Working Paper 325

Improving Taxation Environment: Attracting Foreign Direct Investment

R. R. Singh

June 2016

INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS

Table of Contents

Abstract

With opening of the economy in 1991 and subsequent removal of regulatory and trade barriers, India became an attractive investment (Foreign Direct Investment-FDI) destination. A large number of multinationals have established operations in India to utilise the services of available skilled manpower.

Indian tax administration was always perceived to be difficult. The economic liberalisation had created challenges in integrating Indian tax system with the world economy during the adjustment phase. World financial environment had remained depressed since 2008. The actions of the government in the area of taxation laws during 2012 and 2013 with sudden introduction of General Anti –Avoidance Rules (GAAR) including retrospective amendment to law further aggravated the taxation environment specially in the area of international taxation. This badly affected the sentiments of the international investor community. In other words it can be said that the economic liberalization did not match with the tax aggressiveness and that probably led to some major concerns, and impacted ease of doing business. Though the government did take some steps during 2012 and 2013 and further more steps during 2014 and 2015 to soothe the investor sentiment, there are still areas of persisting concern which need to be addressed.

Section one, introduction, broadly deals with the concerns of the multinationals in the area of taxation environment. Section two deals with the genesis of the recent crisis in this area and issues involved such as introduction of GAAR, international taxation, retrospective amendment dispute resolution etc. Section three deals with GAAR. Section four deals with various issues involved in the area of international taxation including Permanent Establishment, attribution of profits, transfer pricing, taxation of Information Technology (IT) and Information Technology enabled Services (ITeS) sectors, Advance Pricing Agreements (APAs) and Safe Harbour Rules. While Section five deals with retrospective amendments to the Income Tax Act and Section six deals with various aspects of dispute resolution, section seven deals with attitude of the tax administration. Section eight deals with the recent steps taken to address the taxation issues and section nine contains the conclusions and the areas that still needs to be addressed.

Key words: *GAAR, International Taxation, Transfer Pricing, APAs, Safe Harbour Rules, Retrospective Amendments and Dispute Resolution*

JEL Classification: *F21, G11, H25, H26, K34, K41, O15, P45*

Authors' Email: *rajiva_singh@hotmail.com*

Improving Taxation Environment: Attracting Foreign Direct Investment

R. R. Singh

1. Introduction

After the economic reforms of 1991 and subsequent removal of regulatory and trade barriers, India emerged as a major force in the global market, becoming a hub of business process outsourcing, an attractive investment destination for foreign direct investment (FDI) and a dominant exporter of services. In a span of two decades, several multinationals have established operations in India, engaging Indian skilled labor in their business.

However, India's integration with the world economy brought with it numerous challenges related to the tax system. Besides fulfilling the traditional objective of collecting taxes to raise revenue in an equitable and efficient manner, policymakers and administrators now needed to address the challenge of harmonizing the domestic tax system with international practices, standards and norms. This has become imperative not only for minimizing tax gaps and overlap of taxation, but also to encourage greater investment in the economy.

Globalization has created opportunities in new markets, resulting in complex production and supply chains, and leading to the growth of intangibles such as patents, royalties, service fees, etc. Companies have done everything they can to capitalize on these opportunities and shift from a country-specific operation model to a global model that allows businesses to reap cost and location advantages. The emergence of a digital economy comprising of cross country delivery of services and digital products over the internet has provided further benefits to MNEs. By making available legal arbitrage opportunities, these developments have increased the sophistication and scope of tax planning. In this context, Base Erosion and Profit Shifting (BEPS) has been recognized as a serious issue by G20 countries, who are now planning to take coordinated action based on OECD's suggested action plan report.[1] Australia, which held the G20 presidency in 2014, had cited BEPS as one of the critical issues facing the G20, and declared its aim to discuss it at length with partner countries.

The issues pertaining to taxation of international businesses and their transactions are crucial for India as well as developed economies, and both face prospects of revenue shortfalls resulting from the adoption of avoidance practices. Developing economies, in particular, are torn between the need to design robust tax systems attractive to international investors while simultaneously meeting their own revenue targets.

Even as India has made considerable progress in lowering its tax rates, making the tax structure more robust, and broadening the tax base, several issues still need to be addressed. These challenges have assumed greater importance in the presence of complicated corporate structures, transactions and businesses. Broadly, they include the following questions:

[1] OECD (2013), 'Action Plan on Base Erosion and Profit Shifting', OECD Publishing

1. Do foreign enterprises conduct business in India through permanent establishments?
2. How do these enterprises attribute their profits to the permanent establishments?
3. What is the nature of income being generated through these businesses (royalty or fee for technical services)?
4. How is the transaction of goods and services with these enterprises valued under transfer pricing rules?

These questions affect almost all multinational enterprises (MNEs), and have given rise to several tax related disputes. These disputes remain unresolved for long periods of time and increase the compliance cost of businesses. Additionally, unresolved disputes lead to an environment of uncertainty for international businesses, hampering India's global competitive position.

Frequent legal changes, as well as varied and inconsistent interpretation of laws by the Income Tax Department (ITD), have proved to be a deterrent for companies looking to invest in India. From retrospective changes in tax laws to an aggressive stand on transfer pricing (TP) and the hasty introduction of the General Anti-Avoidance Rules (GAAR), the Indian government has been on an overdrive to increase revenue collection. The strong pro-revenue stance and ambiguity in regulations has made the business environment unfriendly for foreign investors looking to capitalize on the growth potential of a market comprising of more than 1.2 billion people.

Recent disputes involving high-profile foreign enterprises, rather than regulatory changes have been the source of apprehension among investors. The tussle between ITD and Vodafone Plc over the latter's acquisition of Hutchison Whampoa Ltd's Indian operations in 2007 was just the beginning and other disputes involving Royal Dutch Shell, HSBC Securities and Capital Markets, Standard Chartered Securities followed. In fact, under the retrospectively amended law, in 2015, Cairn India was slapped with a tax demand of INR 10.247 billion and a penalty of INR 20.499 billion for not withholding tax on capital gains from indirect transfer of assets from Cairn Energy in 2006 as a part of internal reorganization preceding public listing.[2] In response, Cairn India filed an arbitration notice against the Indian Income Tax Department, under the UK-India investment treaty. Both Vodafone and Shell India have challenged the ITD in court, contesting the department's stance on the classification of share transactions under the Transfer Pricing net. Nokia Plc was also slapped with a tax demand for failure to withhold tax on royalty payments made to its Finnish parent. Other MNEs facing tax disputes in India include Morgan Stanley, Convergys, IBM, Microsoft, etc. These actions by the ITD have stirred strong reactions from not just domestic and international businesses but also from industry chambers, associations as well as governments around the world.

[2] Business Standard Reporter (2015), I-T Dept slaps Rs 20,495 cr tax demand on Cairn India, *Business Standard* on 14th March. Accessed: http://www.business-standard.com/article/companies/it-dept-slaps-rs-20-495-cr-tax-demand-on-cairn-india-115031300634_1.html [Accessed: 16th February 2016]

Despite making concrete changes in its dispute resolution mechanism to align it with global practices, the Indian tax administration continues to be blamed for an arbitrary approach, inconsistencies in the interpretation and enforcement of laws, difficulties in the business decision-making process, lack of receptiveness to the needs of taxpayers and absence of consultative policy formulation.

There is little doubt that India needs to reform tax application and administration procedures pertaining to international transactions and businesses. This is most easily attainable by modernizing tax administration through automation and standardization, quick resolution of disputes, and by providing high quality taxpayer information services. An information technology driven tax administration will not only reduce the complexity of doing business but also help in lowering the compliance cost of taxpayers and the administrative cost of the government.

2. Genesis and Background - How it started

In the wake of the global financial downturn, the government's attempts to raise revenue by altering taxation laws[3] (by introducing retrospective amendments through the Finance Act of 2012 and 2013, for instance) created uncertainty for investors. MNEs, which have invested extensively in establishing their production/service units in India, were concerned about the capricious behavior of policy makers and the associated impact on their operating costs, compliance costs and profit margins. Issues that arose relating to the introduction of GAAR, international taxation (permanent establishment, attribution of profits and transfer pricing), changes in law with retrospective effect, dispute resolution and the attitude of tax administration are dealt with in detail in the sections that follow.

I. Introduction of the GAAR

II. International Taxation

(a) Permanent Establishment (PE)

(b) Attribution of Profits

(c) Transfer Pricing

III. Changes in law with retrospective effect

IV. Dispute Resolution and

V. Attitude of the tax administration.

In response to widespread concerns about India's tax regime, the Government of India formulated two committees. The first committee, under Dr Parthasarthy Shome was

3 For instance, introducing retrospective amendments through the Finance Act of 2012 and 2013 and the issuance of circular 2/2013(on application of the profit split method) and circular 3/2013 (on conditions for identifying development centers engaged in contract R&D services with insignificant risk)

mandated to look into issues related to General Anti-Avoidance Rule (GAAR), and the other, under Mr N Rangachari, was tasked with issues related to taxation of Development Centres and the IT Sector.

Since there were a large number of cases which were initiated as a result of these legislations, the new Government has taken steps to address the problems through the Finance Act of 2015 and by setting up additional committees to deal with administrative issues. A High Level Committee under the Chairmanship of Dr Ashok Lahiri, former Chief Economic Advisor, was set up to interact with the industry and ascertain areas where clarity on tax laws is required. Another committee under Justice A P Shah, set up in May 2015, would look into the matter of Minimum Alternate Tax (MAT) on Foreign Institutional Investors and Foreign Portfolio Investors. In addition to this, a committee under Justice R V Easwar was constituted to simplify the provisions of the Income Tax Act, 1961 and address the associated ease of doing business concerns. The first report of this committee was submitted in January, 2016.

3. General Anti-Avoidance Rule (GAAR)

GAAR is a global concept that empowers revenue authorities to deny tax benefits to a taxpayer for a transaction or arrangement, which otherwise has no commercial substance other than to avail tax benefits. One of the major criticisms of a statutory GAAR is that it enables tax administrators to have discretionary power, which often results in high tax rates and compliance burden on the taxpayer. In recent times, with a rise in cross-border transactions, sophisticated forms of tax avoidance have emerged[4]. This has partly been due to the existence of tax treaties spanning multiple jurisdictions, which are aimed at avoiding double taxation. Tax avoidance has become a particularly vexing issue for India because of its treaties with low tax jurisdictions like Mauritius, Cyprus, Singapore, etc., which are the source countries for a substantial part of its capital inflows. However, a balanced approach requires that genuine transactions consummated in a tax efficient manner be differentiated from sham transactions used for evading tax. To enable authorities to make this distinction effectively, GAAR is considered to be a globally accepted, instrument that has been implemented in several countries.

Until recently, anti-avoidance in India was resolved through judicial proceedings in courts on a case by case basis and there was no statute codifying anti-avoidance rules. GAAR was introduced in the Indian Parliament in 2008, as part of the Direct Tax Code (DTC) Bill. While the DTC Bill was pending for the Parliament's consideration, the GAAR legislation was enacted as part of the Finance Act, 2012 empowering the Indian tax authorities to declare a transaction as an 'impermissible avoidance arrangement', devised to avoid tax by using India's tax treaties, and deny all tax benefits that may arise, even if only one of the purposes of the transaction or arrangement was to avail of a tax benefit. This was contradictory to the provisions of GAAR in the DTC Bill (2008), under which rules could be invoked only when the main purpose of the transaction under review was availing tax tax benefits. This sudden introduction of GAAR along with other retrospective amendments to tax laws had a

[4] Expert Committee Report on General Anti-Avoidance Rules (2012)

demoralizing impact on industry, and elicited widespread protest from foreign institutional investors (FIIs) as well as MNEs. In the face of these protests, the provisions of GAAR were put on hold in June 2012 and a committee was set up under the Chairmanship of Dr. Parthasarathi Shome to review the rules. After intensive stakeholder discussions and analysis of the international experience, the Shome committee recommended modifications to GAAR in its report.

Despite GAAR's global acceptance and existence, in India it caused concern because of the abrupt and ill-conceived manner in which anti-avoidance rules were conceptualized and implemented. The Shome Expert Committee Report on GAAR (2012) pointed out the following:

i. Introducing GAAR has generally involved a thorough analysis by experts, wide ranging discussions with stakeholders and caution in implementation. The issue arose of placing immense powers in the hands of the tax administration to review every transaction under the GAAR lens without adequate safeguards, as provided in other countries

ii. The government has not provided any guidelines on the implementation and interpretation of GAAR, and its usage with instruments such as Transfer Pricing (TP), which have been made available to the tax administration since 2002.

iii. Another reason why stakeholders were shocked was the weak and deteriorating economic environment in which GAAR was introduced.

The following issues/provisions related to GAAR were a matter of contention:

i. Unlike the provisions of DTC (2008), GAAR had broadened the scope to cover transactions/arrangements in which only one of the many dominant purposes was to avail a tax benefit. This implied that all transactions resulting in a reduction in tax liability (even when the transaction is otherwise justifiable from a commercial standpoint and has not been carried out with the sole objective of tax benefit) would be brought under the ambit of GAAR.

ii. The provisions authorized the tax administration to treat the whole arrangement of the assessee as an 'impermissible avoidance arrangement', even if only a part of the arrangement was impermissible. There were apprehensions about administrators imposing a penalty on the entire value of the transaction instead of only the part that reflected tax benefit.

iii. Many countries with anti-avoidance rules limit their application to only those transactions/arrangements that have tax benefit as the sole purpose.

iv. The language of GAAR provisions did not clearly define the meaning of an impermissible avoidance arrangement, implying that any arrangement could be potentially considered impermissible without distinguishing whether it is an avoidance arrangement or not.

v. Generally, grandfathering of business arrangements until the date of the enactment is done to allow time to taxpayers to withdraw or modify business arrangements which may constitute impermissible tax avoidance measures.

vi. The enacted GAAR had provisions overriding tax treaties

The Ministry of Finance accepted most of the recommendations of the Expert Committee:

i. It deferred the implementation of GAAR provisions for two years to April 1, 2015.

ii. It agreed that arrangements where the main, and not one of the purposes, is to obtain tax benefit, be considered as an impermissible avoidance arrangement.

iii. GAAR will be restricted to the tax consequences of only the part of the arrangement that is impermissible.

iv. The assessing officer will be required to issue a detailed show cause notice before invoking GAAR and the assessee will have an opportunity to defend the arrangement.

v. The burden of proof was shifted from the taxpayer to the tax authority.

vi. The Government set the limit for invoking GAAR at INR 3 crore worth of the tax benefit.

vii. All investments (and not arrangements) prior to August 30, 2010, would be grandfathered. Those who invested in the period September 2010 to January 2013, would not be covered.

viii. Where both GAAR and Specific Anti-Avoidance Rules (SAAR) provisions co-exist, only one of the two will be applied.

ix. An approving panel would be set up, comprising of three members, headed by a high court judge, with one member from the Indian Revenue Services not below the rank of Chief Commissioner of Income Tax, and one member who shall be an academic or scholar having special knowledge in matters of direct taxes and international trade practices from outside the government.

x. Directions of the GAAR panel shall be binding on income tax authorities.

Subsequently, through the Finance Act, 2015 GAAR was postponed by two years to 1 April, 2017 and now the provisions will apply prospectively only to the investments made on or after 1st April, 2017.

4. International Taxation

With an increase in cross border transactions, new challenges in the area of international taxation have emerged in India. These challenges include: definition of permanent establishment (PE)[5], attribution of profits, and transfer pricing (TP)[6].

---

5 Permanent Establishment (PE) means a fixed place of business through which the business of an enterprise

With increasing globalization, businesses operate and trade in different parts of the world. Every country has the right to tax activities of foreign companies within its territories. This may result in double taxation of companies if they are taxed in countries where they are residents and are also taxed in the source country where they carry out their economic activities. Some countries unilaterally provide relief to their residents and most others enter into Double Tax Avoidance Agreements (DTAA) on a bilateral basis to address these concerns. Others limit taxation of income in either the resident or the source country.

DTAAs are either based on the OECD or the United Nations (UN) model. Under the OECD model preference is given to residence based taxation. This is followed by developed countries as they are providers of capital and technology. On the other hand, the UN model gives preference to source country based taxation. This is generally followed by developing countries, (who are recipients of capital and technology) to avoid erosion of tax base and profit-shifting.

4.1 Permanent Establishment (PE):

The discussion of PE is particularly important under tax treaties due to the nature of Multi National Enterprises (MNEs), which operate through multiple establishments in various tax jurisdictions. It is used as a tool to define the right of a source country to tax profits of an enterprise which is a resident of another country. PE may be defined as the place of business from which the activities of an organization are wholly or partially carried out. In case of business income, the exercise of this right is subject to the requirement of the enterprise having a "fixed place of business". To be categorized as a PE, this fixed place of business must be the place of business of the foreign entity and not of the local entity. Thus, maintenance of a fixed place of business only for preparatory and auxiliary purposes is excluded from the definition of PE.

There are two issues concerning PE –

i. Definition and scope of PE

ii. Attribution of income to PE

Definition and Scope

There is no official guideline in India defining either the term PE or "place of business". The Indian law relies on the term "Business Connection (BC)", which only requires a real and continuous contact leading to a profit making business activity. Such a real or continuous contact for profit could be established by the interface

---

is wholly or partly carried out. It includes especially a place of management, branch, office, factory, workshop, and mine, oil or gas well or any other place of extraction of natural resources. ("Articles of the Model Convention with respect to Taxes on Income and on Capital", OECD)

6 Transfer Pricing (TP) is the general term for the pricing of cross-border, intra-firm transactions between related parties. "Transfer pricing" therefore refers to the setting of prices at which transactions occur involving the transfer of property or services between associated enterprises, forming part of an MNE group. (United Nations Practical Manual on Transfer Pricing for Developing Countries)

between a business activity outside India and some operation within India. In the absence of a business connection, the PE would just be a taxable entity and not a tax-paying entity in India.

India has adopted a much wider definition in most of its DTAAs. Apart from including a place of management, branch, office, factory, workshop, mine, oil or gas well, or any other source of natural extraction, it also includes farms, plantations, warehouses, stores, installations or structures used for the exploration or exploitation of natural resources, a building site or construction, installation or assembly project or supervisory activities, and furnishing of services through employees or other personnel.

Contentious issues relating to PE are:

a. **Agency PE:** Issue related to conclusion of contracts by agents

b. **Service PE:** Services provided by employees of foreign enterprises that do not have a fixed place of business in India for a period of 180 days constitute PE. This threshold of 180 days is lower than in other countries.

c. **Liaison Office (LO):** Though the LOs are not allowed to carry out commercial activities and are subject to monitoring by the Reserve Bank of India annually, they are often treated as PE. India has further expanded the scope of activities that are not auxiliary to preparatory work to include advertising, supply of information, and scientific research. In this regard, India differs from OECD practices, and is of the view that the use of facilities for delivery of goods or maintenance of stock of goods for delivery, captive R&D subsidiaries, and negotiation of contracts for the import of products or services into that country results in a PE.

d. **E-commerce:** The constitution of a "place of business" in the context of "e-commerce" , such as that of foreign telecasting companies, payments to search engines such as Google or Yahoo for online advertisements etc, are other areas subject to varied interpretations.

Attribution of Profits

The other issue central to the concept of PE is the attribution of profits. Although commentaries and international case laws provide reasonable certainty about the existence of PE, there is no authoritative rule for computing its profits. Both India's and OECD's models allow the source country to tax the "profit of an enterprise" but only based on the amount "attributable to" the PE in the source country. The following two questions arise –what are the profits to be attributed and how should they be attributed?

Transfer Pricing (TP)

Transfer Pricing (TP) is one of the most widely debated topics among tax professionals and tax authorities. Broadly speaking, TP refers to the practice of arm's length pricing (ALP)[7] of transactions between group companies based in different countries to ensure that a fair price – one that would have been charged to an unrelated party– is levied. If this is not done, manipulation of prices by group companies in cross-border transactions results in erosion of tax revenues. As MNEs establish a footprint in the Indian business arena, cross-border transactions among group companies spanning multiple tax jurisdictions have increased. There is an associated risk of these MNEs shifting profits earned in the source country to low tax jurisdictions, even if they have little or no business activity in that jurisdiction. This results in trade as well as tax distortions and necessitates TP regulations to determine the arm's length character of these associated enterprises[8]

Income Tax Rules, 1962 define the meaning of associated enterprise, international transactions, methodology for determining the ALP and maintenance of information by persons entering into international transactions. They also require that persons entering into such transactions should furnish a report from an accountant. Further, they lay out the procedure to be followed by assessing officers for making a reference to the Transfer Pricing Officer (TPO) and the process to be followed by the TPO to determine the arm's length character of transfer prices.

Indian revenue authorities are reckoned to be among the toughest globally on TP matters, with cases in India accounting for about 70 per cent of all global TP disputes by volume. The number of cases in India is much higher than in countries such as the US, which has only six TP cases in litigation, and Singapore, Germany and Taiwan, have none. It is reported that out of a total TP related tax demand of INR.70,000 crore raised in FY2012-13, nearly INR.60,000 crore relate to US companies.

Some key TP regulation-related challenges that international businesses face in India are:

i. Application of the arithmetic mean to determine the Arms Length Price (ALP): If the methods prescribed under the rules to determine an ALP for international transactions result in more than one price, the arm's length price shall be taken as the arithmetic mean of such prices. Since the mean is easily distorted by extreme values in the sample, this measure is not very reliable. Other statistical measures such as median and quartiles, which are less influenced by extreme prices, may be better alternatives to determine the ALP. Although OECD guidelines do not recommend any particular method to determine the arm's length price, USA and Mexico follow the inter-quartile

---

7 Arm's Length Price (ALP) refers to a price which is proposed or applied in a transaction between persons other than associate enterprises, in uncontrolled conditions. (Section 92F(ii), Income Tax Act of India

8 "Transfer Pricing: Keeping it arm's length, OECD Observer (2202)

range, where the lowest 25 per cent and the highest 25 per cent prices are ignored in the determination of the ALP.

ii. If the variation between the arithmetic mean of the ALP (determined by applying the most appropriate method (MAM) by the TPO), and the international transaction is within 3 per cent, then the price declared by the taxpayer is accepted to be at arm's length. However, in case the ALP determined by the TPO is outside this margin, then an adjustment has to be made based on the difference between the transfer price and the ALP, without giving any benefit for transaction prices that are within the range of 3%.

iii. The third is using the cost plus method (CPM), usually claimed to be high and unreasonable by taxpayers. In certain types of transactions, the Indian entity of an MNE acts merely on the directions of the foreign entity which provides the taxpayer with all relevant information and intangibles, like design, while also assuming the risks of the work. The average mark-up in industry using this method is between 10 to 20 percent. However, Indian tax administrators apply a mark-up of up to 40 per cent of the total cost for captive Information Technology (IT) and Information Technology-enabled Services (ITeS).

iv. The fourth issue is the aggregate versus transactional approach. Under the Transactional Net Margin Method (TNMM), the taxpayer has to apply the method on a transaction-to-transaction basis. Rules state that a "transaction" includes a number of "closely linked transactions". However, they do not provide any specific guidance or examples on the constitution of closely linked transactions. Additionally, they do not provide examples of instances under which an aggregate or a transactional-based approach may be applied for determining the arm's length character of international transactions. Authorities often show reluctance to regard a group of transactions as closely linked, especially when treating them as independent transactions results in a higher ALP.

v. The fifth issue is the use of data for multiple years. As per rules, any comparison between uncontrolled transactions and international transactions must be done for the financial year in which the transaction took place. Data from preceding years may be also considered in case they influence the determination of transfer prices of the transaction being compared. This ensures that outcomes are not influenced by abnormal factors and reduces the likelihood of anomalous transactions distorting the ALP. This is an acceptable practice in US and Australia and is also recommended by OECD. However, there are no clear guidelines in India on the use of data for previous years for comparability. The absence of these guidelines leaves scope for dispute and disagreement between taxpayers and tax authorities. The TPO, when analyzing the transaction at a later date, may have access to the relevant financial year data that the assessee at the time of preparing contemporaneous documentation did not. Although, the Indian TP provisions have been amended and taxpayers having international transactions have been allowed two additional months for filing of the Accountant's Certificate (to use the financial data of companies for the relevant assessment year), this time period is too short given the lags associated with public database updating. Further, use of single year data does not take into account the business cycle of the comparable companies.

vi. The sixth matter of relevance is the selection of comparables. TP is fact based and more often than not, has to rely on third party comparables to justify the ALP. Therefore, it is fairly common for both the taxpayer and the TPO to accuse each other of cherry picking certain comparables to suit a situation. . The TPOs have been justifying higher mark ups in certain cases on the grounds that MNEs benefit by relocating businesses from 'high cost' to 'low cost' locations and exploiting 'location specific advantages', such as the availability of skilled manpower, large customer base, superior network etc. In doing so, TPOs do not account for the commercial realties that foreign enterprises have to deal with when conducting business in India. This issue has been explained in detail in OECD's revised discussion draft on intangibles, which states that no adjustment on account of location savings is required, as all comparables are exposed to the same circumstances and have the same advantages. Moreover, quantification and allocation of location savings is a subject of controversy since it depends on functional analysis and bargaining power of the two parties involved in the transaction.

vii. Disallowance of advertisement, marketing and promotions (AMP) expenses undertaken by Indian affiliates of MNEs is also a matter of contention. Tax authorities state that any AMP expenditure incurred by an Indian affiliate over and above the bright line (the average AMP expense incurred by comparable companies) leads to promotion of the foreign-owned brand.

viii. Disallowance of royalty payments and management charges by an Indian entity to its associate foreign enterprise on an ad-hoc basis.

ix. Treatment of capital infusion in Indian entity as income. Sometime back, Shell India was slapped with a tax demand of INR. 50 billion for allegedly under pricing an intra-group share transfer and consequently evading taxes. The issuance of shares by the Indian entity to its group entity was re-valued from INR 10 per share to INR 180 per share. The difference between the actual share price and the price of the share so determined was added to the income of the foreign company that was revised to INR 150 billion in the draft order. Further, this shortfall was considered as a loan by the taxpayer to the foreign company and the deemed interest on the amount was taxed.

It is felt that the underlying problem in India is not the provision related to TP regulations but its misinterpretation by tax officials. These officials usually lack specialized knowledge to deal with the complexities of TP. They also do not have an understanding of business dimensions and operations. They have a pro-revenue and anti-taxpayer attitude that leads them to harass foreign enterprises that otherwise making investment in India. Most foreign entities are concerned with the lack of clarity on how transactions will be treated by the TPOs. Since there are no detailed guidelines or examples provided by the Central Board of Direct Taxation (CBDT), the TPOs have a large room for discretion, resulting in disputes and extended litigation.

Taxation of Research and Development Centre

Another adversarial step by the ITD was the decision to tax research and development (R&D) centers in India on the basis of two circulars – Circular 2/2013 (on application of the profit split method) and Circular 3/2013 (on conditions relevant to identifying development centres engaged in contract R&D services with insignificant risk) on March 26, 2013, by the Central Board of Direct Taxes (CBDT). The former imposed the profit split method to calculate tax on R&D centres, while the latter listed conditions to determine arm's length price (ALP)/transfer price for services offered by contract R&D centres. After an uproar, Circular 2/2013 was withdrawn while Circular 3/2013 was modified and replaced with Circular 6/2013 on June 29, 2013, which was in line with recommendations of Rangachary Committee[9].

In 2013, the governments took steps to reduce TP-related litigation, and bring in clarity on taxation of transactions through:

i. introduction of Advance Pricing Agreements (APA)

ii. Safe Harbor Rules.

Advance Pricing Agreements (APAs)

APAs are agreements between the taxpayer and the tax authority concerning the TP method applying to a company's inter-company transactions. Through this, TP adjustments are not made on transactions as long as the taxpayer adheres to the terms and conditions agreed under the APA[10]. APAs can be unilateral, between the government and the taxpayer or bilateral between the governments of two countries or multilateral between governments of more than two countries. Introduced under the

9 BEPS seems to agree with the CBDT notification. BEPS action point emphasizes accurate delineation of a transaction with the objective of identifying the functions and evaluating the value creation; distinguishing funding risk from the operation risk. The BEPS guidance states that if the cash box is not exercising control over the financial risk, it will not be entitled to more than a risk-adjusted financial return. This approach, many find, is in consonance with the CBDT Circular No. 6 of 2013, issued to classify the contract research and development (R&D) centres having significant people functions, ownership of significant assets and risks, financial investments and legal ownership. So, the Indian view and OECD views seems to be align on this. So, if the cash box is not exercising control over the financial risk that is associated with its funding, it will not be entitled to more than a risk-adjusted financial return unless it also controls both the risks. All these cannot be determined only by looking at the balance sheet of the funding entity; rather it will require a detailed analysis. One, therefore, needs to look beyond the contractual arrangement.

10 http://www.transfer-pricing-india.com/Advance_price_agreementapa.html accessed on November 26, 2013

Finance Act 2012, APAs have received a lot of positive feedback, generating a positive sentiment in the business community and reducing the risk of double taxation. APAs remain valid for five years and result in the reduction of disputes related to international taxation and transfer pricing.

The Finance Act 2015, allows the "roll back" of APA signed after 1 April, 2013 to four previous years. Further, the Government has decided to strengthen this agreement by setting up one more APA unit to expedite the disposal of applications and signing of agreements.

The designated tax authority has already received 518 unilateral applications and 57 bilateral applications up to 30th September, 2015. The CBDT has so far signed 41APAs[11] of which 38 are unilateral and two are bilateral, 30 more APAs were expected to be signed by 31st March, 2016. The signed APAs relate to sectors like telecommunication, oil exploration, pharmaceuticals, finance/banking, software development services, ITeS (BPOs) and manufacturing.

Safe Harbor Rules

Provisions related to safe harbor rules were introduced through the Finance Act of 2009 and procedures to put them in operation were notified in September 2013. Safe harbor rules, which are a credible alternative to APA, lay down the framework under which the transfer price declared by taxpayers would be accepted by the tax department for five assessment years. These rules cover the IT Sector, the ITES Sector, Contract R&D in the IT and Pharmaceutical Sectors, Financial transactions-Outbound loans, Financial Transactions-Corporate Guarantees and Auto Ancillaries-Original Equipment Manufacturers. Under these rules, ratios for eligible international transactions based on industry sectors are provided. For instance, with respect to software development or IT services, the safe harbor ratio for operating profit margin-to-operating expense can be 20 per cent or 22 per cent (depending on the aggregate value of the international transactions). The aim is to reduce aggressive scrutiny by the tax department. As a boost to the IT and ITeS sector, the government has also relaxed the transaction limit to INR.500 crore for availing Safe Harbor regulations, making it more relevant for large IT services firms, including Knowledge Processing Outsourcing(KPO) and Business Process Outsourcing (BPO) units.

Other Changes related to Transfer Pricing

Through the Finance Act of 2015, the Government made two significant changes. First, the use of data from multiple years would be accepted for determining arm's length price, while allowing yearly variations to be averaged out.

[11] Press Information Bureau (2016): CBDT Signs Two Bilateral Advance Pricing Agreements (APAs) With United Kingdom on 1st February

Secondly, as against the previous rule for acceptance of “arithmetical mean”, with effect from 1st April 2014, in some cases, the range concept will be applicable for determining the price and will begin with the 35th percentile and end with the 65th percentile of comparable prices. Transaction price shown by the taxpayers falling within the range will be accepted and no adjustment will be made.

Application of Minimum Alternate Tax (MAT) on Foreign Institutional Investors (FII) and Foreign Portfolio Investors (FPI)

The Authority for Advance Ruling (AAR) had earlier held that no tax under MAT was payable in the case of a foreign company, being a FII or FPI and not having any presence or permanent establishment (PE) in India. The AAR reversed their own earlier ruling in the matter in 2012. A taxpayer had gone in appeal to Supreme Court against the 2012 ruling of AAR. Though the rulings of AAR do not have any precedentiary value and is applicable in the case of the applicant only, the taxpayers expect consistency in rulings for stable tax regime. Further, based on this 2012 ruling of AAR, the Income Tax Department initiated proceedings against a large number of FIIs and FPIs for levy of MAT. This led to panic among FIIs and FPIs and as many as five FPIs approached Bombay High Court for relief. The Government through Finance Act 2015 introduced explanatory amendment to the effect that FIIs and FPIs not having presence or PE in India were exempt from levy of MAT. This provision was, however, prospective from 1st April, 2015 and did not apply to earlier period. Since this led to hue and cry spoiling the investment climate, the Government in May, 2015 set up a Committee under Justice A P Shah to look into the matter. The Committee, after examining the legal position, held that the MAT was not applicable in cases of FIIs and FPIs if they do not have presence or PE in India. The Government accepted the recommendation of Justice Shah and also confirmed the position before the Supreme Court.

5. Retrospective Amendments to the Income Tax law:

In the Finance Act (2012), the Government of India introduced over a dozen retrospective amendments to the Income Tax Act (1961), casting a shadow on government’s intent to reform and creating apprehensions with respect to the certainty, predictability and stability of tax laws in India. Ostensibly, these amendments were made to clarify and restate the legislative intent of the source rule of taxation for non-residents in India. In particular, they addressed the situation of transfer of assets in India exclusively between non-residents. It was strongly felt that amendments to certain sections (especially Section 9 on indirect transfer of assets[12] situated in India) of the Act were made to overrule the Supreme Court’s judgment on Vodafone[13]. While such ‘clarificatory’ amendments have been issued in the past, it was the large number of such amendments in the Finance Act 2012 that caused consternation.

[12] Indirect transfer of assets refers to acquisition of assets located in India by foreign entities outside India

[13] Vodafone International Holdings BV versus Union of India & Anr [S.L.P. (C) No. 26529 of 2010, dated 20 January 2012] reported in [2012]107CLA63(SC), [2012]204TAXMAN408(SC)

Although the amendments were ostensibly intended to clarify the existing law, they effectively ended up changing the law against taxpayers.[14]

The amendments to Section 9(1)(vi) Explanation 4 to 6 through the Finance Act 2012 retrospectively identified payment toward shrink-wrapped software, connectivity charges, transponder hire charges and so on as 'royalty'. This implied that the transfer of any right to use computer software, including licensing, would be treated as royalty, irrespective of the transfer medium.[15] Another amendment was made to the definition of 'royalty', to include any consideration with respect to right/property/information irrespective of whether the recipient controls or uses it, or whether it is located in India or outside. Moreover, the definition of the term 'process' was also broadened to include transmission by satellite, cable, optic fibre and so on.

In case of computer software, a person using the right to replicate off-the-shelf software or shrink wrapped software for replication makes a royalty payment and has tax deducted at source. The problem arises when the payment made by the distributor to the replicator is taxed and goes against the underlying concept of royalty. Here, the distributor is not exploiting copyright but is only distributing the product and earning a business income. This has affected both American companies such as Microsoft and Motorola, and non-American companies such as Samsung and Nokia.

Another critical issue that arises in case of software is whether the receipt of payment is for the use of copyright or for purchase of a copyrighted article. In some cases, the tax department claimed that payment for software embedded in the hardware should be taxed as "royalty". . However, the Delhi Special Bench of Income Tax Appellate Tribunal as well as the Delhi High Court rectified the position by deciding that the software was an integral part of the system with no independent existence and the payment for supply of such equipment could not be treated as royalty. Further, when installed on any media in any form, the sale of a copyrighted article is the same as sale of goods. Hence, the payment received is of the nature of business income and in the absence of any PE or business connection is not taxable.

Taxability of capital gains on indirect transfer of capital assets is also a matter of concern. Indirect transfers are taxed even though they result "by means of" or "in consequence of" transfer of offshore shares, which derive their value substantially from assets located in India[16] This particular amendment, being retrospective from the date of enactment, i.e., April 1962, inter-mingled two matters – retrospective applicability of tax laws, and indirect transfer under the same regulation. Indirect transfers refer to sale of assets located in India through selling of shares in the holding company. Such transactions take place outside India, among foreign entities. It was contended by the ITD that the transfer of shares of the holding company, also transferred business assets located in India, though indirectly, and the capital gains arising from it was taxable in India.

---

14 Prateek Andharia (2011) 'The Validity of Retrospective Amendments to the Income Tax Act: Section 9 of the Act and the Ishikawajima Harima Case', NUJS Law Review

15 "Open source for software taxation", Business Line dated March 13, 2012

16 Budget 2012: Retrospective Amendments steal the thunder BMR Advisors

Retrospective amendments are not uncommon. In countries that follow the Westminster system of government (such as the UK, India, Canada, etc.), ex-post facto law is technically possible through the power vested in Parliament by the doctrine of parliamentary supremacy. In the UK, the government retrospectively changed laws through the Finance Act of 2008 to target tax avoidance schemes. The amendment specifically targeted tax avoidance schemes that made use of offshore trusts and double taxation treaties to reduce the tax paid by the scheme's users.

Similarly, in India, the legislature no doubt has the power to make civil law amendments with retrospective effect. However, against the backdrop of the increasing frequency of retrospective amendments, careful examination of this power is needed to determine if it can be exercised with the sole motive of overturning the verdicts of courts. While it holds true that the power to retrospectively make amendments is essential in contemporary tax regimes, the manner, method and frequency of these amendments in India is nevertheless disturbing.

It was widely believed that the retrospective amendment of law was an attempt by the government to get back at Vodafone Plc, which won the case in Supreme Court over the tax demand of INR 18,000 crore as withholding tax against its transaction with Hutchison India. This was followed by many such tax demands raised by the department on international transactions involving multinationals. The effect of these actions on the environment for foreign investment and business in India was extremely adverse.

To alleviate the situation the Government has recently stipulated that the provisions on capital gains from indirect transfer of shares will apply only in cases where 50% or more of the assets of the company are located in India.

6. Dispute Resolution

Tax uncertainties, and inconsistent application and ambiguity of laws are a pressing concern for all corporations in India, whether foreign or domestic. While tax disputes related to interpretation and application of laws are inevitable in all jurisdictions, what makes the experience especially frustrating in India is the inability of the system to resolve them expeditiously without resorting to a prolonged and expensive litigation process. India has a four-tier dispute resolution mechanism. If a taxpayer is not satisfied with the assessment, he/she can file an appeal with the Commissioner of Income Tax (Appeals) (CIT (A)) and thereafter, file a second appeal to the Income Tax Appellate Tribunal (ITAT). The decision of the ITAT on a question of fact is considered final and an appeal can be made to a high court or the Supreme Court on any question of law arising from such an order. There are two inherent weaknesses in the Indian dispute resolution mechanism that are discussed below–the time and cost involved and the anti-taxpayer attitude of the tax administration.

(i) Time Consuming and Costly: India has an extremely time-consuming appellate process. The statute for disposal of appeals prescribes a time limit of one year for CIT (A) and four years for the ITAT. However, the time limitation is not mandatory. There is a huge backlog of appeals with various appellate authorities. It takes 15 to 20 years for cases to get resolved in India, compared to 3 to 4 years in most other developed and some developing countries. This problem persists not only at the appellate level but also at the assessment level, largely due to a plethora of unwarranted cases picked up for scrutiny (audit). Moreover, India does not have sufficient case law in international taxation to serve as judicial precedents. Although the Supreme Court has upheld the applicability of international commentaries and decisions as case law, income tax authorities usually don't recognize them. This attitude makes obtaining a stay order on the tax demand of authorities difficult for the taxpayer.

(ii) Anti-Taxpayer Attitude of Tax Administration: There is a perception that Indian tax authorities have an anti-taxpayer and pro-revenue attitude during the dispute resolution process. Different officers at different levels give conflicting rulings and interpretations of the same issue. Unlike in most developed countries, disputes are not resolved at the tribunal level and the administration does not prefer resolving disputes through arbitration. This makes the process lengthy and costly for the taxpayers.

Apart from the regular appellate procedure, MNEs in India have other avenues for dispute resolution. These avenues were set up on the basis of the best international practices to speed up the process of resolving international taxation disputes. Unfortunately, each of these procedures is beset with difficulties.

Dispute Resolution Panel (DRP):

To resolve TP related cases, a Dispute Resolution Panel (DRP) was introduced consisting of three Commissioners/Directors of Income Tax. Under this mechanism, where tax authorities have made adjustments to the ALP in relation to transactions with overseas affiliates, the concerned taxpayer can contest the same before DRP. This mechanism, applicable to both Indian and foreign companies, has been introduced at the assessment stage itself to provide businesses with a time-bound alternative to the appellate route through the CIT (A). The DRP has a specified time frame of nine months and has wide powers to confirm, reduce or enhance additions proposed in a draft order. The taxpayer has a right of appeal against assessment orders passed under the direction of the DRP in the Tribunal.

Based on American provisions, the DRP was set up in India to independently resolve TP related cases. In the US, authorities handling such cases are kept independent of the Internal Revenue Service (IRS) and they usually arrive at a settlement with the taxpayer after carrying out a probability analysis of the case if it goes to court. This results in very few cases landing in law courts. On the other hand, in India, the DRP consists of officials from the CBDT, making their impartiality suspect in the eyes of taxpayers. The procedure for constitution of DRPs creates the impression that they would not approach the problem independent of tax authorities. An attempt was made in the past to remedy this problem by requiring that no member from the tax department of the city where the assessment was being made would be a part of the DRP.

Moreover, since the DRP's directions are not binding on both parties, there is no finality. Earlier the tax officers had no right to appeal against the orders of DRP. However, this has now been amended and the tax officer has been given the right to challenge the order of DRP before ITAT. This implies that orders issued by the DRP are open to challenge through the entire appellate structure except the CIT (A). This is a retrograde change; in most developed countries tax officers are not allowed to appeal against the orders of higher tax authorities. The Central Board of Direct Taxes (CBDT), while acknowledging that the existing appellate structure results in time-consuming and long drawn out procedures, has suggested the same appellate structure for appeals against the orders of the DRP.[30] This is unlikely to resolve the problem as delays in the appellate machinery takes place not at the CIT (A) level but at the higher appellate level. This means that the problem of prolonged litigation is likely to remain. The only silver lining is that the taxpayer can file an appeal against the assessment order directly to the Tribunal and seek a stay order.

In 2015, the Government set up full time Dispute Resolution Panels to ensure continuity and experience in the area of transfer pricing. Two fulltime DRPs each have been set up in Delhi and Mumbai and Bengaluru.

Mutual Agreement Procedure (MAP)

MAP is a dispute resolution procedure provided under DTAA. Under this, a taxpayer can approach the competent authority (CA) of its country when the actions of tax authorities in either or both countries result in a tax incidence, contrary to treaty provisions. When accepted, the application is sent to the CA of the other country. The settlement is usually achieved through negotiations between the two CAs and any decision made is binding on the tax authorities of both countries. If the settlement is acceptable, the taxpayer gives up any right of appeal on the issue. Once the negotiated settlement is reached, the dispute can subsequently be withdrawn from the formal legal process. However, the MAP has its own inherent problems. The most important of these is the absence of any prescribed time limit for resolving cases.[17] In the recent past, MAP process had been at a complete standstill. In a significant breakthrough ahead of Prime Minister Manmohan Singh's visit to the US in September 2013, the two countries decided to end their three-year old acrimony and re-start negotiations of tax settlements under the MAP.

Authority for Advance Ruling (AAR)

Under the Income Tax Act (1961), Authority for Advance Ruling (AAR) was introduced with the objective of providing certainty on income tax liability and avoiding the possibility of a long drawn litigation. The Authority can be approached by non-residents as well as residents having international transactions for an advance ruling for prospective transactions. Although taxpayers have approached the AAR, there have been instances of some conflicting decisions. Moreover, the Authority has not been able to dispose of cases within the prescribed six month time limit.

[17] "India, US end three-year-old deadlock; to talk tax issues again", published in The Economic Times dated September 18, 2013

Government has since proposed setting up of two additional benches of the Authority to enable quicker disposal of cases. This would also put in operation the facility of advance ruling for resident tax payers.

Reduction of Withholding Tax on payment of Royalty and fees for Technical Services: Under most technology agreements, non-residents receive payments net of taxes, i.e., the Indian company deducts taxes on royalty. In case of residents of a non-DTAA country, the payment is subject to a withholding tax of 25 per cent. Similarly, in case of non-residents earning royalty/fee for technical services (FTS) connected with a PE in India, the applicable withholding tax is 25 per cent. Thus, the cost of importing technology into India has gone up substantially and is especially problematic as technology transfer from developed countries to developing countries is central to the latter's ability to compete in the global economy.

The Government has since reduced the tax to 10%.

7. Anti-Taxpayer Attitude of Tax Administration

The attitude of the Indian tax administration is adversarial and not guided by service obligations toward taxpayers. This aggressive attitude is founded in revenue enhancing motives. . Though 98% of the tax payment and nearly 90% of the returns are filed electronically and thus, without person to person interface and harassment, the time consuming Audit process (scrutiny process) is considered a source of harassment. Even though a computerized risk assessment system exists to objectively select cases for audit, manual selection of cases is still taking place. The same taxpayers are subjected to audit repeatedly.

8. Some Recent Initiatives

1. Pilot project for e-initiative

The government has launched an e-initiative pilot project (e-Sahyog) to reduce compliance costs, especially for small taxpayers. This allows the taxpayer to respond to clarifications required on the e-filing portal itself.

2. Committee to Simplify provisions of the Income Tax Act, 1961

A committee under Justice R V Easwar was set up in October, 2015, with a view to simplifying the provisions of the Income Tax Act, 1961 which has led to litigation due to contrasting interpretation of provisions, impacting the ease of doing business, amongst other indices. The first report of this committee was submitted in January 2016.

3. New appraisal rule for Tax Administrations

The Prime Minister recently announced that the appraisal system of the tax officers would be revamped to take into account the proportion of orders sanctioned by them that were upheld on appeal. . Previously, there were no consequences of such an appellate order on the career of the tax officers. This appraisal system is designed to bring in objectivity in the orders of tax officers.

9. Conclusions and Recommendations

1. The Indian Tax Administration is known to be difficult. The sudden introduction of GAAR and a host of retrospective amendments through the Finance Acts 2012 and 2013 created uncertainty for foreign investors looking to capitalize on the growth potential of a market comprising of more than 1.2 billion people. Realizing that tax issues were hampering the investment climate, the Government put the implementation of GAAR on hold and set up two Committees in July 2012 to look into issues relating to GAAR, and taxation of Development Centers and IT sector. Since the steps taken by the Government were not comprehensive, the legacy issues arising with retrospective amendments became relevant in a large number of cases with tax demand, which continued to depress the investment climate. The new Government has taken several proactive administrative measures during 2014 and through the Finance Act 2015.
2. The contentious issues facing the investors were GAAR and issues pertaining to international taxation (namely, the definition of Permanent Establishment, attribution of profit, and transfer pricing of international transactions, changes in law with retrospective effect, dispute resolution and the attitude of the tax administration).
3. The new Government has taken substantive legislative and administrative action in this area, which are summarized below.
    a) In 2012, GAAR was put on hold initially until 2015, and subsequently until 2017. The application of GAAR was confined to cases where the main purpose was to obtain tax benefit, and restricted the tax consequence to the impermissible part of the arrangement. . The application of GAAR was restricted to cases with tax benefit exceeding INR 3 Crores. The onus of proving the arrangement impermissible was shifted to the tax officer, who would need to issue a show cause notice before invoking GAAR, in order to provide the taxpayer an opportunity to justify the arrangement. An approving panel was proposed, headed by a retired high court judge, a Chief Commissioner of Income tax and a scholar having knowledge in matters of direct taxes and international trade practices. The decision by this panel would be deemed binding on the tax administration. The provisions of GAAR, which were earlier applied to investments made prior to 30th August 2010, have since been changed to apply from 1st April 2017, to allow investors to plan or withdraw impermissible arrangements.
    b) Advance Pricing Agreement (APA) between the taxpayer and the Government (unilateral APA), between Governments of two countries (bi-lateral APAs), and multilateral APAs among governments of more than two countries, which were introduced into the statutes through Finance Act 2012, was made operational in 2013. The APAs which are expected to be valid for five years were further liberalized through Finance Act 2015 by providing for “Roll-Back” to four previous years. 518 unilateral and 57 bilateral applications have been filed up to 30th September, 2015. So

far 38 unilateral and 3 bilateral APA (two with rollback provision) related to telecommunications, oil exploration, pharmaceuticals, finance/banking, software development services, ITeS (BPOs) and manufacturing sectors were signed. An additional 30 APAs are expected to be signed by March, 2016.

c) Provisions related to profit margin ratios under Safe Harbor Rules, which were on statutes since 2009, were notified in September 2013 and covered the IT Sector, ITeS Sector, Contract R&D in the IT and Pharmaceutical Sector, Financial transactions-Outbound loans, Financial Transactions-Corporate Guarantees and Auto Ancillaries-Original Equipment Manufacturers. Under these rules, ratios for eligible international transactions based on industry sectors are provided. For instance, with respect to software development or IT services, the safe harbor ratio for operating profit margin to operating expense can be 20-22% (depending on the aggregate value of international transactions). This aims to reduce aggressive scrutiny by the tax department. As a boost to the IT and ITeS sector, the government also relaxed the transaction limit to INR.500 crore for availing Safe Harbor regulations, making it more relevant for large IT services firms, including Knowledge Processing Outsourcing (KPO) and Business Process Outsourcing (BPO) units. These ratios will remain valid for five years, with the transaction limit notified at INR.500 crore for availing Safe Harbor regulations. The transaction limit for availing safe harbor rules need to be further brought down to cover cases with smaller turnovers. The Safe Harbour Rules were thus seen as a key policy initiative with a view to provide compliance relief, certainty in delivery of tax administration and administrative simplicity. But these objectives did not seem to have been achieved as very few taxpayers opted for the Safe Harbour Rules, finding the profit margin or mark-up and definitions of several crucial terms applied for safe harbor compliance higher/unreasonable than the business case reality. Since the number of multinational companies taking benefit of safe harbor rule are not as many as expected, there is also need to reduce or rationalize the profit margin prescribed under these rules.

d) Through the Finance Act of 2015, the Government allowed the use of multiple year data instead of single year figures for determining arm’s length price. The use of multiple year data allows for yearly variations to be averaged out and would, therefore, add value to transfer pricing analysis. Secondly, as against the previous rule for acceptance of “arithmetic mean” with effect from 1st April 2014, the range concept will be applicable in certain cases for determining price and will begin with the 35th percentile and end with the 65th percentile of the comparable prices. Transaction prices falling within the range will be accepted and no adjustment will be made.

e) As a fall out of the ruling of the Authority for Advance Ruling in a case, Minimum Alternate Tax (MAT) can be levied in cases of FIIs and FPIs. Though the Finance Act 2015, exempted the FIIs and FPIs from levy of MAT w e f 1st April 2015, it did not cover cases from earlier periods. In order to solve legacy cases with these issues, a Committee under Justice A P Shah was constituted, which came to the conclusion that

MAT was not to be levied in cases of FIIs and FPIs, even retrospectively. This has been accepted by the government.

f) While the main case related to tax withholding of INR 13,000 crores on indirect transfer shares is still pending, the Union Cabinet took a decision to not appeal further in the Supreme Court, against the order of Bombay High Court in favor of Vodafone Plc. in a case of transfer pricing amounting to INR 3,200 crores tax demand. It is reported that the Government is discussing the terms for reference for the arbitration with Vodafone Plc. Cairn Energy, which was slapped a tax demand of INR 10,247 crores and a penalty of INR 20,499 crores under retrospectively amended law for indirect transfer of shares as part of internal restructuring in 2006, has moved for arbitration under the UK India Investment Treaty. It is also reported that legacy cases like those of Cairn and Shell (which face tax demand on shares issued to parent) can be referred to Justice A P Shah panel for quick resolution.

g) The government came out with a clear law that would apply the provisions of indirect transfer of shares only in cases where 50% of the assets of the company are located in India.

h) In 2015, the government set up full time Dispute Resolution Panels, thus ensuring independence of the DRP to an extent, and further ensuring continuity and experience of the members in the area of transfer pricing.

i) Mutual Agreement Procedure (MAP) under Double Taxation Agreement, especially with the USA, had come to a standstill for nearly three years. The process was revived after the Competent Authority handling India and USA was replaced in September 2013. Central Board of Direct Taxes (CBDT), apex body of direct tax administration, has resolves disputes to the tune of INR 5000 crore under 150 Mutual Agreement Procedure (MAP) of Tax Treaties[18]

j) Since there were a large number of disputes which were initiated as a result of various legislations in 2012 and 2013, along with other ongoing tax proceedings, the new Government took a number of steps to deal with legacy tax and other administrative issues through the Finance Act 2015, as well as by setting up Committees. A High Level Committee under the Chairmanship of Dr Ashok Lahiri, former Chief Economic Advisor was set up in 2014 to interact with trade and industry in certain areas where clarity on tax laws is required. Another committee to simplify provisions of the Income Tax Act 1961, which has led to litigation in the past due to differing interpretations of provisions, has been set up under Justice R V Easwar in October 2015. The first report of this committee is expected by January 2016.

Certain administrative steps have been taken to improve the way tax administration deals with taxpayers. These are:

---

[18] Press Information Bureau, Government of India, Ministry of Finance (2016), CBDT resolves disputes to the tune of Rs 5000 crore under Mutual Agreement Procedure (MAP) of Tax Treaties on 16th February

a) E-initiative pilot project: The government has launched a pilot project (e-Sahyog) to reduce compliance costs, especially for small taxpayers, by allowing taxpayers to respond to clarifications required on the e-filing portal itself.

b) New appraisal rule for Tax Administrations: The Prime Minister announced revamping of the appraisal system for tax officers, to factor in the number of orders that were upheld on appeal. Previously, there were no consequences for the issuing officers. There have been cases of exploratory audit (scrutiny) orders, which in most cases are not upheld during appeals. This appraisal system will bring in objectivity in the decisions of tax officers.

Though steps have been taken to ensure that tax laws are transparent and taxpayer friendly, further reforms are necessary. Some areas that still need to be addressed are:

1. Since GAAR is a powerful tool which provides the tax administration the authority that could result in imposition of an excessive tax and compliance burden on taxpayers, it is essential that tax officers are given extensive training in the application of law. There is also a need for the issuance of guidelines as mandated under the law.
2. Though a large part of the Indian international taxation law is designed on the lines of OECD provisions, there remains a lack of adequate guidelines in the area of Permanent Establishment, attribution of profits and transfer pricing. There is a need for further clarity on taxation of royalty, either through clear circular/guidelines or through legislative measures.
3. As against 575 applications filed until 30th September 2015, only 41 agreements have been signed so far. APA mechanisms must be made more efficient in order to deliver faster resolution and ensure certainty.
4. Conclusion of Mutual Procedure Agreements needs to be actively pursued.
5. The Safe Harbor Rules have prescribed provisions only for sectors where there are ongoing transactions and disputes, overlooking other sectors where India may have an interest. In addition there is also need to reduce or rationalize the profit margin prescribed under these rules.
6. Even though the Indian government has the power to enact laws retrospectively, the consultation process prior to enactment of these laws is inadequate.
7. The decisions of the Authority for Advance Ruling (AAR) do not have precedential value. Even so, the Indian tax administration has initiated proceedings in a large number of cases based on the AAR ruling, which is not ethical.

Though the new Government has taken other steps as mentioned earlier, in order to promote trade and investment, there is need for an investor friendly tax administration which is fair, predictable, and transparent. These can be achieved by taking following measures:

a) Every successful tax administration undertakes an extensive consultation process, particularly before a new tax law is enacted. Legislative proposals are often preceded by studies and recommendations by a panel of eminent persons and experts. The consultation process involves uploading a draft proposal online for wider consultation with various stakeholders and public hearing. In Australia, UK and USA, all legislations are accompanied by Regulatory Impact Statement (RIS, Australia) or Regulatory Impact Assessment (RIA, UK), which is incorporated into the legislative proposal for approval (in some countries it is also presented as an Annexure to the legislation introduced in the Parliament). The RIS/RIA is also made public to ensure transparency. In fact, the RIS in Australia has already been prescribed by the Parliament. India may consider following a similar process.

a) Countries such as Australia, Canada, New Zealand and the UK have issued detailed documents outlining directions to implement GAAR, mainly for use by tax officers but also made available to taxpayers.

b) The Australian Tax Office (ATO) issues detailed guidelines on Permanent Establishment, Attribution of Profit and Transfer Pricing to make the process simple and intelligible to taxpayers. The various types of rulings and documentation issued by are Public Ruling (similar to Circular in India), Private Ruling (similar to Advance Ruling in India), PLSA (similar to instructions issued for departmental use only), Product Ruling, Class Ruling, among others. Each document contains detailed explanations for each provision and clause, with interpretations of case law and flow charts for procedures, which are then made available online as well. Similar detailed documents are issued by the tax administrations of Canada, New Zealand, UK, USA and other countries. There is a need to publish such detailed documents addressing all areas of tax law and procedures in India as well.

c) Clarity and certainty in taxation of royalty is necessary, either through clear circulars/guidelines or through legislative measures.

d) More APA units need to be established, with experienced officers, in light of the large number of applications pending.

e) In order to promote investment and exports under the Make in India campaign, it is important to make taxation laws in the sunrise sectors more transparent and certain. To this end, it is essential that Safe Harbor rules are proactively prescribed. It is well known that the companies in China which assemble Apple's products only receive a fraction of the cost of the product being assembled – the majority accrues to the original equipment suppliers, suppliers of components and the IPR holder. This must be taken into account while fixing the profit rates for transfer pricing purposes. The sectors which require formulation of Safe Harbor Rules are smart phones, personal computers and laptops, high end television sets and other electronic gadgets, components and products, and defense equipment, where IPR are held largely by developed countries. Moreover, the transaction limit for availing Safe Harbor Rules must be further reduced to cover cases with smaller turnovers.

f) GAAR, International Taxation, and other issues related to specialized law require in-depth knowledge of trade and industry, as well as the practices followed for taxation of such entities. Officers must be trained to become experts in their area of trade and industry, and the subsequent practices and taxation therein.

g) Though the Prime Minister has announced revamping of appraisal system for tax officers, the same may not happen in absence of authentic data. There is an integrated computerized application software covering all areas of work of the Income Tax Department right from filing of returns to assessment after scrutiny of cases to appeals right up to level of Supreme Court. It also provides for capture of data relating fate of appeal at various stages along with variations in tax demand and gain to revenue. However, in most cases first level data up to processing of returns only is there on computers. In most cases post processing data, such as post scrutiny assessment data, rectification, appeals to Commissioner(Appeals), Income Tax Appellate Tribunal, High Court and Supreme Court and consequent modifications in tax demand and collection is not being captured. Unless complete data is captured at all stages it will never be possible to appraise the work of tax officers in an objective manner. There is need for strictly enforce working on computers at all levels. Successful implementation will reduce litigation and improve working of the tax administration.

References

[S.L.P. (C) No. 26529 of 2010, dated 20 January 2012] reported in [2012]107CLA63(SC), [2012]204TAXMAN408(Supreme Court)

Andharia, P. (2011). Validity of Retrospective Amendments to the Income Tax Act: Section 9 of the Act and the Ishikawajima Harima Case, The.*NUJS L. Rev.*, *4*, 269.

Business Standard Reporter (2015), I-T Dept slaps INR 20,495 cr tax demand on Cairn India, *Business Standard* on 14th March. Accessed: http://www.business-standard.com/article/companies/it-dept-slaps-rs-20-495-cr-tax-demand-on-cairn-india-115031300634_1.html [Accessed: 16th February 2016]

D. Sikarwar (2013), India, US end three-year-old deadlock; to talk tax issues again, *The Economic Times* on 18th September. Accessed: http://articles.economictimes.indiatimes.com/2013-09-18/news/42183234_1_advance-pricing-tax-treaty-tax-regime [Accessed:16th February 2016]

Expert Committee, Government of India (2012), *Final Report on General Anti-Avoidance Rules (GAAR) in Income- tax Act, 1961.* India.

http://www.transfer-pricing-india.com/Advance_price_agreementapa.html [Accessed: 26th November 2013]

Income Tax Act of India (s 92F(ii))

M. B and S. Singhania, 2012. "Budget 2012: Retrospective Amendments steal the thunder!", International Taxation, Volume 6, April 2012

OECD (2008), *Articles of the Model Convention with respect to Taxes on Income and on Capital*. Accessed: http://www.oecd.org/tax/treaties/42219418.pdf

OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing

OECD Observer (2002), *Transfer Pricing: Keeping it arm's length*, (OECD Observer No. 230), Accessed: http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer pricing:_Keeping_it_at_arms_length.html

Patil, R. and Gopalani, N. (2013), Open source for software taxation, *Business Line* [Online] on 21st April. Available from: http://www.thehindubusinessline.com/news/education/open-source-forsoftware-taxation/article4637139.ece [Accessed: 16th February 2016]

Press Information Bureau (2016): CBDT Signs Two Bilateral Advance Pricing Agreements (APAs) With United Kingdom on 1st February

Press Information Bureau, Government of India, Ministry of Finance (2016), CBDT resolves disputes to the tune of INR 5000 crore under Mutual Agreement Procedure (MAP) of Tax Treaties on 16th February

United Nations, Department of economic and Social Affairs (2013), *United Nations Practical Manual on Transfer Pricing for Developing Countries,* New York

LATEST ICRIER'S WORKING PAPERS

NO.	TITLE	AUTHOR	YEAR
324	FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION (FSLRC) & FINANCIAL SECTOR REGULATION IN INDIA	JAIMINI BHAGWATI M. SHUHEB KHAN RAMAKRISHNA REDDY BOGATHI	JUNE 2016
323	URBAN WATER SYSTEMS IN INDIA: A WAY FORWARD	MIHIR SHAH	MAY 2016
322	SURVEILLANCE OF CHRONIC DISEASES: CHALLENGES AND STRATEGIES FOR INDIA	UDAYA S MISHRA S IRUDAYA RAJAN WILLIAM JOE ALI MEHDI	MAY 2016
321	PREVENTION OF CHRONIC DISEASES: REORIENTING PRIMARY HEALTH SYSTEMS IN INDIA	ALI MEHDI DIVYA CHAUDHRY PRIYANKA TOMAR PALLAVI JOSHI	MAY 2016
320	INNOVATION (AND UPGRADING) IN THE AUTOMOBILE INDUSTRY: THE CASE OF INDIA	SAON RAY SMITA MIGLANI	MAY 2016
319	THE IMPACT OF GLOBAL LABOUR STANDARDS ON EXPORT PERFORMANCE	KUNTALA BANDYOPADHYAY	MAY 2016
318	FACILITATING INDIA-PAKISTAN TRADE THROUGH THE LAND ROUTE	NISHA TANEJA ISHA DAYAL SAMRIDHI BIMAL	MAY 2016
317	ESTABLISHING INDIA'S NATIONAL TRADE FACILITATION COMMITTEE- A PROPOSAL	NISHA TANEJA SHRAVANI PRAKASH SAMRIDHI BIMAL	MARCH 2016
316	AN ANALYSIS OF NEPAL'S TRANSIT THROUGH INDIA	NISHA TANEJA SAMRIDHI BIMAL ISHA DAYAL	MARCH 2016
315	EFFECTS OF GOVERNMENT INVESTMENT SHOCKS ON PRIVATE INVESTMENT AND INCOME IN INDIA	JAGANNATH MALLICK	FEBRUARY 2016
314	IMPOSITION OF MAT ON SEZS: CONCERNS AND THE WAY FORWARD	ARPITA MUKHERJEE BHAVOOK BHARDWAJ	FEBRUARY 2016
313	TECHNOLOGY, JOBS AND INEQUALITY EVIDENCE FROM INDIA'S MANUFACTURING SECTOR	RADHICKA KAPOOR	FEBRUARY 2016

About ICRIER

Established in August 1981, ICRIER is an autonomous, policy-oriented, not-for-profit, economic policy think tank. ICRIER's main focus is to enhance the knowledge content of policy making by undertaking analytical research that is targeted at informing India's policy makers and also at improving the interface with the global economy. ICRIER's office is located in the institutional complex of India Habitat Centre, New Delhi.

ICRIER's Board of Governors includes leading academicians, policymakers, and representatives from the private sector. Dr. Isher Ahluwalia is ICRIER's chairperson. Dr. Rajat Kathuria is Director and Chief Executive.

ICRIER conducts thematic research in the following eight thrust areas:

- Macro Management Financial Liberalization and Regulation
- Global Competitiveness of the Indian Economy
- Multilateral Trade Negotiations and FTAs
- Challenges and Opportunities of Urbanization
- Climate Change and Sustainable Development
- Physical Infrastructure including Telecom, Transport and Energy
- Asian Economic Integration with focus on South Asia
- Promoting Entrepreneurship and Skill Development

To effectively disseminate research findings, ICRIER organises workshops, seminars and conferences to bring together academicians, policymakers, representatives from industry and media to create a more informed understanding on issues of major policy interest. ICRIER routinely invites distinguished scholars and policymakers from around the world to deliver public lectures and give seminars on economic themes of interest to contemporary India.