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Direct Taxes Code 2009

An Analysis

Date: 12th September, 2009.

The Indian Finance Ministry has proposed a major change in Direct Tax law. It has released a draft Direct Taxes Code Bill. This Code (DTC) proposes to make far reaching changes in the prevalent direct tax laws of India.

(i) Earlier we had prepared a brief note dated 2nd September. It is available on our website. (ii) In a separate chapter on the website, we have given "Clarifications on DTC". It will be useful to read the clarifications. (iii) Present analysis is more detailed on the legal provisions mainly **pertaining to international taxation & tax planning**. We will come out with more analyses in due course.

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Abbreviations and Notes

Abbreviations used in this note:

AEs	Associated Enterprises.
APA	Advance Pricing Arrangement (APA).
BPT	Branch Profits Tax.
CBDT	Central Board of Direct Taxes.
CFC	Controlled Foreign Companies".
DDT	Dividends Distribution Tax.
DTA / treaty	Double Tax Avoidance Agreement.
DTC	Direct Taxes Code Bill, 2009.
FoA	Force of Attraction.
FTS	Fees for technical services.
GAAR	General Anti-Avoidance Rules.
IAAs	'Impermissible Avoidance Arrangements'.
ITA	Income-tax Act, 1961.
MAT	Minimum Alternative Tax under ITA.
Mum.	Mumbai High Court.
NRIs	Non-resident Indians
PAT	Profit After Tax.
PE	Permanent Establishment.
SC	Supreme Court.
TGA	Tax on Gross Assets under DTC.
TP	Transfer Pricing.
TPL	'Tax Policy & Legislation" section of CBDT.
UTC	Underlying Tax Credit.

Notes:

1. Binding Force of DTC:

At present, the Income-tax Act, 1961 (ITA) is valid & binding. Direct Taxes Code Bill is only a proposal. Before passing into a binding law, many changes will be made. One may not take any action based on

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DTC until it is passed into a law. At the same time, Government policy/ trend on "Anti – Avoidance" is clear. Any long term planning or structure of business organisation may be made keeping the DTC in mind.

As per the plans, DTC will be binding for all incomes earned after 1st April, 2011.

2. Grammar:

For correct application of grammatical rules, while referring to DTC, we should use the "Future Tense". However, for the sake of simplicity, at places, this rule of grammar has been ignored. We have used the language as if the DTC is in force. Through out this presentation, Note No. 1 above may be kept in mind.

3. CBDT Clarifications:

Central Board of Direct Taxes (CBDT) has a section for drafting the law – **Tax Policy & Legislation** (TPL). Current Joint Secretaries are – Mr. Arbind Mody & Mr. Ashutosh Dikshit. They are the chief architects of the DTC. They have of course been helped by many commissioners & others. Immediately after the release of DTC, they came to Mumbai and in two conferences gave several clarifications. Relevant clarifications have been given in a separate chapter on this website. Where necessary, this analysis is made considering those clarifications. The Joint Secretaries have promised that many modifications will be made in the draft code before it is presented as final Bill in the Parliament.

4. This analysis is an academic exercise for information. It is not an advice on the law.

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Part I.
Tax Rates applicable to a Foreign Company

The Direct Tax Code proposes to bring in **revised tax rates** and **new taxes** for a foreign company earning income in or from India. Part I of this analysis lists out briefly, the relevant provisions of DTC. Subsequent parts discuss important issues in detail.

Following are the tax rates applicable:

1. Income-tax:

Corporate Income-tax will be levied at the higher of the following:

1.1 Tax on the whole of the **total income @ 25%**; or

1.2 Tax on the **book value of gross assets** as on the close of the financial year @ **0.25% for a banking company or 2% for any other company**.

The basic income-tax rate has been reduced from the prevailing 40% (before surcharge and education cess) to 25%. This is now at par with tax applicable to domestic companies.

Tax on value of gross assets is a major change from the prevailing Minimum Alternate Tax (MAT) that is levied on book profits on Companies whose normal income-tax liability is lower than MAT.

2. Branch Profits Tax:

In addition to income-tax, **Branch Profits Tax (BPT) will be levied @ 15%**. This tax is payable on the total income of the foreign company as reduced by the amount of income-tax thereon. This is an altogether new levy. Credit for BPT would be available to a foreign company against corporate tax paid by it in its home country.

3. Dividend Distribution Tax:

In a case where a foreign company has a subsidiary in India, apart from the income-tax paid by the Indian subsidiary, a Dividend Distribution Tax (DDT) @ 15% will be levied on the amount of dividends declared by it. There is no change in DDT provisions.

4. Surcharge & Education cess:

At present, Foreign companies are required to pay a surcharge of 2.5% on income-tax on incomes exceeding Rs. 10 million. Further an education cess of 3% on income-tax and surcharge is also payable. Under

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the DTC, surcharge and education cess would be as per the Finance Act which could change every year.

5. Comparison of tax rates under ITA and DTC:

An important change is that under the DTC, tax rates are given in the tax law itself. There is no need for an annual Finance Act except where a change in the tax rate has become necessary. Idea is to impart stability in the tax law. As far as possible, changes should not be made. In any case, it should not become an annual ritual to change the law.

A comparative chart of - present tax rates under the ITA and proposed tax rates under DTC for a foreign company - is given below:

Tax Rates Comparison

Sr. No.	Tax	Present Rate- ITA	Present Amount ITA	Proposed Rate DTC	Proposed Amount DTC
	On an Income of Rs. 100:		100		100
1.	Income-tax	40	40	25	25
2.	Income after income-tax		60		75
3.	Branch Profits tax	Nil	-	15	11.25
4.	Total income-tax		40		**36.25**
5.	Surcharge on income-tax	2.5	1	2.5*	0.91
6.	Sub-Total		41		37.16
7.	Education Cess on tax and surcharge	3	2.23	3*	1.11
8.	**Total Income-tax / effective tax rate**		**42.23**		**38.27**
9.	Income after BPT		57.77		62.57

Note: * For our above chart, we have assumed the same rates for surcharge and education cess as are levied at present. These rates would be decided by the Finance Act of each year, and could change.

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6. Special source tax rates:

6.1 Some incomes are chargeable to tax at special rates. These are "**special source"** incomes. These taxes are payable irrespective of whether the non-resident has a branch or activities in India. The special source incomes and the rates are given below:

6.1.1 Investment income by way of:

i.	Interest	20 %
ii.	Dividends on which Distribution tax has not been paid	20 %
iii.	Capital gains	30 %
iv.	Any other investment income	20 %

6.1.2 Royalty or Fees for technical services 20 %

6.2 Compared to the ITA, some major changes in the DTC are as under:

i. Under ITA there are conditions to be fulfilled for taxing interest at a lower rate (Section 115A). **Interest on loan obtained in foreign currency** is taxable @ 20%. Other loans are taxable at normal rates.

Under DTC all interest earned by a non-resident will be taxable @ 20%. No conditions are to be complied with. This is a welcome relief.

ii. Under ITA, Non-resident Indians **(NRIs)** can avail of concessional tax treatment in case of investment in foreign currency (chapter XIIA). This chapter has been removed under DTC. Therefore conditions of investment in foreign currency, etc. are also removed. All incomes covered under chapter XIIA will be taxed at normal rates except where specific reliefs are given under other sections. These are discussed separately in this note. Briefly: NRE & FCNR interest exemptions continue. See Sixth schedule to the DTC, rules 23 & 24.

iii. **Capital Gains** will now be charged to tax @ 30%. Now there is no difference between capital gains & other revenue incomes. Except for inflation adjustment – which is discussed below. There is no distinction between Long Term and Short term capital gain. There is no difference whether the sale takes place on the stock exchange or

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otherwise; whether the mutual funds are equity oriented or debt oriented. All capital gains will now be liable to tax @ 30%. However, for investments held for more than a year from the end of the financial year in which they are purchased, indexation (adjusted inflation) benefit would be available.

iv. Royalty and Fees for technical services are chargeable to tax @ 10% under ITA (Section 115A). Under DTC, the tax rate will be 20%.

6.3 Issues:

When a company is entitled to Double Tax Avoidance Agreement (DTA) benefits, which rates would apply – special source rates as given in the DTC or Treaty rates! In short, it can be said that the treaty rates will be applicable in most cases. For details, please see part III below.

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Part II.
Branch Profits Tax

1. Provision:

India has for the first time proposed BPT through Section 100. This is payable by all foreign companies who have profits from a branch in India. For example, all of the following companies will be liable to this tax:

1.1 A foreign bank sets up a branch in India. (Branch)

1.2 A foreign company takes up an infrastructure project in Indian Permanent Establishment (PE).

2. Scope of BPT:

There is an error in draft of DTC section 100. A simple interpretation would indicate that BPT is payable by all foreign companies on all their Indian incomes – whether they have a branch in India or not. Thus, if a foreign company gets royalty without having any office or set up in India, it will still have to pay BPT.

The department's intention, as clarified by the TPL team, is to **tax only the Indian income earned by a branch or a permanent establishment** of a foreign company. The "**special source**" incomes like interest, dividend, royalty, etc., are **not liable to BPT**. Appropriate amendments will be made in the DTC.

3. BPT is levied on "total income" less normal corporate tax; or in other words, on Profit After Tax (PAT). Assume that a company has corporate income of Rs. 1,000. BPT will be as under:

Particulars	**Amt (Rs.)**
Corporate income	1000.00
Corporate tax @ 25%	250.00
Profit After tax	750.00
BPT @ 15% on 750.	112.50
Net Profits	**637.50**

Total tax Rs. 362.50 or 36.25%.

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As can be seen in Part I.5 above, corporate tax and BPT together constitute 36.25% tax. When the Surcharge and education cess are added, total becomes 38.27%.

4. Purpose:

BPT is an attempt to **equalise branches and subsidiaries**. When a Foreign company has a subsidiary in India; the Indian subsidiary would pay corporate tax as well as dividend distribution tax. However, a branch would not pay the DDT even if it remitted surplus profits abroad.

In the present Income-tax Act, this (equalisation between branches & subsidiaries) is done by having differential rates of tax for domestic companies @ 30% and foreign companies @ 40% (before surcharge and education cess). Under DTC, the branch will have to pay additional tax – BPT.

5. Impact:

Under the present law, foreign companies are taxable @ 40% (excluding surcharge & education cess). Now the rate is reduced to 36.25%. Instead of making one calculation of 40%; the companies will make two calculations and end up paying 36.25%.

6. In some **developed countries**, the Branch Profit Tax is a fully developed concept with complex rules and tax planning potential. With a simple tax on all the post-tax income, Government has done away with all the complexities.

7. **Adverse implication** is as under. If the Indian Subsidiary does not declare any dividend, and ploughs back its profits; it will not pay DDT. However, under DTC, a branch will pay the BPT whether it ploughs back the profits or remits the funds abroad.

The logic behind this may be as under: If the foreign company is in India for long term, it would set up a subsidiary. Then it can avoid BPT. Branches, generally, are for short term. On completion of the project, branch or PE would be wound up and all capital plus profits would be remitted abroad.

8. Under DDT, there is a controversy – whether the shareholder company would get credit of DDT in the Country of Residence under its **Double Tax Avoidance Agreement** with India! In some countries, this credit is available. In some, it is not available.

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Under BPT, it is clearly an income-tax paid by the foreign company. Hence the foreign company should get credit in its Country of Residence -for both the taxes paid in India – Corporate Tax and BPT.

9. Definition of a branch:

The DTC does not provide for the definition of a branch. Will it be considered as a physical place of business, or will a Permanent Establishment be considered as a branch? This can have an implication in following situations:

Normally if a foreign company has a physical branch in India, its business profits will be taxable in India. However there are situations where the foreign company does not have a physical branch. If it has a *"Dependent agent in India"*, or it renders services in India for more than the specified number of days *("Service PE"*), business profit attributable to the agent or the services is taxable in India. Will such profits be liable to BPT?

The CBDT is being requested to clarify the issue.

10. Tax on Gross Assets – (Minimum Alternative Tax):

The MAT under ITA is proposed to be replaced by another tax - Tax on Gross Assets (TGA) under DTC. As stated in Part I.1, the companies will have to pay (i) regular income-tax; or (ii) a tax on gross assets (TGA) which ever is higher. TGA will be equal to 2% of gross assets for non-banking companies. The provisions are covered under the DTC in Sections 2, 97, 98 & Paragraph A of the Second Schedule.

The TGA has to be compared with the Corporate tax only, and not Corporate tax plus BPT. To take an example,

i.	Profit	100.00	
ii.	Corporate tax	25.00	
iii.	BPT	11.25	
iv.	Total	36.25	
v.	TGA (assumed)		30.00

TGA has to be compared only with the corporate tax. Therefore, the total tax payable will be 30 plus BPT @ 15% of profits after tax. It will be 10.5% (100-30 =70. 15% of 70 = 10.5). Total tax will be 40.50%.

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Part III.
Status of Double Tax Avoidance Agreement vis-à-vis Direct Taxes Code

1. Double Tax Avoidance Agreement – Treaty override:

Under the present law, out of the DTA and the ITA, **whichever provision is more beneficial to the assessee**, prevails.

Thus if the Income-tax Act provides for a rate of tax of 10% on royalties, and the DTA provides for 20%, then the rate as per ITA is payable. Vice-versa, if the rate of tax as per the DTA is lower, then the DTA rate is payable.

This principle has been accepted under the law, and several court decisions.

2. The DTC has amended this principle. Section 258(8) provides that:

"For the purposes of determining the relationship between a provision of a treaty and this Code,-

(a) neither the treaty nor the Code shall have a preferential status by reason of its being a treaty or law; and

(b) the provision which is later in time shall prevail."

Thus the DTC and the DTA shall have **equal status.**

Further, the provision which is "Later in Time" shall prevail. This is one of the most important proposals of the DTC pertaining to International Tax.

3. In the case of Azadi Bachao Andolan [*263 ITR 706 (SC)*], it was held that as the India-Mauritius DTA did not have a *"Limitation of Benefits"* clause to prevent treaty shopping, Indian Government could not tax the Mauritian company on Capital Gains earned in India. This was because the treaty is beneficial.

Even if the Government provides in the Income tax Act, any provision to prevent treaty shopping, it may not have any effect as the treaty prevails.

Now with the DTC, the Government can prevent treaty shopping. As DTC will be later in time, DTC will prevail.

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4. This provision of "Later in Time" may cause some confusion too. For example, as per the DTC, interest on NRE account is exempt from tax. Subsequent to the DTC, assume that a DTA is signed with a country which provides that India can tax interest at 10%. Does it mean that NRE account will be taxable as the DTA is later in time?

This is not how the DTA operates. The DTA is not a charging statute. It is simply an agreement between two countries, placing restrictions on taxing rights of both countries to the agreement. DTA cannot increase the scope of income or the tax rate beyond that laid down in the domestic tax law. Therefore NRE interest will not be taxed in India even if changes are made later on in the DTA.

5. So how exactly will the "later in time" principle operate? It will operate as under:

5.1 DTA provision:

The DTA provision which is amended later (or a new DTA is signed), can reduce the rate of tax in India. However it cannot increase the rate of tax.

5.2 DTC provision:

The DTC provision which is amended or introduced later can reduce the scope of income taxable in India. The DTC can also increase the scope of income taxable in India.

Thus increasing the scope of taxable income can be achieved by amending the DTC subsequent to the DTA. This amounts to overriding the DTA.

6. Later Treaty:

Consider the illustration of a DTA which is signed after the DTC comes into effect. As the DTC draft stands today, that DTA will override DTC. If, by chance, there is any provision in the new DTA which overrides General Anti-Avoidance Rules (GAAR), then to that extent, the DTA will be more beneficial to the assessee. To avoid such confusions, a better draft of the section may be:

Proposed Draft: Section 258 –

"(8) For the purposes of determining the relationship between a provision of a treaty and this Code:

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(i) Sections 5 and 104 to 114 of the Code shall prevail over the treaty.

(ii) In all other cases, between the Code & the Treaty, whichever provision is more beneficial to the assessee shall prevail."

Code Overriding the Treaty is major change proposed in the DTC. For department clarifications, please see separate article on "Clarifications", paragraph 6.

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Part IV.
General Anti-Avoidance Rules (GAAR)

The DTC has proposed a completely new set of provisions to bring in GAAR. These are in Sections 112, 113, 114 and 161 of the DTC.

A. Purpose:

1. Broadly, the GAAR seeks to bring under the tax, transactions which were done with the motive to avoid tax.

2. There have been an umpteen number of court decisions on treaty shopping. The landmark decision of **Azadi Bachao Andolan** [263 ITR 706 (SC)] of the Supreme Court lending credence to treaty shopping has been very controversial. Similarly, the recent actions of the tax department relating to **Vodafone's** purchase of Hutchison's Indian assets [311 ITR 46 (Mum.)] have also resulted in a lot of debates over a company's 'separate legal entity' status. Further, the tax department has now started issuing notices in several other doubtful cases. The impact on the afore-mentioned cases is highlighted in Part VII on landmark decisions.

3. In all these decisions or actions, the tax department had laid emphasis on **substance over form**. However, in trying to bring the gains or incomes to tax, there was not much support in the Income-tax Act and its anti-avoidance provisions.

4. The DTC now proposes to bring in provisions in line with the department's interpretation of substance over form by way of the GAAR.

B. Provisions:

5. Overall, the GAAR is in line with international tax practices. It gives powers to a tax officer to bring to tax incomes or gains resulting from specific **'Impermissible Avoidance Arrangements' (IAAs)**.

6. A tax officer can declare as an 'impermissible avoidance arrangement' the following types of arrangements:

6.1 Any step or part of an arrangement whose main purpose is to obtain a tax benefit and:

6.1.1 creates rights or obligations which are not at arm's length; or

6.1.2 abuse, directly or indirectly, the provisions of the DTC; or

6.1.3 lacks commercial substance; or

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6.1.4 is not carried out in a bonafide manner.

As can be seen, a very wide definition has been given to an 'impermissible avoidance arrangement'.

6.2 Typical tax planning arrangements would now be squarely covered under this provision. Some examples of arrangements that would now be covered are:

6.2.1 An FII investing in the Indian stock market through Mauritius presently does not have to pay tax on gains made by it from sale of shares. This is because, as per the India-Mauritius tax DTA, capital gains are taxable only in Mauritius; where capital gains are exempt from tax.

Now, under the DTC, the FII would have to justify to the tax officer that the main purpose of its arrangement to come through Mauritius for making investments in Indian stock market was for bonafide commercial reason. It was not to save tax on capital gain earned by it.

6.2.2 Similarly, an Indian Company proposing to invest outside India through a tax haven country would have to justify that there is substance in its incorporation of an intermediary in such country. It will have to show there are reasons other than tax benefit to invest in such a manner.

C. Impact:

7. Once a tax officer declares such arrangements as **'Impermissible Avoidance Arrangements'**, he has the powers under section 112 of DTC to:

7.1 disregard, combine or re-characterise any or all of the steps in such arrangement;

7.2 treating the arrangement as if it had not been entered into;

7.3 treating or deeming 'connected persons' (*as distinct from associated enterprises*) as one and the same person;

7.4 disregarding any accommodating party, or treating them as one and the same person;

7.5 reallocating amongst the parties to the arrangement, or re-characterising, any accrual or receipt and any expenditure or deduction, relief or rebate;

7.6 re-characterising any debt as equity or vice-versa;

7.7 in such other manner as the tax officer deems appropriate for preventing the tax evasion.

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Therefore, a tax officer has all the powers now to disregard shell companies, holding companies, intermediary companies, etc., which are formed with the main purpose to avoid payment of tax in India.

8. Further, the **onus** on proving that a transaction or part of it is not an impermissible avoidance arrangement is on the assessee. By way of Section 114, it is presumed that the main purpose for all arrangements was to obtain a tax benefit, unless proved otherwise by the assessee.

D. Controversies:

9. There may be several cases where an assessee gets tax benefit in a bonafide structuring of its transactions. For example, a group of companies may have an existing holding company in an offshore country. It may have manufacturing companies in several countries around the world. If investment in India has come through the offshore country, it may now have to prove that it has structured its transactions through the offshore country for a purpose other than tax benefit.

10. Issues regarding tax **avoidance versus tax evasion** have been debated in the past. Now under the DTC, Government does not recognise difference between the two.

One can say that if a tax benefit is as per the Government intention, the assessee may obtain the relief (e.g. SEZ unit). If it is not the intention of the government that a person should get a relief, then GAAR will apply.

E. Assessment:

11. These powers under the DTC have been given to the Commissioner of Income-tax. Therefore, it seems that such transactions would have to be referred by the tax officers under him and only transactions having merit would be taken up by the Commissioner at his discretion. Therefore, one may expect that notices may not be issued without reasonable cause for doubt.

12. Further, under Section 161, the Commissioner has to issue a notice to the assessee and give him a chance to present his case. The Commissioner then has to issue his order for determining a transaction as an impermissible transaction within 12 months from the end of the month in which this notice has been issued.

13. Unlike Transfer Pricing provisions, the assessee is not required to report any transaction under set parameters for review by the tax officer. The tax officer has to scrutinise and find out cases from details submitted by the assessee.

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Government views on this matter are discussed in "Clarifications", paragraphs 7 & 8.

G. Conclusion on GAAR:

14. As a large number of transactions can get covered under the provisions of Section 112, litigation and disputes are assured.

15. Clients proposing to enter in to outbound or inbound transactions may get their plans thoroughly reviewed. It would also be prudent to maintain proper documentation reflecting the reasons behind structuring decisions made by an assessee.

16. Apparently these powers are too wide in the hands of the Income-tax department. An assessee would be exposed to uncertainties as well as harassment. Appropriate system for **checks & balances** can be introduced in the law. The TPL team has invited suggestions from all concerned for such a system of checks & balances. The collegium of tax commissioners to consider all assessment orders which are adverse to the assessee is one safe guard. Further checks on department's powers need to be introduced.

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Part V.
Transfer Pricing

DTC has proposed changes in the Transfer Pricing (TP) rules as under:

1. Associated Enterprises (Section 113(5)):

TP rules apply if there are international transactions between Associated Enterprises (AEs). The meaning of Associated Enterprises has been enlarged in the DTC compared to that in the ITA. The main changes are:

1.1 In the ITA there are two groups of tests. One group of tests is based on **Capital, Management and Control**. The second group is based on specific issues like the extent of loan, the extent of guarantee, ownership beyond 26%, etc. Our view is that at least one test from each group should apply before two enterprises are considered as AEs.

1.2 Now the DTC has provided for only one group of tests (13 tests in all). Satisfaction of any one test is sufficient to make enterprises as AEs. The conditions regarding Capital, Management & Control is deleted.

1.3 Other tests where changes are proposed are:

i) If one enterprise holds 10% or more of the voting power. (ITA provides for 26% of voting power.)

ii) If one person holds 10% or more of the voting power in two or more enterprises. (ITA provides for 26% or more of voting power.)

iii) If one enterprise has given a loan which constitutes 26% or more of the book value of the borrower enterprise. (ITA provides for loan constituting 51% or more.)

iv) If one enterprise appoints more than one-third of the directors or one or more executive directors of the other enterprise. (ITA provides for appointment of more than half the directors.)

v) If one person appoints more than one-third of the directors or one or more executive directors of both the enterprises. (ITA provides for appointment of more than half the directors.)

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vi) If two-third or more of the raw material and consumables required by one enterprise are supplied to another enterprise. (ITA provided for supply of 90% or more of the raw material and consumables.)

1.4 One may examine the implications of removing the general test based on capital, management & control. Consider the following example:

There is a family of two brothers. One brother is in India carrying on business of trading in furnishings through his company. The other brother is in USA in the business of running a hotel through his company. Both are in different businesses. Both do not hold any capital in the other's business. Management of both brothers' business is independent of each other. If the brother in India supplies furnishings to the other brother for his hotel, will transfer pricing rules apply?

Under the ITA, as there is no participation in capital, control or management by one brother in the other brother's business, in our view transfer pricing rules cannot apply. However with the DTC, the transfer pricing rules will clearly apply. When both brothers have independent operations, applying transfer pricing rules can cause avoidable hardships.

On the other hand, it is known that several diamond merchants and exporters have businesses in different countries. The businesses in different countries are managed by relatives having independent companies. Under ITA, they were not covered by TP rules. Now under DTC, transfer pricing rules will clearly apply.

2. Advance Pricing Arrangement (Section 107):

2.1 TP analysis by its very nature is **subjective**. TP is more a business subject rather than a tax subject. There are so many variables which affect the determination of a price, that it is impossible to determine a specific and correct transfer price. Tax officer may consider one price and the assessee may transact at another price. There is no way to prove which is the correct "arm's length price". This leads to **litigation.**

To reduce possibilities of litigation, the DTC proposes to have a mechanism of **Advance Pricing Arrangement** (APA). An APA is an arrangement where the department analyses the business of a person. It lays down parameters where, if the person enters into a transaction within the parameters, then the price with the associated enterprise is accepted. The APA need not lay down the specific price at which the transaction has to be entered into between AEs. It however lays down the basis on which the transactions can be entered into.

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2.2 The department can enter into an APA with a person who has an International transaction with an associated enterprise. It can be for a period of up to 5 years. The APA will be binding on the person concerned, the tax department and for the transaction concerned.

2.3 The department will frame a suitable scheme so that it can enter into APAs.

2.4 Practically, an APA is a time consuming and costly affair as has been experienced internationally. One will have to see how the APA scheme works in India.

Over all, where the transactions are large, APAs could provide some certainty.

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Part VI.
Force of Attraction

1. Some DTAs signed by India provide for "Force of Attraction" (FoA) clause in Article 7(1) (for example with U.S.A., Italy etc.). In short this clause provides as under: If a Non-Resident has a PE in India, the profits attributable to the PE are taxable in India. **In addition**, profits attributable to those activities carried out in India which may not be connected with any PE, would also get taxed under the FoA clause. However, profits attributable to non-resident's foreign activities are not covered under FoA. Hence these remain free from Indian income-tax.

Income-tax department had tried to tax even profits attributable to offshore supplies of good & services. This attempt was incorrect. But it started controversies & litigation.

2. As decided by the Honourable Supreme Court in Ishikawajima case, Government of India has no jurisdiction to tax a **Non-Resident's foreign sourced income**. (A detailed note on this case is given in Part VII below.) Section 5(5) of the DTC attempts to override this decision by extending the scope of taxable income of a non-resident even when the source of income is outside India. However this applies only to salary & special source incomes like interest, royalty and fees for technical services, freight, etc. - listed in section 5(2). It does not apply to rent, business income and capital gains listed in section 5(1).

3. Under ITA, it is an accepted principle that if there is a difference between the provisions of ITA & DTA, which ever provision is more beneficial to the assessee shall apply. Under DTC, section 258(8) seeks to do away with this beneficial treatment.

What will be the combined impact of all these amendments on FoA! In our view, there should be no impact. Reason is discussed below.

To simplify the issues involved, let us see a chart. This chart explains the situation where the non-resident has business income and the DTA contains the FoA clause. It explains that the FoA clause only extends the scope of taxable income under DTA for the business income sourced in India. FoA clause never covered incomes (i) which are not business incomes; and (ii) any incomes which are sourced outside India.

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Non-Resident's Business Income

Income Sourced in India		**Income Sourced Outside India**
Attributable to PE	**Not Attributable to PE. i.e. Direct activity without PE**	
1	**2**	**3**
Taxable in India under ITA, DTA & DTC.	Taxable under DTA because of FoA.	Not taxable under ITA, DTA and DTC.

Section 5(5) extends the scope of taxable income only for non-business incomes. So both the provisions – (i) FoA clause & (ii) Section 5(5) of DTC are in mutually exclusive areas.

In conclusion, we are of the view that even after taking into consideration all the changes in the DTC, the impact of FoA remains unchanged.

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Part VII.
Impact on Landmark International Taxation Decisions

1. Vodafone Case:

1.1 This case represents a tax planning through tax haven companies. It was common under ITA. Under DTC, this will be difficult. Brief facts of the case are as under.

Hutchison of Hong Kong invested in India through a network of tax haven companies in Cayman Islands, Mauritius & the Netherlands. It held substantial share holding in Hutchison Essar – an Indian company in Mobile telephone business.

When Hutchison wanted to sell this stake to Vodafone, a British company; it transferred the shares of the Cayman Islands Company. Vodafone's Dutch subsidiary purchased the shares. Their claim was that: (i) A company is a separate legal entity; (ii) When shares in a Cayman Islands Company are sold; there is no transfer in India; (iii) Hence Hutchison is not liable to Capital Gains tax in India and (iv) Vodafone is not liable to deduct tax at source (v) Since the share transfer took place outside India, Government of India had no jurisdiction to tax the same.

1.2 In the first round of litigation, Vodafone has lost the case before Mumbai High Court as well as Supreme Court. Second round of litigation is yet to begin. No one knows what will be the final Court decision.

In a similar case of tax planning in future, under DTC sections 112, 113 & 114, the assessing officer will be able to disregard the Cayman Islands, the Mauritius and the Dutch companies. On disregarding these companies, the impact would be – Hutchison, the Hong Kong company has sold shares in the Indian company to Vodafone, the British company. Tax consequences would follow.

1.3 Apart from GAAR provisions, even following provisions may help the Income-tax Commissioner.

DTC section 5 (1) (d) provides as under:

"Income deemed to accrue in India.

5(1) The income shall be deemed to accrue in India, if it accrues, whether directly or indirectly, through or from:

(a) …….

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(b) …….

(c) …….

(d) *the transfer, **directly or indirectly** of a capital asset situate in India."*

It has been a view of the Income-tax Commissioners that – in Vodafone's case, the shares in Mauritius and Cayman Islands companies were merely title documents – like warehouse receipts. What were really transferred were the shares in the Indian company.

Such a stand would now be strengthened under this new deeming provision.

[Citation of the Decision: Vodafone International Holdings B.V. v. Union of India and Another (311 ITR46) Mum.]

2. Supreme Court Decisions:

In the recent past, there have been some important Court decisions. Some of these decisions have opened up substantial tax planning potential. DTC proposes to nullify the impact of these decisions and make tax planning difficult. We may consider a few decisions.

2.1 "Treaty Shopping" & "Azadi Bachao Andolan" case:

When a company invests in India through a tax haven country, to get benefits of the tax haven's DTA with India, it is called treaty shopping. Many investors and especially financial institutions have invested in India through Mauritius, Singapore & Cyprus. Supreme Court decision in Azadi Bachao Andolan case held that since the Government has not made any "anti-avoidance" provisions in the ITA or DTA; such treaty shopping is legal.

Now DTC proposes to bring in anti-avoidance provisions and avoid treaty shopping. GAAR under sections 112, 113 & 114 now give the power to the Assessing Officer to disallow treaty shopping. Consider an illustration:

A British bank (Nat West) wants to invest in an Indian bank – HDFC. If it were to invest directly, in case of sale of shares, the capital gains would be liable to tax in India. If it invests through Mauritius offshore company, Indian capital gains tax is avoided. Now the Assessing Officer can hold the investment through Mauritius as an "Impermissible Avoidance Agreement" and disregard the fact that investment into India

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has come through Mauritius. So the India-Mauritius DTA benefits will not be available.

Will the assessee get benefit of the India–U.K. DTA? Under the existing law, such benefit would not be available. Under the DTC it seems to be the intention of the law. However, the treatment will be given by the assessing officer at the time of tax assessment. How exactly he will give the treatment is to be seen. This may become a matter of controversy and litigation. CBDT can avoid litigation by providing guidelines in Rules.

[Citation of the Decision: Union of India vs. Azadi Bachao Andolan (SC) (263 ITR 706)]

2.2 Ishikawajima – Offshore Services:

Honourable Supreme Court has held that when services are rendered outside India, the source of income is outside India. Hence, Government of India has no jurisdiction to tax the income of a Non-Resident arising from services rendered outside India. This meant Section 9 (1) (vii) provisions are ultravires the Constitution. Fees for technical services (FTS) earned by foreign companies would be tax free despite the provision to tax it under the Income-tax Act as well as DTA.

The Government has tried to overcome the decision by an amendment in the ITA. However the language is not satisfactory. Under the DTC, section 5(5) makes specific provision to tax such incomes. It is self explanatory:

"Section 5(5):
The provisions of sub-section (2) shall be applicable regardless of the fact that,

(a) the payment is made outside India;

(b) the services are rendered outside India; or

(c) the income has otherwise not accrued in India."

Thus clearly, incomes in the nature of interest, royalty and fees of technical services will be taxable in India even if the same are sourced outside India.

[Citation of the decision – Ishikawajima - Harima Heavy Industries Ltd. v. DIT 288 ITR 408.]

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3.3 Chettiar's case

In Chettiar's case, Honourable Supreme Court has held as under-

If an Indian resident earns any income abroad and it is taxed abroad, then the same cannot be taxed in India. With due respect, the decision is contrary to the operation of the DTA. India follows **"credit method"** to eliminate double tax, i.e., the foreign income of an Indian resident is taxed in India. Tax paid in the foreign country is reduced (credited) from the Indian tax. The net amount is payable in India.

The implication of Chettiar decision is that the "credit method" of double tax relief system has been converted by Honourable Supreme Court into an "exemption" system.

To overcome this decision, the DTC in section 3(3) provides:

"Any income which accrues to a resident outside India in the year, or is received outside India in the year by, or on behalf of, such resident, shall be included in the total income of the resident, regardless of -

(a) the income having been charged to tax outside India; or

(b) the method for granting of relief for the avoidance of double taxation under any agreement referred to in section 258."

Thus all incomes will be included in the total income of an Indian resident. Double tax will be relieved in accordance with the credit method.

[Citation of the decision – CIT Vs. P. V. A. L. Kulandagan Chettiar 267 ITR 654.]

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Part VIII.
Residential Status of a Company

1. Under Section 4 of the DTC, a foreign company would be held to be an Indian resident if even a part of the place of its control & management was situated in India at any time in the year.

Department's stand is: At present there is a "**minimalist**" definition of a foreign company's residential status. Under Section 6(3) of the ITA, a foreign company would always be a non-resident of India unless the whole of its control & management was situated in India. This allows substantial tax avoidance. For example:

An Indian resident is liable to Indian tax on this global income. If he invests abroad or otherwise earns any foreign income directly in his personal name, he will be liable to Indian income-tax. However, if he simply incorporates a tax haven company abroad; and then makes the foreign investment or otherwise earns the foreign income through such company; he will escape the Indian tax on the foreign income. Department cannot do any thing with this "**Minimalist**" definition.

Department does not want to permit such tax avoidance. Hence they are proposing a "**Maximalist**" definition. The foreign company which is controlled by the Indian shareholder(s) will be treated as an Indian resident and taxed in India.

The issue is: "Where is the dividing line!" In an attempt to curb tax planning, genuine foreign or non-resident companies may be put to avoidable troubles. For example, Tata group has acquired a British company - Corus. Corus is certainly controlled at least partly from India. Will its global income be taxable in India?

Under the DTC as per the present draft, Corus's global income will be taxable in India. A proper system will have to be built in the DTC to avoid this kind of injustice.

2. Residential Status vs. CFC.

For controlling such tax avoidance, several countries have passed legislation for "Controlled Foreign Companies" (CFC). India has proposed to change the definition of residential status. The two concepts are fundamentally different.

Under the CFC provisions, normally only **passive** income is taxed. Under residential status, all income will be taxable. Normally, when CFC

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provisions are introduced, simultaneously, the provisions for **Underlying Tax Credit** (UTC) are also made. Under DTC, tax net is cast wider than CFC provisions & UTC is not granted.

This part covers a section of the DTC. We will be preparing more analyses of the DTC. We look forward to your suggestions & comments.

Thank You.

Rashmin, Naresh & Rutvik.

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