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India at the Crossroads

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India is an emerging economic and political power. While currently ranked ninth in terms of the gross domestic product, as one of the faster growing economies, it is expected to rank as high as third or fourth within the next 25 years.

Today, India is at the crossroads. While the country's technical resources have attracted many top foreign multinational enterprises (MNEs) and led to a burgeoning high-tech sector and the birth of a number of home-grown multinationals, it is still starved for foreign investment to continue fueling its engine growth to expand the ranks of its middle class and raise the living standards of its vast population.

In seeking to attract foreign investment, and the continued investment of foreign companies currently doing business in India, the country is walking a fine line. India wants international investment, but it also wants to change the rules, specifically the tax rules, that currently prevail in the international community. It has challenged the industrialized member-state Organisation for Economic Co-operation and Development (OECD) model treaty framework and its basic tenets regarding the rights of resident and source countries, and called into question the conditions of permanent establishment. This not only has created consternation and disagreements among sovereign trading partners, but moreover uncertainty for multinationals and foreign businesses operating or considering operating in India.

India has every right to challenge the existing framework. Indeed, the world has changed dramatically since principles underlying the model treaty were first laid down shortly after the League of Nations in 1920s. (For an enlightening historical retrospective, see Brett Wells and Cym Lowell, "Tax Base Erosion and Homeless Income", Tax Law Review, Vol. 3, No. 65.) The OECD and the G-20 recognize the current system—with its numerous deficiencies that enable multinationals to shift profits, not only out of emerging economies, but out of developed economies as well, with little or no tax paid to any country—is in need of repair, and have called for a comprehensive and fundamental review (see OECD, Base Erosion and Profit Shifting study). India is to a certain extent engaging in nothing more than protecting its own self-interest to preserve (or secure) its taxing rights and, accordingly, its fair share of tax revenues.

However, to many in the business and international tax community, the rhetoric and actions of India are as troubling as they are confusing. Though it is an official observer and regular commentator to OECD pronouncements, India is not a member of the OECD and is not bound by the OECD model treaty or its Transfer Pricing Guidelines (OECD Guidelines). Still it is signatory to a number of double tax avoidance agreements formulated in reference to the OECD model, and its own domestic transfer pricing rules follow the same principles and employ most of the same pricing methodologies of the OECD Guidelines. At the same time, its tax officers and lower tax courts have undertaken aggressive and contrary positions on a number of cases across a variety of international tax areas, including permanent establishment (PE) doctrine, royalty characterization and characterization of service providers, with the combined effect of creating a de facto source-based tax regime.

A few examples of assessments and rulings that are transforming the Indian tax regime:

- The Income Tax Appellate Tribunal held that a U.K.-based MNE had a PE in India due to the marketing activities of its Indian subsidiary.
- A back-office processing subsidiary of a foreign-based MNE was held a PE.
- A foreign firm performing services in India constituted a PE, even with less than 183 days presence.
- A foreign company serving Indian customers via servers located in India is likely to be held a PE in India.
- The Income Tax Appellate Tribunal found that a distributor’s software payment is a royalty, subject to withholding tax.
- The Delhi Income Tax Appellate Tribunal held that licenses to use “off the shelf software products” were “licenses” and payments that constituted royalties under Indian withholding tax rules, regardless of whether they could be characterized as sales under U.S. shrink regulations or the OECD model.

Despite these rulings, the Indian courts, and most important the Supreme Court, have maintained the international norm that the attribution of profit to a PE is still limited to the arm’s length compensation based on the functions, risks and assets employed in the source country.

Vodafone: A Case of Mixed Signals

The one case that best exemplifies the quixotic state of India’s international tax environment and the mercurial nature of India international tax policy is that of Vodafone. The dispute originated from Vodafone’s 2007 acquisition of a majority stake in Hutchison Essar Ltd. (HEL) from the Hong Kong-based Hutchison Whampoa Inc. (Hutchison Group).

The Hutchison Group owned a 67 percent controlling interest in HEL through CGP Investments (Holdings) Limited (CGP), a Cayman Islands company owned by another Cayman Island company, Hutchison Telecommunications International Holdings Ltd. (HTIL). Vodafone entered into an agreement with HTIL to acquire CGP for roughly USD 11.1 billion.

The Indian government subsequently claimed Vodafone was an assessee in default, with a tax liability of USD 2.6 billion, for failure to withhold tax on its payment for Hutchinson shares, as most of the assets were based in India and local tax law requires buyers to withhold on capital gains tax liabilities. Vodafone countered that the acquisition was of the shares, and India law limits gains from the transfer of capital assets to only assets situated in India. (At the time of the transaction, India law had no provision to look-thru a purchase to the location of the underlying assets.) Moreover, given that the transaction involved the transfer of share(s) of a non-resident entity to another non-resident entity, there was no nexus to impose a withholding obligation in India under Section 195 of the Income Tax Act (I-T Act).

After a five-year legal battle that included a key loss in the Bombay High Court, in which the court took a “telescopic” view that capital assets within India possess “income deemed to accrue or arise” from India and such income was sufficient to create nexus, the Supreme Court of India issued a simple and direct holding that the tax office had no jurisdiction.

Under Indian law, non-resident tax is assessed on the transfer of a capital asset if, and only if, three elements exist: (1) transfer, (2) existence of a capital asset and (3) the location of the asset in India. Moreover, the court held that at the time of the transaction the right of the Indian tax office could not be inferred (to extend) to indirect taxation, as that provision was only added by the Direct Tax Code in 2010. Similarly, the imposition of look-thru (to underlying assets) or the limitation of benefits could not be invoked without specific government enactment.

Shortly thereafter, India’s Ministry of Finance introduced new legislation in its Finance Bill of 2012 to retroactively impose the necessary provisions to overturn the Vodafone decision, and provide its tax officers the authority to reexamine and reassess countless other foreign multinational entities’ tax files. Fortunately, the resulting outcry of the business and international community was so strong and swift, both in reaction to the contravention of the ruling and to the overly broad and retroactive application of the law, the government quickly tabled the provision.

And Another Thing

In the latest twist the government has leveled another tax assessment against Vodafone in the amount of USD 244 million, based on the underpricing of share capital. A similar USD 2.9 billion assessment has also been leveled on the Indian subsidiary of a major multinational oil & gas firm.

Notices went out in late January 2013 to several others, including Indian companies with foreign subsidiaries, for similar “underpricing” of shares in fiscal year 2008–2009.

These latest assessments appear to emulate from an earlier, separate ruling (Castleton Investment Limited - AAR No.999 of 2010) by India’s Authority for Advance Ruling (AAR). As per that ruling, transfer pricing rules shall apply to share transactions between foreign companies even when income is not chargeable under the I-T Act. Sections 92–92F of the I-T Act relating to transfer pricing require only two conditions to be met if a transaction is to be brought under the transfer pricing rules, namely, the transaction should be (1) international and (2) between associated parties. Section 92 states that “Any income arising from an international transaction shall be computed having regard to the ‘arm’s length price’.” The AAR, a quasi-judicial tax authority, also has ruled in other recent orders that the country’s transfer pricing rules shall apply to share transfers between foreign parents and affiliates of Indian companies and to buybacks.

As per the transfer pricing order to the major multinational oil & gas firm in March 2009, the company issued equity shares to its holding company based in the Netherlands, amounting to 867 million shares issued at the price of Rs.10 (USD 0.18). The order disputes the price at which the shares were issued to the parent company and values the oil & gas firm’s shares at Rs.183 (USD 3.37). The order also disputes the valuation method adopted by the companies for pricing shares issued to their group companies. The valuation carried out by the issuing company applied the net asset value method. However, the Indian income tax authorities insisted on the use of the discounted cash flow method for the valuation. The firm’s holding company originally paid an amount of about USD 160 million for the new share subscription. However, applying India’s Income Tax Department’s (ITD) method, the multinational oil & gas firm is presumed to receive a value of USD 2.922 million for its investment. For the purposes of its tax calculation, ITD is treating the difference between the actual investment made and ITD's estimate as an interest-free loan granted to the holding company by the oil & gas firm, on which the firm would have otherwise earned taxable interest income.

As expected, the order has created quite a stir in the international investor community with the chairman of the oil & gas firm's India entity, publicly stating her displeasure: "Taxing the money received … is in effect a tax on foreign direct investment (FDI), which is contrary not only to law but also to the spirit of the recent global trip by the finance minister, as he attempts to attract further FDI into India."

The tax authorities completed transfer pricing assessments for fiscal year 2008–2009 in January 2013, which covered orders sent out due to the alleged under-pricing of issued shares. Share issuance is a common practice of funding a subsidiary in India and globally. Being a common practice, similar transactions of numerous other companies can be assumed to have taken place in the prior assessment periods for which no retrospective action can be taken to avoid falling under the tax evasion parameters. Accordingly, a panic has set in among the international community regarding the impending onslaught of tax assessments, with U.S. critics worrying that overly aggressive tax authorities could undermine future investments into India.

Which Way From Here?

India has made no secret of its opposition to the existing residence-based tax regime, and the administrative prescriptions and economic principles espoused by developed economies and embodied in the OECD Guidelines. Yet, these are largely the same principles and guidelines of its own current tax regime. So while it would prefer a new international order, one that recognizes the large and growing potential of emerging economies, and the contributions of human capital/labor that these economies provide, it has not made clear what such an order would look like or, more important, how it would interface with the existing order.

At present, businesses are confounded and uncertain how to integrate the tax regimes of their home countries with the ever-changing regime of India. As a result, businesses are reluctant to invest or expand their current investment in India. Foreign governments, too, are frustrated and reluctant to engage India on a way forward without a clear policy position. The United States, one of India's most important trading (and political) partners with more than 140 unresolved bilateral tax cases, has expressed an unwillingness to move forward on any of the U.S.-India cases waiting to be resolved.

Numerous trade associations and business groups, as well as individual multinationals, have appealed to the Indian government to moderate its positions, and specifically for the United States and India to bridge their differences and formally engage the system.

India, for now, has opted to engage directly with taxpayers, proposing a new unilateral Advance Pricing Agreement Program—the government has indicated that some 20 corporations have initiated pre-filing consultations—that it says will be independent of the tax audit offices, with apparently a different, prospective only, perspective. Whether this perspective is based on the existing internationally accepted principles of the taxpayer's home country or on the modified principles of the Indian tax regime is anybody's guess. (As a general matter Advance Pricing Agreement cases are not made public, unless the taxpayer chooses to do so.) However, given that such agreements are unilateral, it is also uncertain whether the taxpayer's home country government would accept the conclusion as arm's length.

For its part, the United States has cautioned its taxpayers that it is unlikely to accept any unilateral agreement concluded with the Indian government, meaning companies could be subject to double tax.

For foreign-based companies doing business in India, the way forward is anything but clear and that cannot be good for business, India or the international community.

This newsletter was developed with contributions from a member of American Appraisal's financial valuation practice: Varun Gupta, managing director. American Appraisal has teamed with McDermott's international tax and transfer pricing practice to deliver transfer pricing solutions on a global basis.

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