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Transfer Pricing Report™

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Practitioners Examine Indian Budget's Provisions On Transfer Pricing, Blast Amendment Aimed at *Vodafone*

NEW DELHI—Indian Finance Minister Pranab Mukherjee in an amendment to his March 16 budget has dealt what is being called a ''body blow'' to investors and multinationals by retrospectively amending the Income Tax Act to effectively undo the Supreme Court's recent ruling on the *Vodafone* tax case.

Meanwhile, the Supreme Court March 20 dismissed the government's petition seeking to overturn its Jan. 20 ruling in Vodafone's favor. (See the related article.)

The court had held that the company could not be taxed in India on its 2007 purchase of assets from Hong Kong-based Hutchison Whampoa Ltd. because the transaction—for which Vodafone was assessed a $2.2 billion tax bill—was not taxable under Indian law.

Practitioners said the amendment attempting to undo the result in the case could have a far-reaching effect on foreign investment in India. Alpana Saksena, former commissioner of income tax with the Indian Revenue Service, told Bloomberg BNA that although *Vodafone* itself does not involve a transfer pricing issue, the amendment to the Income Tax Act has implications for transfer pricing if related companies are involved in transactions similar to the one addressed in that case.

''I think this would apply to all corporations who have a global presence with existing structures of the same kind as *Vodafone*,'' said Saksena, currently with KPMG LLP's Washington, D.C., office. ''The key thing is that any share or interest in the company outside India would be deemed to be situated in India if such shares or interest have a substantial value directly or indirectly from assets located in India.''

The budget includes a series of other changes related to transfer pricing—the creation of an advance pricing agreement program, the extension of transfer pricing regulations to certain specified domestic transactions, the adoption of the general anti-avoidance rule (GAAR) aimed at preventing tax evasion, and the expansion of the definition of ''international transaction.'' A further change allows the tax authorities to contest the orders of dispute resolution panels.

Direct Taxes Code

Both the APA and GAAR provisions had been part of the proposed new Direct Taxes Code (DTC). But with the introduction of the DTC put off, those provisions were removed from the proposed new tax code and included in the March 16 budget.

K.T. Chandy of Ernst & Young in Bangalore, speaking on a Bloomberg BNA webcast March 20, said the move to place ''some of the more sticky provisions'' into the current budget leaves some question about what will remain in the DTC when it ultimately is enacted. ''The DTC doesn't contain any more hidden punches,'' Chandy said.

Intended to replace the Income Tax Act of 1961, the DTC contains numerous provisions to expand the tax base while reducing tax rates. The federal Ministry of Finance had brought out a draft in 2009, but after opposition from the private sector and the public, unveiled a revised draft in 2010.

Last year, it was hoped that the DTC would be introduced by April 1, 2012, but this deadline, like earlier ones, was missed. The postponement was inevitable given that the parliamentary standing committee looking into the DTC gave its report to the government as recently as March 9 (20 *Transfer Pricing Report* 592, 12/1/11).

As many experts had predicted, Mukherjee refrained from giving another target date for the introduction of the DTC, saying merely, ''We will examine the report expeditiously and take steps for the enactment of the DTC at the earliest.'' Experts say the DTC now probably take effect April 1, 2013.

Transfer Pricing Changes

Saksena noted that under the budget, ''international transaction'' has been broadened to include certain other transactions, such as business restructurings, debts arising in the course of business, outstanding receivables, and marketing intangibles.

These various changes all are aimed at creating greater clarity for taxpayers, she suggested.

''They have covered a lot of things which are causing litigation, and they are putting it in the law itself so that it gives certainty to anyone who is entering into an international transaction to understand what they are doing . . . so they can make informed decisions,'' she said. ''These are areas that have not been earlier spelled out, so they were probably causing enormous litigation.''

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Reaction to *Vodafone* Amendment

The budget amendment aimed at *Vodafone*, experts say, amounts to the government's effectively challenging the country's Supreme Court.

N.C. Hegde of Deloitte Haskins & Sells in Mumbai said the government ''is behaving like a spoilt child. A company thinks it has gone through the due process of law and won its case and now the government wants to retrospectively reopen the case.''

Hegde predicted the amendment ''will deal a huge blow to nonresident taxpayers as it will negate virtually all the benefits that have obtained through court rulings.'' Pointing to provisions in the amendment aimed at taxing indirect transfers, software payments, and payments for use of equipment, Hegde told Bloomberg BNA that these ''are retrograde and ignore the internationally accepted views on these matters.''

The relevant new amendment in the Income Tax Act states, ''For the removal of doubts, it is hereby clarified that an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be and shall always be deemed to have been situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India.''

The amendment is worded to apply to transactions as far back as 1962 that relate to assets in India, and the next few months are expected to show whether such a retrospective amendment will stand up to judicial scrutiny.

''In theory, the amendment can be applied to all court rulings since 1962, if the government so wishes, although the legal code in India does not allow the reopening of cases after a period of six to seven years. We will have to wait to see how it affects *Vodafone* and other cases,'' Hegde said.

Going forward, several taxpayers in similar situations, however, may find themselves at risk.

Saksena said the key issue will be how ''substantially'' is interpreted—whether it is seen as 50 percent, 60 percent, or 80 percent.

This amendment is a clarification of existing policy, she said. ''The legislature has always believed the government has the right to tax transactions of a certain nature.''

Rahul Garg of PricewaterhouseCoopers in New Delhi agreed with Hegde's assessment that the amendment targets *Vodafone*. He said it also could apply to a case involving Azadi Bachao Andolan, in which it was held that an entity having a tax remittance certificate from Mauritius would be exempt from paying tax in India.

Dinesh Kanabar of KPMG in Mumbai told Bloomberg BNA it was ''dismaying'' to see the government retrospectively amending the taxability of *Vodafone*-type transactions. ''The question that we need to answer is, 'Are we respecting the judicial system or not?' '' Kanabar said. ''The government may or may not agree with the Supreme Court, but it needs to respect it. If an assessee gets an answer after years of litigation only to find the law amended retrospectively, why litigate at all?'' he said.

Advance Pricing Agreements

Mukherjee, in his budget speech, said his government soon will begin implementing an APA program. R.N. Dash, who recently retired as Director General, Income Tax, International Taxation, told Bloomberg BNA the government has appointed Batsala Jha Yadav as director of the coming APA program (20 *Transfer Pricing Report* 1027, 3/8/12).

He also said the APAs would be both multilateral and bilateral. ''The rules and guidelines are ready so implementation can be almost immediate. Applications for unilateral APAs will go to the Director General, International Taxation, while applications for bilateral APAs will have to be filed with the competent authority,'' he said.

Unilateral Versus Bilateral

Even if India's program begins with bilateral negotiations, Saksena noted, ''it will definitely be unilateral as well.''

In some countries, the initial years of an APA program involve more unilateral APAs than bilateral ones, she said.

''For example, in China, where an APA scheme was introduced in 2004, by the end of 2008, only three bilateral APAs had been concluded,'' Saksena said, ''while many unilateral APAs had been concluded at the same time.''

In Australia, almost half of the APAs negotiated are unilateral, she added.

Normally, she said, multinationals with subsidiaries having relatively small operations or revenue prefer to negotiate a unilateral APA because it is more cost effective and faster to resolve, especially if the parent company and its major subsidiaries already have negotiated bilateral APAs. Larger multinationals prefer bilateral APAs, which provide ''more certainty on the tax front,'' she said.

APA Office Likely to Be in Delhi

Saksena said there are indications, as the revenue department currently prepares its field formations, that the APA directorate will be based in Delhi, with another office in Mumbai—the financial hot spot of India.

Mumbai ''is the location for 50 percent of audit adjustments'' in India, she said.

''If other cities have APA applicants, they may be required to approach the central APA office in Delhi.''

Implementation Key

In more general comments, practitioners welcomed the APA announcement. Dash predicted APAs will ''reduce transfer pricing litigation and provide certainty to foreign investors.''

Saksena agreed that the APA program likely will lead to reduced litigation.

''This is going to bring a lot of certainty,'' she said. ''The country is so keen to stem the tide of burgeoning litigation.''

However, she added, the key will be implementation.

''We will have to see how the implementation gets going and it will be dependent on how taxpayers respond, but I feel India is looking forward and joining the elite band of countries that have successful APAs.''

Uday Ved of KPMG in Mumbai agreed, noting that APAs have worked well in other countries. ''It will need to be seen what the detailed proposals are. We need to

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see the fine print. If implemented right, this should boost foreign investment. Implementation is the key.''

Some aspects of the APA program, to come into effect from July 1, include:

- the Central Board of Direct Taxes will be empowered to enter into an APA with any person undertaking an international transaction;
- the arm's-length price may be determined under any method whether prescribed or not;
- the agreements will not cover more than five consecutive years;
- the APA will be legally binding on the taxpayer and the income tax authority for the international transaction to which the APA applies unless there is change in law or facts;
- the APA will be void in the case of fraud or misrepresentation;
- the taxpayer will file a modified return within three months of the end of the month in which the APA was entered for applicable fiscal years where an income tax return already has been filed;
- assessments or reassessments pending or completed for the years to which the APA applies will be completed or reassessed by tax authorities in accordance with the APA; and
- detailed rules, forms, and procedure will be prescribed by the CBDT.

Other Transfer Pricing Changes

A detailed assessment of the transfer pricing provisions by Deloitte, Haskins & Sells also highlights that:

- effective, July 1, the assessing officer can appeal before the Income Tax Appellate Tribunal (ITAT) against the order of a dispute resolution panel;
- the definition of international transactions is expanded to include business restructuring or reorganization with retrospective effect from April 1, 2002;
- the transfer pricing officer can determine a transfer price for international transactions not referred to by the assessing officer or not disclosed by the taxpayer in form 3CEB; and
- failure to report transactions attracts a penalty under 271G and could lead to reopening of assessments.

Domestic Transactions Included

While Indian transfer pricing regulations apply only to cross-border, related-party transactions or international transactions, Ashutosh Mohan Rastogi of Amicus Services in New Delhi said the budget proposes to extend them.

''The regulations are to be extended to specified domestic transactions—for example, transactions with tax holiday units—that would be subject to similar compliance and procedural requirements as in the case of international transactions. The proposed legislation provides a monetary threshold of 50 million Indian rupees [US$996,000] for the applicability of transfer pricing provisions to such domestic related-party transactions,'' he told Bloomberg BNA.

Other changes include:

- specified domestic transactions may be any allowance for expense, interest, or income; and
- provisions relating to determining an arm's-length price will be applicable to the ''specified domestic transactions.''

Domestic transactions covered under the new provision of 92 BA are:

- those that are not international transactions;
- transactions covered under section 40A (2) (b)—Expenses/Payment transactions between related persons; and
- transactions that involve the transfer of goods, services, or business by the assessee covered under the beneficial provisions of 80IA *or* under Chapter VI A or 10 AA where the provisions of 80IA is applicable.

Specified domestic transactions described above will be subject to transfer pricing compliance requirements including documentation, certification, litigation, and penalty provisions.

General Anti-Avoidance Rule

Another unwelcome measure—which, like the APA provision, was removed from the DTC and introduced directly in the budget—was the GAAR, which gives sweeping powers to tax authorities to examine the motivation for financial transactions. The rule allows the income tax commissioner to disregard a transaction when its main purpose is to avoid tax.

The introduction of GAAR was expected, but after the Supreme Court's *Vodafone* ruling—which restrained the tax department from taking action against transactions suspected to have been devised for the purpose of avoiding tax—it was clear that GAAR would feature in the budget.

Vijay Mathur of PricewaterhouseCoopers in New Delhi told Bloomberg BNA that GAAR ''has come in because governments the world over are feeling the need to scrounge for revenue from any source and this is accompanied by the perception that revenue collection has been seriously undermined by tax avoidance and tax evasion.''

Mukherjee has accepted the recommendation by a parliamentary standing committee that an independent panel of experts be created to ensure tax officials do not misuse their powers to harass taxpayers with legitimate transactions. Mukherjee referred to the fact that a ''panel'' would be set up but did not give details about its composition or functioning.

Dash said the panel ''gives multinationals a safeguard which they can welcome.''

Practitioners Concerned

Practitioners expressed concern, however, noting that when GAAR is invoked, treaty provisions would be overcome.

''You would not have treaty protections for the transactions in question,'' Chandy said.

''GAAR is going to haunt us in times to come,'' said KPMG's Kanabar. ''What do the provisions mean to the India-Mauritius tax treaty? The safeguard of an independent panel is not at all sufficient. These provisions are likely to result in huge tax litigation.''

Equally unimpressed was Hegde of Deloitte Haskins & Sells, who expressed concern about the impact on foreign investors if treaty relief were not guaranteed.

''This will impact investment into India as the GAAR provisions confer powers to tax officers to apply GAAR where they believe that the taxpayer has routed the investment for getting treaty benefits such as Mauritius, Cyprus, and Singapore,'' Hegde said.

Mathur, too, said multinationals would be wary about GAAR because it replaces ''the specific with the general.''

''Instead of tax officials looking at specific cases of tax avoidance, GAAR deals with attempts where the main purpose of a transaction is to gain tax benefits,'' he said. When a transaction is disregarded, he said, ''the onus is on the taxpayer to show that obtaining a tax benefit was not the 'main' purpose of the arrangement. The onus is not on the commissioner to prove the opposite.''

By Amrit Dhillon and Dolores W. Gregory

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