BALANCING INVESTMENT ATTRACTIVENESS AND CHECKING ABUSE

A COMPARATIVE STUDY OF INDIA AND CHINA

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Investment is important

'Private international capital flows, particularly foreign direct investment, along with international financial stability, are vital complements to national and international development efforts. Foreign direct investment contributes toward financing sustained economic growth over the long term. It is especially important for <u>its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship, and ultimately eradicate poverty through economic growth and development. ……..</u>'

'To attract and enhance inflows of productive capital, countries need to continue their efforts to achieve a transparent, stable and predictable investment climate ……' (Monterrey Consensus, 2002)

Tax policy affects investment

- ‘Tax policies are obviously capable of affecting the volume and location of FDI, since, […..] higher tax rates reduce after-tax returns, thereby reducing incentives to commit investment funds.’ (Gordon and Hines (2002))

- Effective average tax rates tend to play a significant role in discrete location choices; the decision to increase existing capital in one country is influenced by the marginal effective tax rate; and differences in statutory tax rates appear to play a significant role in the location of taxable income.(Devereux (Data appendix by Maffini) (2006))

Meta-analysis by de Mooij and Ederveen (2003) shows a median tax rate elasticity of foreign capital of −3.3 - i.e. a 1%- point reduction in the host-country tax rate raises foreign direct investment in that country by 3.3%. According to them FDI seems more responsive to effective or average tax rates than to statutory tax rates.

Tax policy affects investment

- 'Complexity and uncertainty, in the sense of multiple tax rates, indeterminate language in the tax law, and inconsistent changes in the tax laws have a significant negative effect on inward foreign direct investment.' (Edmiston, Mudd and Valev (2003))

But also bear in mind that:

- 'Inbound FDI is recognised as being attracted by macroeconomic stability; a supportive legal and regulatory framework; skilled labour and labour market flexibility; well- developed infrastructure; and business opportunities tied to market size (with profitability of the domestic market tied to the purchasing power of the population, and foreign markets reached via an extensive network of trade agreements).

In other words, a number of non-tax factors are central drivers to FDI decisions.' (OECD, 2007)

Tax policy affects investment

‘For policy-makers and academic researchers alike, accurate estimates of the FDI response to host country taxation are difficult to make, given the need to consider jointly tax and non-tax factors in different locations, and the prospect that the tax elasticity of FDI may vary considerably across business activities, host countries and time. Indeed, a complicating factor is that the possible impact of host country tax on FDI will differ across countries with varying host country characteristics (non-tax factors).’ (OECD, 2007)

[…] additional empirical work required to better understand the role of taxation amongst key factors influencing FDI location decisions.’ (OECD, 2007)

Tax Competition is a reality

Trend of falling statutory corporate tax rates in developing as well as developed countries. More intense amongst developing countries? (Keen and Simone, 2004)

Since the 1980s, globalization and greater capital mobility have led many developing countries to adopt the policy of competing with one another to attract capital investment. One of the main forms taken by this competition has been the granting of tax holidays and other tax reductions to investing multinationals. (Avi-Yonah, 2001)

Aggressive/Abusive practices to reduce or escape tax liability are also a reality

Tax evasion

Tax avoidance - 'Sliding scale of legitimacy'

The challenge

'[…] is striking an appropriate balance of policy considerations in devising rules that adequately protect the tax base […] without imposing excessive compliance costs on firms, or otherwise hampering normal business operations.' (OECD, 2007)

Difficult but not impossible

Case study
Taxation of capital gains

Focus – 'Anti-abuse provisions' in bilateral tax treaties and domestic laws applied to bring capital gains arising in transactions involving non-residents in the host country's tax net.

Countries under study

a) India – The 'not so successful' story.
b) China – The success story.

Ranks	*Country*	*2010-11 (April - March)*	*2011-12 (April - March)*	*2012-13 (April – Sept.)*	*Cumulative Inflows (April '00 - Sept. '12)*	*%age to total Inflows (in terms of US $)*
1.	**MAURITIUS**	31,855 **(6,987)**	46,710 **(9,942)**	34,139 **(6,259)**	323,610 **(70,428)**	**38 %**
2.	**SINGAPORE**	7,730 **(1,705)**	24,712 **(5,257)**	6,151 **(1,120)**	83,739 **(18,273)**	**10 %**
3.	**U.K.**	12,235 **(2,711)**	36,428 **(7,874)**	3,153 **(592)**	77,814 **(17,061)**	**9 %**
4.	**JAPAN**	7,063 **(1,562)**	14,089 **(2,972)**	7,305 **(1,320)**	65,156 **(13,633)**	**7 %**
5.	**U.S.A.**	5,353 **(1,170)**	5,347 **(1,115)**	1,492 **(273)**	49,382 **(10,837)**	**6 %**
6.	**NETHERLANDS**	5,501 **(1,213)**	6,698 **(1,409)**	5,242 **(968)**	37,567 **(8,078)**	**4 %**
7.	**CYPRUS**	4,171 **(913)**	7,722 **(1,587)**	1,538 **(284)**	31,208 **(6,683)**	**4 %**
8.	**GERMANY**	908 **(200)**	7,452 **(1,622)**	2,354 **(430)**	23,182 **(5,051)**	**3 %**
9	**FRANCE**	3,349 **(734)**	3,110 **(663)**	1,419 **(260)**	14,797 **(3,187)**	**2 %**
10.	**U.A.E.**	1,569 **(341)**	1,728 **(353)**	556 **(100)**	10,876 **(2,343)**	**1 %**
TOTAL FDI INFLOWS *		**97,320 (21,383)**	**165,146 (35,121)**	**70,132 (12,845)**	**845,138 (183,825)**	**-**

India-Mauritius DTAA

Origin of the problem

- Effective date - 1 April 1983 (India) and 1 July 1983 (Mauritius).
- <u>Problem area – Article 13 (4</u>) - Allocates exclusive taxing rights in all cases other than the limited ones covered in the Article to the country of residence of the alienator.

Net implication of this - By virtue of the DTAA, gains arising to a resident of Mauritius from a alienation of shares of an Indian company were taxable exclusively in Mauritius. However, Mauritius has no capital gains taxed. Thus, essentially, the gains were not taxed any where.

Note: This is not the general treaty position of India with respect to Article 13. More than 75% of India's treaties have provisions modelled on Article 13(4) and (5) of the UN Model Tax Convention (UN Model), thus allowing a country to tax gains from alienation of shares of a company resident in that country.

India-Mauritius DTAA

Origin of the problem

1991-1992 - Liberalisation of Indian economy and Mauritius Offshore Business Activities Act, 1992 (MOBAA) enacted in Mauritius. Companies incorporated under MOBA 'resident' of Mauritius but subject to no income tax there.

Circular 682 of 30.3.1994 issued by Central Board of Direct Taxes (CBDT) - Capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius taxation laws and will not be liable to tax in India. This position was taken by India after MOBAA came into force.

Relying on this, a large number of FIIs, resident in Mauritius, invested large amounts of capital in shares of Indian companies with expectations of making profits by sale of such shares without being subjected to tax in India.

Why did India agree to such a treaty provision in the India-Mauritius DTAA?

JPC 2002 – '[…]main objective to give encouragement to mutual trade and investment'

CAG 2005 – '[…in view, perhaps of the fact that Mauritius was a less developed country than India and had long standing special relationship with India.'

SC – '[…] so called 'abuse' of 'treaty shopping'' perhaps 'intended' when DTAA was entered into.

India-Mauritius DTAA

Origin of the problem

- March 2000 – Assessing Officers in Mumbai issued show cause notices to some FIIs as to why they should not be taxed for profits and for dividends accrued to them in India.

- Basis of notice – Though these companies were incorporated in Mauritius under MOBAA, they were actually residents of other countries like Luxembourg, UK and USA – essentially recipients of income arising in India were ‘shell companies’ operating through Mauritius only to take advantage of the India-Mauritius DTAA. According to the Assessing Officer, as these FIIs were not bonafide residents of Mauritius, they were neither residents of Mauritius, nor of India and so benefits of India-Mauritius DTAA were not available to them.

- Alleged reaction – ‘Panic-driven withdrawal of funds’ by FIIs.

- Indian FM’s Press Note of April 2000 – ‘[…] views taken by some of the income-tax officers pertained to specific cases of assessment and did not represent or reflect the policy of the Government of India with regard to denial of tax benefits to such FIIs.’

- Circular 789 of April 2000 - Clarified that wherever certificate of residence is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence (which would also apply in case of capital gains on sale of shares) as well as beneficial ownership for applying DTAC accordingly.

Azadi Bachao Andolan, 2004

The SC's decision

- Treaty overrides domestic laws.
- 'Liability to tax' not the same as 'payment of tax' as the condition of 'residence' and hence entitlement to treaty benefits.
- Access to treaty benefits even if it means no taxation of gains at all.
- Treaty shopping must be checked by suitable term of limitation incorporated in the treaty – Not for court to take action in that regard.
- 'Legal form' cannot be ignored.
- Tax planning is legitimate in India. 'Shams' or 'colourable devices' prohibited.

Comments: Court stressed heavily on importance of 'attracting investment' for a country like India.

How true was the 'alleged reaction'?

CAG 2005 – 'Appraisal of transactions in capital markets during November 1999 and 2000, as highlighted in Reports of SEBI indicates that was neither substantial decrease in investment consequent to denial of benefits to a few third country based companies investing through Mauritius by Mumbai's Assessing Officers, nor marked increase after issue of Circular 789 in April 2000. However, fluctuations in market at the same time were simply attributed to this action and fear created that there will be huge investment outflows.'

JPC 2002 – Revenue loss through Mauritius route 'substantial'.

Post *Azadi-Bachao Andolan*

Position of Revenue and of the Adjudicating bodies

- Repeated attempts by Revenue to apply additional factors, beyond TRC, to decide on access to benefits of the India-Mauritius DTAA
- Various cases - example - *E* Trade Mauritius* case - The AAR relied on Circular 789 and Azadi Bachao and concluded that that a Mauritian TRC was at least a 'presumptive evidence of the beneficial ownership of the shares and the gains arising therefrom', even if it did not give rise to a conclusive presumption. However, questioned the logic of TRC being made a determining factor to infer beneficial ownership – asking itself if there was an 'inextricable nexus' between the two.
- According to the AAR, particularly in light of *Azadi Bachao*, the motive of tax avoidance was not relevant so long as the act is done within the framework of law, 'treaty shopping' through conduit companies is not against law and the lifting of corporate veil is not permissible to deny the benefits of a treaty.
- However, in the AAR's view, it 'looks odd' that the Indian tax authorities are not in a position to levy the capital gains tax on the transfer of shares in an Indian company. And this, according to it, was 'an inevitable effect' of the 'peculiar provision in India-Mauritius tax treaty, the Circular issued by CBDT and the law laid down by Supreme Court in *Azadi Bachao* case'.

Post *Azadi Bachao Andolan*

Timeline of efforts to re-negotiate India-Mauritius DTAA

- JPC Report 2002 shows that problem realised by India in 1993 – However efforts could not make much headway – fear of diversification of Mauritius based funds to other markets .
- 2005 - India first proposes re-negotiation of the India-Mauritius treaty.
- 2006 – (Joint Working Group (JWG) to put in place 'adequate safeguards' to prevent misuse of the treaty. With this objective India proposed amendment to the effect that: 'the benefit of the capital gains exemption in the source country be limited to the companies that: 1) are listed on a recognized stock exchange; or 2) have a total operational expenditure of not less than USD 200,000 in the residence state in the immediately preceding period of 24 months from the date the gains arise.'
- Mauritius does not agree to the amendment.
- 2012 – After seven rounds of agreement Mauritius showed willingness to agree to Limitation of Benefits (LoB) in the treaty but wants 'sanctity of Article 13' to be maintained. Possible trigger – General Anti-Avoidance/ Abuse Rule (GAAR) 2012?
- August 22-24 2012 talks of the JWG largely inconclusive – everything seemed to hinge on the GAAR.
- Shome Committee Report, 2012 – Where treaty has LoB, GAAR will not apply. In case of India-Mauritius DTAA, GAAR provisions shall not apply to examine the genuineness of the residency of an entity set up in Mauritius.
- FM's recent announcement and subsequent clarification.

How has India fared in other similar situations?

- Such situations were found in treaties with Singapore, Cyprus, and UAE.
- India-Singapore treaty- 1994 version of the treaty followed Article 13 (5) of the UN Model.
- By 2005 Protocol, treaty amended to reflect same position as with Mauritius. But anti-abuse provision also provided.

Article 3 of the Protocol**:** 1. A resident of a Contracting State shall not be entitled to the benefits of Article 1 of this Protocol if its affairs were arranged with the primary purpose to take advantage of the benefits in Article 1 of this Protocol.

2. A shell/conduit company that claims it is a resident of a Contracting State shall not be entitled to the benefits of Article 1 of this Protocol. A shell/conduit company is any legal entity falling within the definition of resident with negligible or nil business operations or with no real and continuous business activities carried out in that Contracting State.

3. A resident of a Contracting State is deemed to be a shell/conduit company if its total annual expenditure1 on operations in that Contracting State is less than S$200,000 or Indian Rs 50,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 24 months from the date the gains arise.

4. A resident of a Contracting State is deemed not to be a shell/conduit company if: (a) it is listed on a recognised stock exchange2 of the Contracting State; or

(b) its total annual expenditure on operations in that Contracting State is equal to or more than S$200,000 or Indian Rs 50,00,000 in the respective Contracting State as the case may be, in the immediately preceding period of 24 months from the date the gains arise.

How has India fared in other similar situations?

- Article 6 of the Protocol – Article 13 of the India-Singapore treaty to remain the same till Article 13 of the India-Mauritius DTAA has the same position.
- Part of larger ‘Comprehensive Economic Cooperation Agreement’ (CECA).
- In 2006, Singaporean tax authorities were reported to have received representations from several financial service companies who have said that the definition of a ‘shell company’ as contained in the protocol to the tax treaty is proving to be restrictive. Many of these companies have special purpose vehicles (SPVs), which are not covered by the twin conditions had again asked for a re-negotiation to bring the treaty completely at par with India-Mauritius DTAA.
- No such change brought about while signing amending Protocol of 2011.
- Cyprus-India treaty - Mauritius like situation – same treaty provision and no capital gains tax in Mauritius.
- In 2007, it was reported that India would like to include LoB clause in the treaty to prevent possible abuse of Article on capital gains.
- Reported in 2008 that consensus had been reached to amend the treaty in order to tax capital gains earned by a resident of Cyprus from disposal of shares of Indian companies, in India.
- No reports of any further progress.

How has India fared in other similar situations?

- India-UAE treaty – Amending Protocol of 2007 provided:

 - gains from the disposal of shares of a company, which primarily holds immoveable property in a state, may be taxed in the state in which the immoveable property is located; and

 - gains from the disposal of shares in a company, which is a resident of the state, may be taxed in the state which the company is resident of.

- Also, LoB clause inserted – 'An entity, which is a resident of a contracting state, is not entitled to the benefits of the tax treaty if the main purpose or one of the main purposes of establishing the entity was to obtain the benefits of the treaty (i.e. conduit companies).' Cases of legal entities not having bona fide activities are covered by this Article.
- Amending Protocol of 2012 – Details not in public domain yet. Has Article 13 been reverted to pre-2007 position? - http://gulfnews.com/business/economy/uae-india-fix-double-tax-problem-1.1010536

Post *Azadi-Bachao Andolan*

Position of the SC - *Vodafone* case, 2012 – SC's decision

- Legitimacy of tax planning in India and SC's position in *Azadi Bachao* upheld. 'Form' and not the' economic substance of a transaction determines its economic liability. Revenue to invoke the 'substance' over form' test only when it is able to establish on the basis of the facts and circumstances surrounding the impugned transaction that it is a 'sham or tax avoidant'.
- Difference between 'pre-ordained' transaction created for tax avoidance purposes and transaction that evidences 'investment to participate' – Six factors that can help differentiate – 'participation in investment, duration the holding structure, the period of business operations in India, the generation of taxable revenues in India, timing of exit and the continuity of business on such exit'.
- 'Look at' legal nature of transaction as a whole rather than adopting a 'dissecting approach'.
- If the parent exercises 'such steering interference with subsidiary's core activities that the subsidiary can no longer be regarded to perform them on the authority of its own executive directors' or if a non-resident enterprise makes an indirect transfer through 'abuse of organisation form/legal form and without reasonable business purpose' which results in tax avoidance, then the existence of the companies of the group may be ignored as a device or conduit.

Post *Azadi-Bachao Andolan*

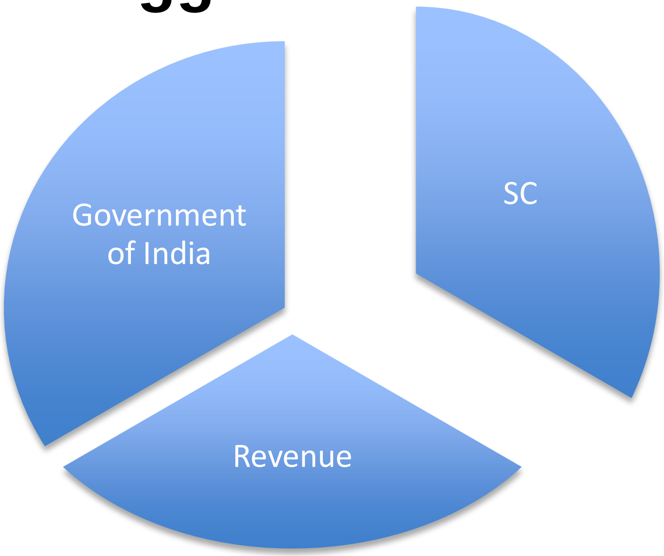
Position of the SC - *Vodafone* case, 2012 – SC's decision

- Section 9 (1) of the IT Act cannot not be interpreted as a 'look through provision' and cannot be used to bring gains arising from indirect transfers of Indian assets within India's tax net.
- 'Situs' of shares where company incorporated.
- The court held that the $11.1 billion acquisition by VIH only contemplated a transfer of CGP and assignment of certain loan obligations. The other rights identified with the Revenue vested with the other downstream entities and were not legally transferred. However, as they were an integral part of the transaction, the acquisition of CGP allowed VIH to indirectly benefit from such rights.
- **Note:** SC's observations on importance of maintaining investor-friendly climate - concerns at all levels – from certainty and stability in the fiscal system that can enable the taxpayers to know where their stand, respect for common practices and principles in international business and taxation, to the beneficial role that jurisdictions such as Cayman Islands or Mauritius can play for a developing country like India, in terms of it becoming beneficiary of large-scale investment routed from them. With this, the court was not oblivious of the potential of abuse. But saw it the duty of the legislature to take appropriate legislative action in this regard rather than resort to such abrupt measure such as in Vodafone.

Post *Vodafone*

Changing positions, resulting tensions and perception of aggressiveness

Government's gradually changed position - Transaction that essentially generates it value from within India, in this case by virtue of underlying assets here, must pay taxes in India and should not be allowed to take advantage of investment structures spanning over multiple jurisdictions to escape them.



Position in *Vodafone* an extension of that in *Azadi Bachao*

In case of India-Mauritius DTAA had already tried to introduce additional grounds to deny access to treaty benefits. After Vodafone ready challenge other high value transactions - Transactions under the scanner include SABMiller's acquisition of Foster's India, Vedanta Group's purchase of a majority stake in Sesa Goa through the acquisition of Finsider International, and General Atlantic and Oak Hill Partners' buyout of GE's 60% stake in Genpact.

Post *Vodafone* - Changing positions, resulting tensions and perception of aggressiveness – Intensifying factors

Finance Bill 2012 - Retrospective amendment – 'Clarified' meaning of transfer under section 2 (47), and of 'through' and 'asset' under Section 9(1) - Result – Position in law deemed to have provided for taxation of gains arising from indirect transfers of Indian assets since 1961.

- GAAR introduced - Wider than 2009 and 2010 drafts of the Direct Tax Code (DTC).

Internationally unprecedented action - Vodafone's 'Notice of Dispute' to the Government of India under the India-Netherlands Bilateral Investment Protection Agreement (BIPA) – Violation of legal protections granted to Vodafone under BIPA - Asks the Indian government to abandon retrospective aspects of the proposed legislation

- Finance Ministry's reaction – No action on the Notice.

Other strong international reactions - Government's 'back-door attempt' to get Vodafone and many others into the tax net by altering the very basis of the SC's decision

- Creating uncertainty.

Then prevailing economic climate - GDP growth had slowed to 5.3 per cent in the fourth quarter of 2011-12, as compared with 9.2 per cent in the corresponding quarter of the previous year. Global recession was hitting the export growth and both oil and non-oil imports were widening trade and current account deficits. International investors, partly because of the challenges they were facing elsewhere in the world, were holding back investments, which adversely affected the rupee, which was already weakened by the rising current account deficit, leading to sharp depreciation of the currency. In April, Standard and Poor, lowered India's credit rating outlook from 'negative' to 'poor' stating slowing GDP growth and 'roadblocks to reforms' as the causes. Similarly, Fitch lowered India's credit rating outlook to negative, citing corruption, inadequate reforms, high inflation and slow growth.

Post *Vodafone*

Changing positions, resulting tensions and perception of aggressiveness – And then?

Things were proceeding in the normal course – DTC Discussion Papers and drafts of 2009 and 2010

DTC 2009 – Envisaged to improve the efficiency and equity of the Indian tax system by eliminating distortions in our tax structure, introducing moderate levels of taxation and expanding the tax base. Three fold strategy was adopted to broaden the tax base included minimising exemptions, checking ambiguity in tax law by a periodic rewriting of the Tax Code in the light of new trends in interpretation by the judiciary, aggressive tax planning by taxpayers, and new opportunities for reducing compliance cost and checking tax evasion .

Two main aspects –

1) Section 5(1)(g) - Introduced as a source rule for taxing indirect transfers. Seeks to tax income arising from transfer of shares of a foreign company India if assets in India, held directly or indirectly by the company, represent at least 50% of the fair market value of all the assets owned by the foreign company. The 50% test is to be applied at any time during the 12 months prior to transfer. (DTC Bill, 2010)

2) GAAR – 'All tax avoidance, like tax evasion, is economically undesirable and inequitable'. It was recognised that tax avoidance spanning across jurisdictions was leading to 'severe erosion' of India's tax base and that courts and appellate authorities had been placing a 'heavy burden' on the revenue in dealing with such matters. In this scenario, it was thought 'necessary and desirable' as well as 'consistent with international trend', to introduce a GAAR that would serve as a 'deterrent against such practices'. (DTC Discussion Paper, 2009)

Post *Vodafone*

Changing positions, resulting tensions and perception of aggressiveness – And then – Worse off than being back to square one?

<u>Casualty No. 1 – GAAR</u> - 2010 Discussion Paper to the 2010 DTC Bill – Highlighted concerns regarding - '[…] absence of distinction between tax mitigation and tax avoidance' as any arrangement to obtain a tax benefit could be considered an impermissible voidance arrangement. To avoid its arbitrary use, the following legislative and administrative safeguards were suggested: 1) CBDT will issue guidelines to provide for the circumstances under which GAAR may be invoked; 2) GAAR provisions will be invoked only in respect of an arrangement where tax avoidance is beyond a specified threshold limit; and 3) The forum of Dispute Resolution Panel (DRP) will be available where GAAR provisions are invoked. However, the 2010 Direct Code Bill was introduced in the Parliament without any of these changes.

<u>First blow</u> – GAAR introduced suddenly in the Finance Bill, 2012. Purpose test in 2009 and 2010 drafts of GAAR required that the main purpose of the arrangement must be to obtain tax benefit. But in the introduced GAAR 'main purpose or one of the main purposes is to obtain a tax benefit'. Definition of commercial substance was also left out. - Broad and vague language that made its scope unclear.

<u>Draft GAAR Guidelines 2012 CBDT</u> – Suggestion for monetary threshold for invocation of the GAAR, where only part of arrangement is impermissible, tax consequences of an impermissible arrangement to be limited to it, onus of proving that there is an impermissible avoidance arrangement on the Revenue, constitution of Approving Panel amongst other changes.

Post *Vodafone*

Changing positions, resulting tensions and perception of aggressiveness – And then – Worse off than being back to square one?

Second blow - Shome Committee Report 2012 – Although some useful suggestions, GAAR has been deferred for 3 years. The Committee recognised that the 'poor response to the GAAR in India was attributable to the somewhat more stringent drafts put out by the government between 2009-2012, as well as the perceived lack of adequate consultation with stakeholders.' GAAR is an extremely advanced instrument- 'one of deterrence, rather than for revenue generation ' – for which intensive training of tax officers, who would specialise in the finer aspects of international taxation, is needed. In the Committee's view lack of preparedness of India in this respect does not guarantee that an environment of certainty can be regenerated with an immediate application of GAAR, however modified.

Amongst other recommendations - Only arrangements, which have the main purpose, and, not one of the main purposes of obtaining tax benefit should be covered under GAAR; Section 97 amended to include definition of 'commercial substance'; monetary threshold of Rs. 3 crore of tax benefit (including tax only, and not interest etc.) to a taxpayer in a year; grandfathering all investments by residents and non-residents existing on the date of commencement of GAAR provisions so that on exit (sale of such investments) on or after this date GAAR provisions are not invoked for examination or denial of tax benefit; GAAR provisions shall not override treaty; where Circular 789 applies GAAR provisions shall not apply to examine genuineness of residency of entity set up in Mauritius; distinction between tax mitigation and tax avoidance and negative list for invocation of GAAR.

Comments: Consultation – Hallmark or lop-sided? – Uncertain future?

Post *Vodafone*

Changing positions, resulting tensions and perception of aggressiveness – And then – Worse off than being back to square one?

Casualty No. 2 – Amendments to Section 2(47) and Section 9 - Uncertain future
Shome Committee - Recommendation to apply the provisions prospectively – However, in case the Government decides to proceed with retrospective application then amongst other recommendations – No person should be treated as an assessee in default under Section 201 read with Section 9(1)(i) of the Act as amended by Finance Act, 2012, or as a representative assessee of a non-resident in respect of transfer of shares of a foreign company having underlying assets in India as this would amount to the imposition of a burden of impossibility of performance. This would imply that the Government could apply the provisions only to the taxpayer who earned capital gains from indirect transfer. Also no interest or penalty to be levied where demand raised on account of retrospective amendment.

No announcement in this regard till now.

Casualty No. 3 – Direct Taxes Code – Uncertain future
FM's Budget Speech 2013 – 'The Standing Committee on Finance has submitted its report and we attach great weight to its recommendations. My team in the Ministry of Finance is examining the recommendations and I intend to work with the Standing Committee and its Chairman in order to finalise the official amendments. I shall endeavor to bring the Bill back to this House before the end of the Budget Session.'

Post *Vodafone*

Changing positions, resulting tensions and perception of aggressiveness – Impact on investment inflows

No stark change in pattern of FDI inflows could be detected in 2012 so as to attribute a significant negative impact only to changes in tax laws.

General overall reduction in investment inflows as compared to past years - Multiple factors highlighted in FM's budget speech of 2012 – A cumulative effect.

Vodafone case – From Bombay HC to the SC and post-*Vodafone* developments and the blame for uncertainty – Affects investment attractiveness.

UNCTAD's World Economic Investment Report, 2012 states that major global companies consider India their third most favourite investment destination after China and the US and investment flows are expected to increase by more than 20% in this year and next.

Nagesh Kumar, Chief Economist, United Nations Economic and Social Commission for Asia and the Pacific, while commenting on India's poor economic performance and the role post-*Vodafone* developments have played in it said that compared to many other places, India is doing better in terms of growth. According to him, 'corporate investors look at long term prospects and recent controversies over retroactive tax proposals broadly aimed at taxing companies like Vodafone, or proposed general anti-tax avoidance rules (GAAR) would not hurt India's prospects as an investment destination.

COUNTRY 2

CHINA

WHAT MAKES IT A SUCCESS STORY?

Unit: US$ 100 million

Country/Region	No.of Project	Share %	Realized FDI Value	Share %
Total	27420	100	1147.34	100
Hong Kong	13070	47.67	605.67	52.79
Virgin Islands	761	2.78	104.47	9.11
Singapore	781	2.85	54.28	4.73
Japan	1762	6.43	40.84	3.56
U.S.A	1502	5.48	30.17	2.63
R.O.K	1695	6.18	26.92	2.35
Cayman Islands	109	0.40	24.99	2.18
Taiwan Province	3072	11.20	24.76	2.16
Samoa	409	1.49	17.73	1.55
France	183	0.67	12.38	1.08
Mauritius	102	0.37	9.29	0.81
the Netherlands	117	0.43	9.14	0.80
Germany	364	1.33	8.88	0.77
U.K.	278	1.01	7.10	0.62
Macao	274	1.00	6.55	0.57
others	2941	10.73	164.17	14.31

Denial of treaty benefits

Xingjiang Case

- In March 2003 Xingjiang Company A and Uruqmi Company B established a Company C, which was engaged in manufacture and sale of LPG. A and B contributed 97.5 and 2.5 % respectively.
- In July 2006, companies A and B entered into joint venture agreement with a Company D – a company established in Barbados in May 2006 and wholly owned by a US company, under which D would purchase from A 33.32 % of equity interest in C for USD 33.8 million. As a result of this transfer Companies A, B and D held 64.18, 2.5 and 33,32 % of equity interest in C respectively.
- 27 days after the transaction was over, A applied to increase and subscribe to additional registered capital of C. The amount it paid for this was equivalent to the purchase price that was paid to it by D to purchase equity interest in C. As a result, Companies A, B and D came to hold 73.13, 1.88 and 24.99% of equity interest in C respectively.
- In June 2007, D transferred to A all of its interest in C for a consideration of USD 45.968 million and derived capital gains of $12.7 million.
- The then Article 13 (4) of the China-Barbados tax treaty limited limited taxability of gains to country of residence of alienator. Guo Fa [2000] – Treaty takes precedence over domestic law. On behalf of D, A applied to local taxation Board claiming treaty benefit.
- State Tax Administration (SAT) – 1) Company D not ‘resident’ of Barbados and hence not entitled to treaty benefits; 2) ‘Commercial purpose’ or ‘economic substance’ of the transaction - Sale of D’s shares to A represented a pre-determined arrangement between the parties. D had purchased shares of Co C from A only one month after its establishment. SAT could not find any independent operational objective for Co D’s investment in C. And the period of time between Co A’s selling and re-purchasing the shares of C was a very short. Together all these factors led the SAT to conclude that the parties were abusing the Barbados-China treaty.

Denial of treaty benefits

***Chongqing* case**

- Singapore Company, owned a Singapore SPV, which in turn held 31.6 % interest in Chinese target. In 2008, the Singapore Company sold the its 100 per cent shareholding in the Singapore SPV to a Chinese resident company for RMB 63.38 million, realising a gain of RMB 9 million .
- Commonly accepted principle - Source of income from a share transfer is determined by the place where the shares are situated. Based on the 'legal form' of the transaction , the target company being transferred was a non-resident, and therefore capital gains derived by the Singapore resident Company from this transaction were not 'sourced' in China . Hence, *prima facie*, China did not have the right to tax them.
- Chongqing State Taxation Board (CSTB) - In its investigations the CSTB found that the total capital of SPV amounted to only S$100SPV and it had 'no real business operation' other than holding 31.6% equity interest in the Chinese target Company. On this basis it proceeded to ignore the legal form of the transaction. It disregarded the Singapore SPV for tax purposes and concluded that 'substance' of this transaction was a transfer of equity interest in Chinese target Company. Accordingly, it imposed a withholding tax on capital gains as 'Chinese source income' and the Singapore parent had to pay income tax in China at a 10% rate on the capital gain from the sale as if it had sold the Chinese subsidiary directly.

The controversy – Legal basis of these decisions?

***Xingjiang* case** - Pre 2008 decision – No LoB in China-Barbados tax treaty and no anti-abuse provision in prevailing domestic tax legislation – Foreign Enterprises Income Tax Law – then on what basis did China deny treaty benefits to company D?

***Chongqing* case** – Pre-2008 transaction – Investigation and decision in 2008 - China-Singapore tax treaty – 1986 treaty replaced by new treaty in 2007, which became effective from January 1, 2008 – No possibility of taxation under Article 13(5) of either 1986 treaty as that provides for right to tax in case of alienation of shares of company or legal person 'resident in that State' (unless Article 13 (5) interpreted in a very broad way to cover indirect participation) – Gains in all other cases taxable exclusively in the country of residence of alienator. Such interpretation is in dispute even of the wording in the Article 13(5) of the new treaty which is based on Article 13 (5) of the UN Model and provides for taxation by a Contracting State of gains arising to resident of another Contracting State if 'direct or indirect' participation of at least 25% in the capital of the company or other legal person', held by a resident of the contracting state, in a company resident in the other contracting state at 'any time during the twelve-month period preceding the alienation'. UN Model sheds no light on it.

New treaty - Article 26 - States that 'nothing in the agreement shall prejudice the right of each contracting state to apply its domestic law and measures concerning prevention of tax avoidance, whether or not described as such, in so far as they do not give rise to taxation contrary to the agreement.'. If Chinese tax authorities proceeded to tax on the basis of Article 26 of the new treaty – Static interpretation – Could not do so as there was no anti-abuse provision in the then prevailing domestic law – But if ambulatory interpretation then GAAR in the Enterprise Income Tax Law (EITL) of 2008. Official Report of the case not clear on this.

International legal position – OECD Model Tax Convention's Commentary to Article 1 – Paragraph 7.1 and 9.2 and 9.3.

The controversy

Legal basis of these decisions? – Familiar reactions?

PricewaterhouseCoopers - '[…] when these two cases were unveiled, many [multinational companies], tax practitioners, and general business communities were astonished, because *there was no legal basis in the domestic tax legislation … for the Chinese tax authorities to take such stance at that time.* Both transactions took place before 2008 and the former tax regime, [the] *Foreign Enterprise Income Tax Law, did not provide the legal basis for the Chinese tax authorities to challenge such holding structures and transactions using [tax avoidance] factors*.'

'[…] in the absence of an article in the current Barbados-China tax treaty allowing China to apply the anti-avoidance measures in its domestic tax law, it may be technically difficult for the Chinese tax authorities to unilaterally challenge it.'

'[…]]he CSTB [Chongqing State Tax Bureau] … make reference to the principle of 'Substance over Form' when they argued that the Singaporean SPV had no commercial substance (lacking personnel, assets and operations) and the main purpose of the transfer of this SPV['s] shares by the Singaporean holding company was just to dispose of the Chinese investments. As a result, the CSTB disregarded the existence of the Singaporean SPV. Then the CSTB went on to determine that the source of the capital gain on [the] equity interest transfer in the hand[s] of the Singaporean holding [company] should be China. *The CSTB made such an argument and determination as if the GAAR under the CIT regime and the Measures were in place before 2008.*'

The controversy

Legal basis of these decisions? – Familiar reactions but a key difference – EITL and post EITL legal framework

The EITL came into force on January 1, 2008. Two key objectives – protecting China's tax base and using tax policy as an instrument in promoting sustainable development. Chapter VI of the EITL dedicated to 'special tax adjustments' This chapter contains transfer pricing rules, thin capitalization rules, CFC rules, and a general anti-avoidance rule (GAAR).

<u>Article 47 – GAAR</u> – 'if an enterprise enters into any 'business arrangement without bona fide commercial objectives' that 'results in reduced taxable revenue or income', the tax authority is entitled to make adjustments based on reasonable methods'. Article 120 of the *Regulations for Implementation of Enterprise Income Tax Law* , explains the term 'without reasonable commercial purpose' as referring to where the 'main purpose is reduction, exemption or deferral of tax payments'.

<u>Article 48</u> of the EITL subjects the tax arrears due to adjustments to taxable income, made in accordance with the provisions of this Chapter, to additional interest as stipulated by the State Council. Article 121 of the Regulations explains that the underpaid tax shall be subject to interest levy on a daily basis until starting from June 1 of the tax year following the year to which the tax payment is related until the day the underpaid tax is settled.

EITL - Supplementary legal framework

GAAR supplemented by Articles 92-94 of the *Guoshuifa* (2009) No. 2 – *Circular on the Implementation Measures of Special Tax Adjustments* (Circular No. 2), issued by the SAT - Article 92 of the Circular states that pursuant to Article 47 of the CIT Law and Article 120 of its Implementation Rules, the tax authorities can launch a general anti-avoidance investigation on enterprises where the following tax avoidance arrangements are identified: (i) Abusive use of tax preferences; (ii) Abusive use of tax treaties; (iii) Abusive use of the forms of enterprise organization; (iv) Tax avoidance by means of tax havens; (v) Other arrangements without reasonable business purposes.

Article 93 instructs the tax authorities to follow the ‘substance over form’ principle and take into account the following factors to determine whether the GAAR applies to a particular arrangement: (i) The form and the substance of an arrangement; (ii) The time and effective period of an arrangement; (iii) The implementation method of an arrangement; (iv) The connection of each step or part of an arrangement; (v) The changes in each party’s financial situation involved in an arrangement; (vi) The tax result of an arrangement.

Article 94 permits them to redefine or re-characterise it in accordance with the enterprise’s ‘economic substance’ and cancel the tax benefit obtained by the enterprise from such a tax avoidance arrangement. The article further provides that in cases where the enterprise is without economic substance, particularly those incorporated in tax havens and enabling tax avoidance by their related parties or non-related parties, the tax authorities are empowered to deny its existence from a tax collection perspective. Targeted at conduit companies, this part of the article would allow the tax authorities to ‘look-through’ such an entity and make the transaction subject to tax in China.

EITL - Supplementary legal framework

‘*Guo Shui Han [2009] No. 698 - Notice on Strengthening the Administration of Enterprise Income Tax on Share’ Transfer Income of Non-resident Enterprises*’

Circular 698 – Issued by SAT on December 10, 2010. Effective retroactively as of January 1, 2008. The main rationale behind its introduction was to prevent foreign investors from circumventing the EITL’s position on taxation of capital gains by non-resident investors.

In case of indirect transfers of equity in a Chinese company, where the intermediary is located in a jurisdiction that has an ‘effective rate of tax’ is less than 12.5% or where such jurisdiction does not levy any tax on ‘foreign source income’, Article 5 of the Circular stipulates that the foreign investor must provide the following documents to the competent tax administration within 30 days of signing of the equity transfer contract: (1) Equity transfer contract or agreement; (2) Relationship between the foreign investor and the non-resident intermediate company in terms of capital, business and purchase and sale; (3) Statuses of production and operation, personnel, finance and properties of the intermediate company; (4) Ties of the intermediate company and the Chinese resident enterprise in terms of capital, business and purchase and sale; (5) Explanations for reasonable commercial purpose of the establishment of the intermediate company; and (6) Other related documents required by the taxation administration.

Article 6 of the Circular – If the intermediate company lacks ‘reasonable commercial purpose’, and has been established for tax avoidance purposes, then the competent taxation administration may re-characterise the transaction in accordance with its ‘economic substance’. After reporting to the SAT for examination and approval, the tax authorities may be permitted to ‘look-through’ the intermediate company and accordingly impose Chinese capital gains tax.

EITL - Supplementary legal framework

'*Guo Shui Han [2009] No. 698 - Notice on Strengthening the Administration of Enterprise Income Tax on Share' Transfer Income of Non-resident Enterprises*'

Earned strong criticism from the business community - Lack of clarity on the scope of various key terms used therein – 'Indirect equity transfer' not defined; unclear what tier of holding structure or what percentage of equity being transferred will trigger action by the tax authorities; lack of clarity on how the 'effective tax burden' of an enterprise was to be ascertained and what would constitute 'foreign source income' for the purpose this Circular; did not make it clear as to what would constitute 'adequate substance', which made it difficult for investors to structure their operations through the use of intermediate entities; heavy compliance burden it imposed by way of extensive information requirements; the fact that it applied retroactively, made it particularly onerous for the businesses that had made indirect transfers in that period.

On March 28, 2011 SAT released *Bulletin 24* - Clarifies the tax treatment of non-resident enterprises, particularly in relation to indirect transfers of the shares of a Chinese entity. Explains what is meant by 'foreign investor', 'effective tax burden' and 'foreign-source income' for the purposes of this Circular. How tax authorities would interpret 'reasonable commercial purpose' and 'substance' still unclear.

EITL - Supplementary legal framework

Guoshuihan [2009] No. 601 (Circular 601)

Issued in October 2009. When a treaty resident applies for treaty benefits in respect of dividends, interests, royalties, etc., 'beneficial owner' has to be considered - A 'Beneficial Owner' is an individual, company or other organisation that has the ownership and control over the relevant income in question (e.g. dividends, interests, royalties etc.), or has the ownership and control over the assets or rights employed for the purpose of generating the relevant income.

As a 'Beneficial Owner' will generally conduct genuine business operations, agents and conduit companies are not regarded as 'beneficial owners' - Conduit companies are companies that are established for the purpose of avoiding tax, reducing tax, transferring profits or accumulating profits. Such companies are only established in the corresponding jurisdictions to fulfill the legal requirements as a formality, but they do not conduct actual business operations such as manufacturing, sales, management, etc. It would seem that an "intermediate holding company" established for pure investment holding purposes would be seen as a conduit.

'Substance over form' approach in determining treaty resident as a beneficial owner - Factors that may jeopardise the recognition of a Treaty Resident as a Beneficial Owner - The Treaty Resident applying for treaty benefits ('the applicant') is obligated to remit most of the relevant income (say, above 60% of the income) to the third country/jurisdiction residents within an agreed timeframe (for example, within 12 months of the receipt of the particular income); apart from owning and controlling the assets or rights employed to generate the PRC sourced income, the applicant does not conduct or almost not conduct other business operations; . In case the applicant is an entity (such as a company), the entity only has a limited amount of assets, operating scale and number of employees, and the above do not match with the income generated; The applicant does not have control over the assets or rights employed to generate the relevant income, and it bears no risks or almost no risks associated with the assets or rights; amongst others.

Criticism – These requirements caused lots of problems for foreign investors with genuine business reasons to set up SPVs to hold investments in China.

EITL - Supplementary legal framework

Circular 601 – Announcement 30

On 29 June 2012, the SAT released Announcement [2012] No. 30 (Announcement 30) to provide further clarifications on the implementation of (Circular 601). Some clarifications:

For the determination of whether beneficial ownership exists seven negative factors listed in Circular 601 shall be 'collectively' considered, which means a tax authority should not deny an application purely because the applicant's failure in a single 'negative factor' assessment.

Taxpayers cannot use a lack of tax avoidance motive as an argument to escape from applying the factors.

In reviewing the factors, Announcement 30 stresses the importance of reviewing various legal and financial documents, including articles of association, financial statements, board minutes and resolutions, functional analyses, legal contracts, asset ownership certificates and invoice registers.

A company that is a tax resident of a DTA partner state and is listed in that jurisdiction (Listed Parent) will automatically satisfy the beneficial ownership criteria in respect of PRC dividends received.

Subsidiaries that are wholly owned by the Listed Parent, directly and/or indirectly, and are tax residents of the same DTA partner state, may also be automatically regarded as the beneficial owners of any PRC dividends they receive. However, if the subsidiary is indirectly held by the Listed Parent through an intermediate holding company that is not a tax resident of the DTA partner state, this safe harbour will not be available.

Post-EITL legal framework

Taken strongly to anti-abuse route to bring indirect transfers within China's tax net

***Jiangsu* Case –** Article 25 of Hong Kong-China Tax Arrangement and Article 13 of the SAT's Circular on Interpreting and Implementing Some Clauses in the Arrangement between Mainland China and Hong Kong – Lead to EITL and Circular 698 – Using notion of 'substance', SAT could extend its tax net to transactions essentially taking place outside the country and between non-residents.

***Fujian* Case –** Circular 601 principles applied in case of capital gains. Both horizontal structures and structures directly below the non-resident considered to determine participation of a non-resident in a Chinese resident company, although such declaration by Chinese tax authorities in relation to the Hong Kong for application of Article 13(5). Focus on 'economic reality' - Article 25 of the Hong Kong-China Arrangement – leads to GAAR – enforcing obligation under Individual Income tax Law (IITL)?

***Shenzhen* Case –** Hong Kong-China Arrangement - GAAR and Circular 698 **–** But both are a part of EITL framework not IITL? the Report of the case refers to it as a 'breakthrough' in tax practice. It further states that the case will 'advance the development of tax legislation', 'overcome the bottleneck of applying tax anti-avoidance amongst different taxes' and be seen as a milestone in achieving 'fairness ' and as an exercise of China's sovereignty over its taxing right.

***Xuzhou* Case -** Despite holding valid tax resident certificate Barbados entity asked to establish that it was 'effectively managed' from Barbados and was the 'beneficial owner' of gains.

***Shanxi* case –** GAAR and Circular 698 – Largest tax imposition in an offshore indirect transfer case.

Relevant treaty changes successfully negotiated

Hong - Kong China Tax Arrangement, 2006 – Article 13 on the lines of Article 13 of the UN Model **-** Article 25 - Miscellaneous Provisions – 'Nothing in this Arrangement shall prejudice the right of One Side to apply its domestic laws and measures concerning tax avoidance, whether or not described as such. For the purpose of this Article, "laws and measures concerning tax avoidance" includes any laws and measures for preventing, prohibiting, avoiding or resisting the effect of any transaction, arrangement or practice which has the purpose or effect of conferring a tax benefit on any person.'

China - Singapore Income Tax Treaty, 2007 – Article 13 on the lines of Article 13 of the UN Model **-** Article 13(4) and (5) and anti-abuse wording; Article 26 - Miscellaneous Rule **– '**Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the Agreement. No such rule in the 1986 treaty.'

Relevant treaty changes successfully negotiated

China - Macau Tax Agreement, 2003 - Article 13 on the lines of Article 13 of the UN Model and anti-abuse wording inserted in Article 13(4) and (5) by 2010 Protocol. Also ‘Miscellaneous rule’ inserted as Article 27 that provides – ‘Nothing in the arrangement shall prejudice the right of each contracting party to apply its domestic laws and measures concerning the prevention of tax avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the arrangement.’

Barbados - China Tax Treaty, 2000 - Article 13 on the same lines as Article 13 of the UN Model. Anti-abuse wording added in Article 13(4) and 13(5) by virtue of the 2010 Protocol. The protocol provides that the treaty does not prevent a contracting state from the application of its domestic anti-evasion or anti-avoidance rules on the condition that the application is not in conflict with the provisions of the treaty.

China – Mauritius Tax Treaty, 1994 - Article 13 on the same lines as Article 13 of the UN Model. Article 13(5) amended in 2006 to introduce anti-abuse wording.

Introduction of a strong anti-abuse focus in domestic laws and in treaties and the impact on investment inflows

1) Foreign enterprises are responding to the law by reducing their investment in China; and
2) The magnitude of the response is larger for Hong Kong – Macau – Taiwan (HMT) investment enterprises than that for other foreign enterprises, which supports the claim that some Chinese investors engaged in 'round tripping'.

- (Zhiyong An, 2011)