One single assessee may have hundi loans from hundreds of small people. These people were provided black money in cash. They deposited cash in their own bank accounts. They issued cheques to the assessee. These were declared as loans received.

When the scandal broke out, full scale investigation was launched. A special circle in Ayakar Bhawan was formed titled "Hundi Circle".

Today the amounts involved are large. Hence the hundi game has become international. Instead of routing the money from small individuals, now the round tripping takes place through tax havens and large international banks. Instead of the hundi agents (finance brokers) tax consultants and solicitors are involved.

It is well said that history repeats itself. However, in every new avatar it takes new forms.

1.2 Let us see the interaction of both these provisions.

First of all, it is clear that: **section 68 applies to both domestic loans as well as international loans**. However, S. 68 provides that the assessee who has taken a loan, should explain his source. This section does not require the assessee to explain the "Source of the source".

This needs elaboration. It is now a settled principle of law in India that the assessee has to establish: (i)the **identity** of the lender, (ii) his **capability** to give such a loan; and (iii) the **genuineness** of the transaction. The primary burden of proof is on the assessee. The burden may be discharged when (i)the assessee proves the identity. (ii) Genuineness of the transaction will be proved when: (a) loan receipt is by cheque or demand draft; (b) periodical interest payments are by cheque, (c) where applicable, brokerage has been paid; and (d) loan has been repaid by cheque. (iii) If prima facie the lender is a proper money lender, or otherwise a man of means, no borrower can go beyond. Problem arises if the money lender turns out to be apparently unable to give such loan. For example, the assessee has taken loans of ₹ ten lakhs each, from 100 rickshawallas. In such apparent cases, assessee will be required to produce the bank statements of the lenders & establish that the lender is genuinely capable of giving the loan. In normal cases, assessee cannot be asked to prove the "source of the source".

This case rests on the **facts of the case**. If assessee's facts are weak, his primary burden of proof is more. If his facts are strong, his primary burden of proof is less. Same principle will apply for S. 94A also. We will see it later below.

III. 1.3 While the title of section 68 is "**Cash Credit**", the word "Cash" is not used in the text of the section. Even if the assessee has received a loan by cheque, he has to provide prima facie information about his source.

1.4 Hence if the assessee receives loan from a foreign tax haven company, he will have to establish the identity of the company, its capability to lend & genuineness of the transaction. Section 68 applies to domestic as well as foreign loans.

S. 94A goes one step further. It asks the assessee to provide the "Source of the Source". In other words, the details of the source of funds in the hands of the tax haven lender also have to be given.

We may now analyse two sub-sections (4 & 5) in more details:

III.2 S.s 94A (4): This sub-section applies when all of the following conditions have been fulfilled:

A Procedural Compliance:

(i) The Indian assessee has received or credited any sum;
(ii) From any person;
(iii) Who is located in a notified jurisdictional area.
And:
(iv) Indian assessee does not offer explanation about:

(iv.a) the source; OR
(iv.b) the source of the source; OR
(iv.c) the source in the hands of the ultimate beneficial owner; OR
(iv.d) the explanation offered is found to be unsatisfactory by the CIT.

Consequences of the above circumstances would be that the whole of the sum received or credited by the Indian assessee would be treated as income. Hence the Indian assessee will have to pay full tax. This is the attempt to counter round tripping by Indian residents.

In the process it is possible that people borrowing genuinely from non-residents may also be affected. Consider the case of an Indian company which takes ECB (External Commercial Borrowing) from a foreign bank. His assessing CIT asks for "Source of Source". In other words, the CIT asks for the source of funds for the bank. How does a bank with capital employed of billions of dollars give source of a loan of $ 5 millions! CIT will have to stop once the enquiry reaches the bank.

Still, it would be in the interest of every Indian assessee to take care of the following:

(i) Whenever a loan is taken from abroad, prima facie **avoid tax havens.**

(ii) If a tax haven cannot be avoided, maintain complete justification and explanation about the source of funds in the lender's hands. Where a lender is a tax haven company, the source in the hands of its shareholders or the ultimate beneficial owners who provided the funds would be required. The tax haven company may have received the funds as equity or as loans. In either case the source will have to be explained.

Thus for example if XYZ Pvt. Ltd. has received loan from some unidentified people, it can come into difficulty. Whether XYZ Pvt. Ltd. receives equity contribution or loans or in any other form, the source has to be explained.

However, if the lender has received the funds from an established bank, the assessee would have discharged his primary burden of proof. There after if the CIT has any doubts, the burden of proof will rest on the CIT to investigate and find out the facts.

The fact that XYZ Pvt. Ltd. is investing in an Indian company and the Indian shares or debentures are offered as security to the foreign bank should be sufficient justification for the foreign bank to give the loan. After all, a bank is in the business of lending.

III.3 **Section 94A(5).**

The non-resident receiving the money whether in the form of expenses paid by Indian resident or otherwise will be liable to tax at the highest rate in India. Normally these non-resident assessees are situated in tax havens. They are not liable to tax in their own jurisdictions. Hence they are not even interested in claiming refund of the tax deducted at source. However, assuming a case where in reality the non-resident is from a country where he is paying normal taxes. In such a case, he may be able to claim set off of the taxes paid in India. Let us examine this issue in little more details.

Let us say a company in Cyprus has earned technical know-how fees & royalty from an Indian company. Under the law all provisions of section 94A become applicable and the expenditure is disallowed in the hands of Indian resident. Now these technical know-how fees will be taxed @ 42% as income earned by foreign company. Whereas under the India – Cyprus Double Tax Avoidance Agreement FTS is liable to tax at the rate not exceeding 15%. Can the Cyprus Income-tax officer refuse to allow credit for the taxes paid in India beyond 15%?

The Income-tax rate in Cyprus is only 10%. Hence even 15% would be a surplus credit available. Assuming for some reasons that the Cyprus assessee wants to claim full credit of 42%, can he get the credit?

The Cyprus income-tax officer will allow credit for taxes paid in India only to the extent of tax payable under the DTA. Excess tax paid may not be allowed.

Is the tax paid under section 94A, a tax paid as per DTA?

United Nations & OECD both have accepted in their commentary to Model Convention for Double Tax Avoidance Treaties that the member countries are entitled to make anti avoidance provisions in their domestic legislation. Such domestic provision would override the treaty. Hence the taxes paid under section 94A may be considered as the normal tax.

III.4 It may be noted that section 94A is an **enabling** provision. It is not a straight application of law. For example, section 64 is a clubbing provision. It is a straight application of law. Consider an illustration: husband gives gift to wife. Wife earns interest income on the gifted amount. Such interest income will be straight away taxed in the hands of husband. No further action is required on the part of the CIT.

Under section 94A there are several steps in between.

(i) First of all the foreign lender or investor has to be located in a tax haven.

(ii) When several such investments are made, income-tax department may ask for information from the tax haven Government.

(iii) The tax haven Government may or may not provide full information. If the information is not received, or the information is found to be ineffective, then the Government of India may notify that country as an NJA.

(iv) Even when a jurisdiction is notified as an NJA the assessee can still escape harsh provisions. In case of a genuine loan or investment, he should be able to explain the source of source. If he can do so, there will be no penal consequences.

II.5 A possibility may be noted here. Government of India is targeting Indian residents having black money & resorting to round tripping. It may happen that the Indian resident is genuinely taking a loan from NRI or other non-resident friends. However, the **non-resident has got black money**. He may not have paid taxes in his own country. Hence he may be lending from a tax haven company. This non-resident lender will not be ready to provide sufficient details. Even in such cases Indian resident assessee will come into difficulties. Hence borrowers in India should be fully prepared. In all cases of investments from abroad they should be able to provide full details. If the details are not provided, they may have to face consequences under section 94A.

III.6 Retrospective Effect:

Can the provisions of section 94A apply retrospectively?

This query can be raised in different circumstances.

(i) Section 94A will come into effect from 1st June, 2011. Can it affect transactions completed on or before 1st June, 2011?

(ii) A jurisdiction may be notified under section 94A on 1st April, 2012. Can such notification affect transactions completed before 1st April, 2012?

Let us consider both these aspects.

Every assessment year (or previous year) is a separate year by itself. Hence whatever has happened in the past cannot impact current assessment year. Consider an illustration. Mr. IR took a loan of ₹ 100 crores from a non-resident company in the previous year 2009-10. The foreign lender is situated in British Virgin Islands (BVI) Section 94A comes into effect on 1st June, 2011. Nothing turns on the section being effective. Only when Government of India declares a particular country as an NJA, things start.

Let us assume further that on 1st April, 2012 BVI is declared as an NJA. Now the CIT is making an assessment for previous year 2012-13. In this year he cannot ask under section 94A any details about the loan taken during 2009-10. The assessment of 2012-13 cannot be affected by a transaction in 2009-10.

He **cannot even reopen** the assessment for 2009-10. For previous year 2009-10 section 94 A was not in effect.

However, for the previous year 2012-13 Mr. IR may pay interest on the past loans taken. This **interest expenditure** can be disallowed if relevant information is not given by IR. Hence this section will have some impact for current transactions based on past transactions.

Similarly, an Indian resident may have entered into a **foreign collaboration** agreement in the year 2009-10. As per the agreement Indian assessee may have agreed to pay a **royalty** of 25% of sales price to the foreign collaborator. Foreign collaborator is situated in an NJA. After the notification, Indian assessee would be required to maintain all necessary records under Transfer Pricing. If he cannot maintain records or he cannot give satisfactory explanations to the CIT, his royalty expenditure for the previous year after the notification can be disallowed.

III.7 Some issues to be noted:

III.7.1 Section 94A causes double damage. When an Indian assessee incurs expenditure which may be disallowed under this section, the Indian assessee suffers. He will have to pay tax and probably interest & penalty. At the same time the amount paid to the non-resident will be treated as his income. This income will be taxed at the highest rate. Since Indian resident would be the payer, it will be his duty under section 195 to deduct tax at source. The non-resident may not bear the cost of TDS. In such a situation, the Indian resident would be paying double the tax on the expenditure claimed by him.

7.2. The section is a tool box in the sense that it is a broad attack against several tax avoidance measures. It covers within its scope all kinds of expenses. Even if a capital asset is purchased from a person covered by section 94A, the depreciation on such a capital asset can be disallowed.

7.3 Throughout this article, we are presuming that wherever FEMA provisions are applicable, the same will be complied with.

7.4 It covers tax havens as well as countries not considered tax havens.

It covers countries with which India has signed DTA as well as others.

7.5 Section 94A is a code by itself. It provides for complete mechanism in the limited area where it is to operate. Yet rules may be necessary to determine a country liable to be notified under this section.

7.6 Since this is an anti-avoidance provision, under the U.N. as well as OECD commentaries; it will override the Double Tax Avoidance Agreements. Still Government can reduce litigation by including it in section 291 (9) of the DTC. It specifically provides that the listed sections override Treaties.

7.7 It should be noted that the combined might of sections 68 to 69D is limited. The instruments used today have become for more sophisticated.

7.8 **Within USA the State of Delaware** operates as a near tax haven. It is not a separate jurisdiction. Hong Kong is a part of China. However, it is declared as a special territory or zone. Hence a Government can declare Hong Kong as an NJA without declaring China as an NJA. In comparison Delaware is very much a part of USA. Politically Government of India may not declare USA as an NJA. Hence companies operating from Delaware may still be able to give loans to Indian assessees and escape the provisions of section 94A.

7.9 A root problem is current legal – judicial system is as under:

(i) Assume that Government of all nations are Sovereign and equal. For example, in United Nations, Mauritius with a population of one million gets the same voting right as India with a population of 1150 millions. This first step is fair as far as U.N. is concerned.

(ii) A further assumption is, that a Government cannot be presumed to be party to tax evasion and tax avoidance. SC decision in Azadi Bachao Andolan is based on, with respect, this assumption.

Fact is, tax haven Governments design their laws to actively help tax evasion and tax avoidance. Some Governments stop at this level. Some Government go further and abet even money laundering.

When legal assumptions are at variance with real facts, difficulties are bound to come up. Section 94A is an attempt to tackle this variance.

Conclusion: Section 94A is a well drafted provision attempting to curb some tax avoidance schemes. However, where ever international banks & financial institutions collude with the assessees, this provision will fail.

Thanks.

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