YEAR IN REVIEW 2015
The year 2015 was a momentous year for the Indian economy. Economic growth picked up, interest rates fell, albeit marginally, and several reform measures were announced, especially in the area of foreign investments. While several big ticket reform initiatives remain stuck, the momentum of last year will hopefully pave the way for bigger and bolder reforms in the year 2016.

In this year’s review, we discuss in detail some of the key issues that affected businesses in 2015 and set the tone for developments in the coming year. We discuss nine broad topics that address key developments as well as issues that we worked on in the course of the year as we helped our clients navigate through challenging tax and regulatory issues.
YEAR IN REVIEW: 2015

FROM OUR CEO

As I pen this preface, I happen to be reflecting on the newspaper headlines of the last few weeks. Two headlines, in particular, stand out—‘India to remain fastest growing - World Bank’ and ‘Crude under $35 lowest since ‘04’. More than a year and a half after the NDA government was voted to power on the promise of bringing in “Acche Din”, I believe that these are powerful indicators of India’s economic outlook changing for the better.

The year 2015 was by most measures a very eventful year. We had our share of natural disasters (the floods in Chennai and the earthquake in parts of Bihar and Nepal) and political surprises (in the Delhi and Bihar State Assembly elections) as well as proud moments, with Obama visiting India during our Republic Day celebrations, and India finally outpacing China in economic growth. The Prime Minister’s hard sell of the government’s flagship ‘Make in India’ campaign and his relentless drumming-up of investment in India during his many overseas visits were also highlights of the year.

The year also saw remarkable activity on the tax front. 2015 began with the government announcing that it would accept the decision of the Bombay High Court in the Vodafone case regarding the non-applicability of transfer pricing to share issues. This put an end to what threatened to escalate into a large scale controversy affecting multiple taxpayers. During the year, several circulars were issued that were aimed at making the tax regime simple and predictable. For the first time, an in-house mechanism was set up to deal with taxpayer grievances against high-pitched assessments. It has also been reported that the outcome of appellate proceedings in respect of orders passed by officers will be a factor in their performance appraisal going forward. This step by itself is likely to be a game changer. The year also saw a record number of Advance Pricing Agreements (APAs) signed, a revival of the Mutual Agreement Procedure (MAP) process, and significant disposals of tax cases by the specially constituted tax bench of the Supreme Court. Committees to deal with contentious issues such as applicability of Minimum Alternative Tax (MAT) to foreign companies and for the simplification of the Income-Tax Act were also steps in the right direction. Very rarely has India seen so much activity on the tax reform front!

As we look towards 2016, we are certain to see a lot more action on the tax front. The forthcoming budget will be an important one with the proposed lowering of the tax rate and the phasing out of incentive regimes likely to dominate headlines. Issues such as the forthcoming General Anti-Avoidance Rules (from 2017-18), the applicability of Place of Effective Management (POEM) Guidelines, the impact of the BEPS outcomes and complications arising from Income Computation and Disclosure Standards (ICDS) (if not deferred based on the recommendation of the Easwar Committee) are likely to occupy CFOs, tax heads and tax professionals alike in the coming year.

The big let-down of 2015 was the failure to pass the Goods and Services Tax legislation. With political consensus still proving elusive, the implementation of GST in the near future seems challenging. One hopes that 2016 will see progress towards this very important goal. Another important action item for the government should be the revival of the Authority for Advance Rulings. With the pace of rulings having slowed down drastically over the last few years, there is an urgent need to constitute additional benches to bring down the large pendency of cases.

All in all, 2016 will prove to be a crucial year for the government. One hopes that the momentum of 2015 will lead to more far reaching reforms in the coming years. The stage is set and the world is watching! Over to the Finance Minister!

Dinesh Kanabar
CEO
TABLE OF CONTENTS

YEAR IN REVIEW: 2015
1. A tale of two budgets – legislative developments and agenda
2. Trends in the Supreme Court’s direct tax jurisprudence
3. Shades of grey– the judiciary on the form v. substance debate
4. Navigating tax disputes – challenges and opportunities
5. The role of tax in M&A transactions
6. Transfer pricing – the road ahead
7. BEPS and India – what to expect?
8. Open doors – the impact of new foreign investment norms
9. Indirect taxes - trends and outlook
10. About Dhruva
A tale of two budgets – legislative developments and agenda

The year 2015 saw the unveiling of the first full-fledged budget by the NDA government. The Finance Minister had a formidable task of presenting a budget that could live up to the sky high expectations of the investor community at large while simultaneously tackling the burgeoning fiscal deficit.

The budget for 2015-16 was a mixed bag at best. On the one hand, the government brought in much-awaited clarity on the taxation of indirect transfers but on the other, they introduced a strict residency test for foreign companies and made key changes to the ‘income’ definition to include subsidies of all kinds. In a first, the Finance Minister announced the government’s intention to bring down corporate tax rates to 25 per cent over a four year period (commencing from financial year 2016-17) while simultaneously eliminating various tax incentives. The highlights of the key legislative changes that were introduced in the last budget and some expectations for the upcoming budget in February 2016 are set out below.

With respect to the taxation of gains arising on indirect transfers, the Finance Act, 2015 provided that indirect transfer provisions in India will be triggered only if the value of the Indian assets exceeds INR 10 crores and if it represents at least 50 per cent of the value of the total assets of the foreign company. The valuation methodology for this is to be separately prescribed, and is still awaited. Specific exemptions were provided for the non-taxability of gains arising on (a) amalgamations/demergers undertaken outside India subject to meeting certain conditions; and (b) for small shareholders holding less than a 5 per cent stake and not having management and control. However, no tax neutrality was provided for the taxation of gains in the hands of foreign shareholders of amalgamating or demerged companies or for the transfer of listed company shares. One hopes that this gap will be corrected in the forthcoming budget.

The most far reaching amendment brought by the Finance Act, 2015 is perhaps the ‘Place of Effective Management’ (POEM) as the test for determining corporate residency. A foreign company is now regarded as a resident in India if its POEM in that financial year is in India. POEM is defined to mean a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are, in substance, made. Recently, (as promised in the Explanatory Memorandum), draft guiding principles for the determination of POEM were released for public comments. While the guidelines are undoubtedly helpful, the concept of POEM remains extremely subjective in its application and may lead to litigation. There have also been calls for deferring POEM by one or two years to enable industry to adapt better to the new regime.

The Finance Act, 2015 also made a change to the definition of ‘Income’ so as to include any assistance in the form of subsidy or grant or cash incentive or duty drawback or waiver or concession or reimbursement by the central or state government or any authority or body or agency. As a result, any such assistance received by a taxpayer is regarded as taxable income. Given the wide reach of this provision, it could potentially undermine the very purpose of government agencies providing assistance to taxpayers under various promotional schemes. It is also likely to have a direct impact on the economic viability of projects, especially at a time when the government is actively promoting India as a global manufacturing hub under the ‘Make in India’ campaign. Businesses will need to pay close attention to the impact of this amendment on their tax positions. Particularly, in cases of companies which enjoy incentives from state governments and local authorities in the form of sales tax deferral schemes, concessional land, electricity, stamp duty benefits etc., the impact of this amendment on effective tax rates could be significant.

Another much talked about issue that dominated the news this year relates to the applicability of Minimum Alternative Tax (MAT) to foreign companies, and specifically, Foreign Institutional Investors (FIIs) and Foreign Portfolio Investors (FPIs). The Finance Act, 2015 excluded foreign companies from the ambit of MAT on a prospective basis in respect of specified streams of income. However, the prospective application of this law, led to much uncertainty as to the applicability of MAT to prior years, particularly when notices began to be issued to FIIs/FPIs in respect of their MAT liability for earlier years. To its credit, the government responded swiftly and decisively to investor concerns, and based on the recommendations of the A.P. Shah Committee clarified that MAT will not apply to any foreign company if it was a resident of a country having a tax treaty with India and did not have a permanent establishment/place of business in India. It was also stated that an appropriate amendment to this effect would be carried under the law. Taxpayers can expect this amendment to form part of the budget 2016-17.
With a view to bring more stability in the tax regime, the Finance Minister in his budget speech, announced the intention of the government to **reduce the corporate tax rate** from 30 per cent to 25 per cent over the next four years. However, this reduction of rates will be accompanied by a corresponding phase-out of **tax exemptions and deductions**. A roadmap for phasing out of incentives has been released for public comments. While the phase-out itself is proposed to be made on a gradual basis, the proposed withdrawal of key incentives such as the weighted deduction for Research and Development (R&D) activities has been met with some disappointment. With most governments around the world providing incentives for R&D, there is widespread expectation that this incentive will be retained. Amendments in this regard will be keenly awaited in the forthcoming budget. Emphasizing the need to simplify the existing income-tax law, the government recently set up a committee to identify clauses that lead to litigation and to suggest modifications to bring about predictability and certainty in tax laws. This committee has submitted a preliminary report for stakeholder comments, which may be incorporated into the forthcoming budget.

Last but not least, certain aspects of the **OECD BEPS Action Plans** could also find a place in the forthcoming budget. For instance, measures relating to action plans on transfer pricing (especially country-by-country reporting), Controlled Foreign Companies, the prevention of abuse through use of hybrid instruments, the digital economy, limiting interest deductions, etc. are being evaluated by the government and the possibility of some of these recommendations being enacted in this budget remains high.

With increased pressure on the government to speed up the pace of reforms, and the limited role of the Rajya Sabha (where the government does not enjoy a majority) in the annual budget exercise, the forthcoming budget offers the perfect platform for initiating bold reform measures. With GST and other key reforms stuck in Parliament, the budget also offers an excellent opportunity for the government to showcase its reform credentials. Whether these expectations are met, and whether this budget paves the way for ‘Acche din’ for the Indian economy, remains the billion-dollar question.
Trends in the Supreme court’s direct tax jurisprudence

By most measures, 2015 was a year of landmark developments at the Supreme Court of India. The Court had occasion to deal with several path breaking cases including notably the validity of the National Judicial Appointments Commission and the constitutionality of section 66A of the Information Technology Act.

On the tax front though, the year 2015 was fairly subdued, especially if one were to compare it with the last few years when the Supreme Court decided several of the most important tax cases in its history such as the Vodafone case and the validity of the National Tax Tribunal. However, this is not to say that nothing of importance happened in the Supreme Court this year. The court decided several cases, each significant in its own right, and the principles emerging from them will undoubtedly have a far reaching impact on India’s tax jurisprudence in the coming years.

A specialised tax bench comprising Justice A.K. Sikri and Justice R.F. Nariman was set up in the Supreme Court in May 2015 to exclusively hear tax matters. With reports indicating that tax matters amount to nearly 18 per cent of all cases pending in the Supreme Court, the decision to set up a dedicated bench with judges of proven tax expertise is a very helpful one. In fact, results are already visible, with the number of tax cases heard and disposed of by the Supreme Court showing a marked increase post May 2015.

Another important trend that is highlighted in the tax cases heard by the Supreme Court this year concerns the type of cases that are entertained by the court. Even if one were to ignore the hundreds of Special Leave Petitions (SLPs) that are routinely rejected by the Supreme Court every year, many cases heard by it do not involve weighty and complex questions of tax jurisprudence. Several involve questions of fact (e.g. Mangalore Ganesh Beedi Works v. CIT where the court had to determine whether expenses incurred by the taxpayer were for protecting the business or for personal reasons), concern the interpretation of contracts (ONGC v. CIT) or require the mere application of earlier Supreme Court decisions to the case at hand (CIT v. Bhagat Construction Co., Chennai Properties & Investments Ltd. v. CIT and CIT v. Victory Aqua Farm Ltd.). If this trend continues, one runs the risk of not only overburdening the Supreme Court, but also de facto turning it into simply another layer in the tax appellate hierarchy.

The delays in the Indian judicial process are highlighted in the Supreme Court deciding cases that are decades old, some dating as far back as financial year 1989-1990. Some of these cases also relate to provisions that no longer exist such as Jeyar Consultant & Investment Pvt. Ltd. v. CIT, dealing with the interpretation of section 80-HHC and CIT v. Sati Oil Udyog, dealing with the repealed section 143(1A). While the law laid down will undoubtedly help in resolving pending cases and in interpreting other similar sections, the long pendency does not augur well for taxpayers.

The decisions themselves reflect a balanced approach to tax matters. In Stock Exchange, Bombay v. V.S. Kandalgaonkar & Ors, the court reiterated the principle that government debts (including income tax dues) do not have precedence over those of secured creditors, and held that the stock exchange, having a lien over its member’s securities, would take priority over tax dues. In Fibre Boards (P) Ltd. v. CIT, the court adopted a pragmatic reading of the provisions of the General Clauses Act, and concluded that a separate subsequent notification of “urban areas” for the purposes of section 54G would not be required and that notifications issued earlier in the context of the omitted section 280Y would suffice. Similarly, in CIT v. G.M. Knitting Industries (P) Ltd., the court rejected a hyper-technical approach to procedural compliance and held that additional depreciation should be granted even though the applicable Form (i.e. Form 3AA) was not filed along with the return of income, but subsequently during the course of tax assessment proceedings.

However, in Joshi Technologies International Inc. v. Union of India, the court held that the benefit of a deduction under section 42 in respect of the business of the prospecting, etc. of mineral oil could not be granted in the absence of a specific provision to this effect in the Production Sharing Contract between the government and the taxpayer. The court concluded that such a provision was mandatory under section 42 and that the benefit could not be granted even though it was admitted by the Ministry of Petroleum and Natural Gas that the omission of such a provision in the Production Sharing Contract was due to oversight.

Another decision that will have a far-reaching impact is that of Japan Airlines Co. Ltd. v. CIT. In this case, the court was called upon to decide whether landing and parking charges paid by an airline to the Airports Authority of India was liable to withholding as ‘rent’ (at 20 per cent as alleged by the tax authorities) or as payment to contractors for...
‘work’ (at 2 per cent as contended by the taxpayer). The court concluded that notwithstanding the wide definition of ‘rent’ under section 194-I, it would be simplistic to assume that the landing and parking charges were for a simpliciter usage of land. Instead, it looked to the substance of the charges and concluded that the charges were for services and facilities in connection with aircraft operations. It therefore upheld the deduction of tax at 2 per cent under section 194C. Although this decision was in the context of a fairly narrow fact pattern involving airlines, the principle adopted here will have a bearing in several cases, most importantly in interpreting the expanded scope of the term ‘royalty’ (following the retrospective amendments made by the Finance Act, 2012). Specifically, as regards the use of equipment, this decision may support the view that notwithstanding the wide scope of Explanation 5 to section 9(1)(vi), it is only when the payment is in substance for the use of equipment that it should fall within the meaning of ‘royalty’.

Similarly, the court’s decision in CIT v. Sarkar Builders in the context of section 80-IB(10) will have an impact on several other areas of tax jurisprudence. The court in this case dealt with the issue of whether conditions prospectively introduced in section 80-IB(10) would apply to projects that were sanctioned and commenced before the date of the amendment. It held that vested rights accruing to taxpayers could not be taken away and that it was not appropriate for the tax authorities to expect taxpayers to do something that was nearly impossible. These findings could have a bearing on other cases, particularly those involving withholding obligations arising from retrospective amendments.

The court in CIT v. Sati Oil Udyog favoured the reading-down of the anti-avoidance provision in the erstwhile section 143(1A) so as to restrict its applicability only to taxpayers who attempt to evade tax. The court noted that even bona fide taxpayers could get caught within the ambit of the section (which at the relevant time provided for an additional penal tax of 20 per cent on the difference between the returned income and the assessed income). Hence, following the decision in K.P. Varghese v. ITO (1982) 1 SCR 629, it favoured a reading down of the provision.

Other significant cases decided by the Supreme Court this year include Hero Cycles (P) Ltd. v. CIT where the court upheld a deduction of interest on funds borrowed for making advances to a subsidiary. Curiously, in this case, the court followed its earlier decision in S.A. Builders Ltd. v. CIT 2007 (288) ITR 1 (SC), even though the correctness of the S.A. Builders case had been questioned in ACIT v. Tulip Star Hotels Ltd. and the issue is currently pending before a larger bench of the Supreme Court.

With an increased focus on the part of the government to reduce prolonged tax litigation, one would expect that these decisions of the Supreme Court will truly settle the law at the ground level, and that appeals in other cases on such issues can be avoided. The year 2016, of course, brings with it its own set of challenges, but one hopes that with the tax bench now firmly up and running, the Supreme Court will set the tone for the rest of the judiciary in ensuring the quick, consistent and judicious resolution of tax disputes.
Shades of grey—the judiciary on the form v. substance debate

The debate between ‘tax planning’ and ‘tax avoidance’ continues to be a controversial issue in the Indian context. While some taxpayers seek to plan their taxes by taking advantage of gaps between the black and white provisions set out in income-tax law, the tax authorities tend to look beyond the letter of the law and ascertain if the taxpayer has ‘avoided’ the payment of taxes by improper means. The distinction between ‘tax planning’ and ‘tax avoidance’ has shades of grey, and ascertaining which way a particular transaction falls can be a challenging exercise. Most controversies revolve around an alleged lack of ‘substance’ and the use of ‘colourable devices’. In the ensuing paragraphs, we have highlighted the key trends in the manner in which the judiciary has, over the last few years, dealt with this important issue.

Any discussion on tax planning and tax avoidance is incomplete without a reference to the landmark decisions of the Supreme Court in the case of McDowell & Co Ltd and Vodafone International Holdings B.V. The key principles that emerge from these decisions are:

- The McDowell decision is the foundation for a large majority of cases involving tax avoidance. This decision held that tax planning was legitimate provided it took place within the framework of law. It was held that colourable devices could not form part of tax planning and it was wrong to encourage or entertain the belief that it was honourable to avoid the payment of tax by resorting to dubious methods. The court also noted that it was the obligation of every citizen to pay taxes honestly without resorting to subterfuge.
- The Supreme court in the case of Vodafone International Holdings B.V v DIT (supra) observed that it was the duty of the court to ascertain the legal nature of a transaction and while doing so, it had to look at the transaction as a whole and not adopt a dissecting approach.

The above cases set out the broad parameters within the scope of which transactions and structures are evaluated by the tax authorities and the judiciary. While on the one hand, the tax authorities are within their rights to find out the legal nature of the transaction and in doing so it may ‘lift the corporate veil’, on the other hand, they need to look at the transaction as a whole and cannot adopt a dissecting approach. In dealing with various situations such as loan transactions, restructuring/divestments, etc., the courts have been taking divergent (and often highly nuanced) positions within these broad parameters.

Loan transactions

In the context of loan transactions, the key issue that arises is the allowability of interest expense on funds borrowed by a tax payer at a higher interest rate and thereafter lent to group companies/sister concerns at a lower interest rate. The Gujarat High Court in the case of CIT v Atir Textile (P) Limited departed from the tax authorities’ approach of splitting the transaction and disallowing a portion of the interest expenses. The High Court held that once the primary transaction of lending and borrowing and the payment of interest was found to be genuine, merely because the interest loss or an equal amount of income would not make it a colourable device.

However, recently the Mumbai Tribunal in the case of Deepak Nagji Vira v ITO disallowed a portion of interest expense on funds borrowed by a shareholder at 12 per cent and re-lent to the company at a lower interest rate of 11 per cent. The Tribunal held that the loss was self-inflicted and pre-mediated, and was nothing but a scheme to shift the losses of the company to its shareholders. In arriving at this conclusion, the tribunal did not consider the decisions of the Supreme Court in the case of Hero Cycles (P) Ltd. v. CIT and S.A. Builders Ltd. v. CIT, as well the jurisdictional Bombay High Court’s decision in the case of Vassantram Mehta & Co (P) Limited, which upheld a deduction of interest on funds borrowed by a company for making advances to its subsidiary/sister concern for business purposes.

Deemed dividend transactions

In the case of CIT v Subrata Roy, the Delhi High Court dealt with two inter-group transactions - one, an inter-group credit transaction involving the company and its financing agent firm (in which the Managing Director and partner were the same person) and two, a loan transaction between the firm and the partner/Managing Director. While seeking to apply the deemed dividend provisions, the tax authorities contended that the firm was a ‘conduit’ and that the transaction should be treated as a single transaction. The court in dismissing the contention of the tax authorities observed that the firm had a legal existence independent of the company and carried on significant commercial activity, for collecting substantial amounts. There was no nexus between the two transactions and the two transactions, i.e., one of advancing the loan (by the firm to the taxpayer) and the other of the use of the funds of the company by the firm being in reality one transaction was without any basis.

Group Restructuring

While sanctioning Schemes of Arrangement involving mergers, demergers, reconstruction, etc., the courts have been evaluating whether the main purpose of the scheme is tax avoidance. For instance, the Gujarat High Court while sanctioning a scheme for the demerger of passive telecommunication infrastructure assets in the case of Vodafone Essar Gujarat observed that the scheme was undertaken in order to achieve a commercial purpose i.e. inter alia the segregation of passive infrastructure. Thus, it could not be said to be a mere device/subterfuge with the sole intention to evade taxes. Furthermore, the court held that even if the ultimate effect of the scheme resulted in tax benefit or if the scheme was framed with

1. (1985) 3 SCC 230 (SC)
2. (2012) 341 ITR 1 (SC)
3. (2015) 230 Taxmann 104 (Guj)
4. ITA No. 268/Mum/2015
5. ITA No. 268/Mum/2015
6. 2007 (288 ITR 1) (SC)
7. (2010) 234 Taxmann 102 (Bom)
8. (2010) 35 Taxmann 355 (Del)
Interestingly, the Karnataka High Court in the case of CIT vs Wipro Limited10 could not set-off capital losses during the same period, as the taxpayer claimed a set-off of capital loss because the transactions were "incestuous". The Gujarat High Court observed that merely a motive to avoid tax, would not become a colourable device. The Bombay High Court held that if the law permitted a company to buy back its shares in more than one way, the company could not be compelled to follow only the method that resulted in the payment of tax. Since it was legally permissible for a company to buy back its shares following the procedure under section 391 of the Companies Act, the fact that this might not attract income tax should not result in it being treated as a device to evade income tax (this controversy arose since S. 115QA of the Income-tax Act, 1961 which provides for the payment of tax on the distributed income of a domestic company for the buy-back of shares, does not cover within its ambit a buy back undertaken pursuant to sections 391-394 of Companies Act, 1956).

Intra-group asset transfers

Capital losses arising on the intra-group transfer of assets has often been used by taxpayers to shelter gains. The Gujarat High Court in the case of CIT vs Special Prints Limited11 held that a transaction that was genuine and traded at a proper valuation, even if entered into with a motive to avoid tax, would not become a colourable device. The Gujarat High Court observed that merely because the taxpayer claimed a set-off of capital loss against capital gains during the same period, it could not be branded as a colourable device. Interestingly, the Karnataka High Court in the case of CIT vs Wipro Limited10 held that the purchase of shares at a higher price and their subsequent sale at a lower price within a short span of time was not legitimate tax planning and was a device adopted to evade the payment of taxes.

Similarly, the Delhi High Court in the case of CIT v Abhinandan Investment Ltd12 observed that in order to avoid the payment of taxes, the taxpayer had entered into transactions for the renunciation of rights with related group companies and held that these transactions served no business purpose other than to contrive a loss in the hands of the companies.

Specifically, in the Abhinandan Investment case, the court cited the decision in Vodafone International Holdings B.V v. Union of India (supra), and observed that in order to examine whether a transaction was a colourable device or a subterfuge, the question of whether the transaction had any reasonable business purpose would be vital. Applying this standard, the court found that these transactions with related parties were "incestuous" and had no business purpose other than to create a loss in the hands of the taxpayer to offset gains realised elsewhere. It concluded that the transaction in question was a colourable device, since at a standalone level, it purported to indicate an alienation of a right by the taxpayer, while at a group level, there had been no alienation since the rights remained within the group.

The legal principle applied by the court in this case is not new. However, its application to the specific facts of the case highlights a potential dichotomy in the treatment of transactions between group companies. If group companies are treated as separate taxpayers under law (amongst whom no consolidation is permitted), disregarding losses on intra-group transactions on the grounds that they are "incestuous" and that the benefit of the transferred assets remain within the group could lead to inequitable outcomes. This issue may therefore require further consideration, from a judicial as well as a policy perspective.

Conclusion

The debate on tax avoidance and tax planning through the use of colourable devices is likely to continue and will largely depend on the specific facts/circumstances of the case. The key trends that appear to emerge from these decisions and that are critical for taxpayers are summarised below:

• The courts are open to adopt a ‘look at’ approach for a legally valid transaction. However, the courts may require a taxpayer to demonstrate some commercial rationale for the transactions undertaken. As long as tax avoidance is not the main intention of the transaction, the transaction ought not to be treated as a colourable device.

• Intra-group transactions involving the transfer of assets are likely to be challenged on the grounds of purchase of artificial losses. Such transactions will need to be supported by adequate documentation such as valuation reports to justify the sale price, the timing of the sale transactions, the commercial expediency of the sale, etc.

The General Anti Avoidance Rules (GAAR) rules will come into effect from 1 April 2017, and through them the tax authorities will be entrusted with wide powers inter alia the re-characterisation of transactions. The key principles emerging from these decisions could provide important guidelines in evaluating situations involving tax avoidance especially under the GAAR regime.

9. (2012) 34 taxmann.com 323 (Guj)
11. (2013) 33 taxmann.com 463 (Guj)
12. (2014) 30 taxmann.com 583 (Del)
Navigating tax disputes – challenges and opportunities

Undergoing a tax audit, and following it through to litigation, is a challenging task at the best of times. This is particularly exacerbated in an Indian context where aggressive adjustments are routine and the process of litigation is long and uncertain, resulting in the blocking of substantial funds. According to numbers from the Centre for Monitoring Indian Economy, the total amount locked in tax disputes relating to listed Indian companies was INR 2,18,897 crore in the last financial year. Hence, successfully facing a tax audit in India and navigating the judicial process requires a solid understanding of the prevailing tax landscape and the typical challenges that arise in the course of assessments, as well as experience in leveraging a wide range of traditional and non-traditional dispute resolution strategies.

Surveying the landscape

The increased global focus on transparency and tax avoidance is, in many ways, seen as a vindication of India’s long standing position. Detailed scrutiny of complex transactions and arrangements and wide-ranging information requests are already the norm in tax assessments in India, and this trend is likely to continue. With countries gearing up for an automatic exchange of information regime as well as information inflows through Foreign Account Tax Compliance Act and Common Reporting Standard, one can expect to see a renewed push towards greater transparency and disclosure by taxpayers in the days ahead.

Provisions in tax treaties for the exchange of information have been in place for several years now. However, it is only in the last few years that this is being widely resorted to by tax officials, in the cases of both resident and non-resident taxpayers. In several cases, financial and other records, as well as confirmation of the amount and nature of payments, receipts etc. are being sought under this route. Such information is typically used to validate and plug gaps in information provided by taxpayers.

A characteristic feature of tax assessments in India is that they by and large tend to pick up steam in the weeks and months just before the expiry of the statutory deadline. However, one needs to be mindful that if a request is sent by the tax authorities to an overseas country for the exchange of information, the statutory deadline is extended by the time taken for such information to be received. Thus, in cases where the exchange of information process is resorted to by the tax authorities, the period of limitation for concluding tax assessments gets extended.

Even though some of the most challenging issues faced by taxpayers over the last few years, such as transfer pricing adjustments on share issues and the levy of MAT on foreign companies, have been addressed, there are several areas in the law that are ripe for litigation. In addition to the usual suspects such as section 14A, 40(a), etc., there are many recently-introduced provisions, in respect of which there is little judicial opinion. For example, the provisions relating to the taxation of indirect transfers, POEM, the taxability of income from other sources under section 56(2)(viiia) and 56(2)(viib) and the interpretation of ICDS pose serious interpretational issues, which are likely to lead to disputes in the coming days. Likewise, the provisions of section 115QA (dealing with the buyback tax) also have the potential to give rise to conflicting views, especially as regards the quantification of the tax liability. These will warrant well-informed and carefully-considered positions, either to prevent unnecessary litigation, or to prevail when litigation is inevitable.

Challenges in the tax assessment and appellate process

Complying with the information and document requests raised by the tax authorities is a key challenge in many tax assessments. These requests often tend to be very detailed, and fulfilling them requires a significant investment of time and effort. This problem is particularly acute in multinational companies, where the internal record-keeping systems (MIS) are geared towards group level consolidated reporting, rather than entity level statutory accounts. In such cases, the production of requested information and the reconciliation of supporting documents (e.g. invoices, bank statements etc.) with the tax return figures proves to be a mammoth task.

An inability to meet these requirements almost always leads to adverse inferences being drawn by the tax authorities. More importantly, exclusive reliance on legal arguments without providing the factual information/documents called for by the tax authorities also leads to adjustments at the assessment stage. Taxpayers who have made significant investments in building robust MIS/documenation systems find the process of tax assessments far easier to navigate. In such cases, the scope and quantum of adjustments made is also contained and is often restricted to pure interpretational issues, which are more easily addressed in the appellate process.

Even though India has an extremely credible judicial system, the appellate/judicial process brings with it its own set of challenges. These
include delays and the huge pendency in the courts, the costs of litigation as well as publicity/confidentiality concerns. Hence, as discussed in the ensuing paragraphs, there is a need to develop a comprehensive and holistic strategy towards tax controversy management, rather than focus only on a litigation centric stage-by-stage journey from the departmental appeals process up to the Supreme Court.

Controversy management – a holistic approach

The dispute resolution process in the Indian tax world has undergone a sea change in recent times. A few years back, tax dispute resolution was confined to the usual appellate remedies in addition to a restrictive Settlement Commission process and the Authority for Advance Rulings (AAR) for non-residents. Today, in addition to these, we have the Dispute Resolution Panel, Local Committees, High Powered Committees (dealing with specific issues such as indirect transfers), Advance Pricing Agreements (APAs), a revived Mutual Agreement Procedure (MAP) and an AAR with an expanded scope. In addition, in appropriate cases, the provisions of Bilateral Investment Promotion Agreements are also being invoked to initiate international arbitration against the government on tax matters.

This changed landscape offers a perfect platform for taxpayers to develop a customised approach for resolving their disputes with the tax authorities. Such an approach, could, inter alia, involve the following elements:

- Pre-empting disputes by taking full advantage of the APA and AAR process. Specifically, in the context of the APA process, a rollback can be considered.
- Focussing on obtaining relief at the early stages of the tax assessment/appellate process. This will involve developing robust internal systems for obtaining the information that is required by the tax office in a timely manner. It will also involve recourse to Local Committees and High Powered Committees (where appropriate) so that internal departmental processes can be fully leveraged to minimise disputes and litigation.
- Making representations through industry associations. With the government in a listening mode, there are significant opportunities to engage with it to address industry level tax issues through the issuance of appropriate circulars and clarifications. This could play a crucial role in addressing long standing issues.
- The revival of the MAP process in the past year, which could form the basis for the highly effective resolution of treaty disputes.

To sum up, navigating tax disputes in India remains a highly challenging and complex exercise. While traditional assessment and dispute resolution strategies may ultimately lead to favourable outcomes, the delays and costs involved warrant a more hands-on and proactive approach. As discussed above, a holistic approach to tax controversy management involving multiple strategies to prevent, mitigate and resolve disputes remains key to ensuring the overall success of the tax function.
The role of tax in M&A transactions

There has been increasing scrutiny of M&A deals by tax authorities worldwide, resulting in significant uncertainty for companies. The trend has continued in India as well, with the tax authorities actively scrutinising transactions and schemes relating to merger, demerger, capital re-organisations initiated under section 391-394 of the Companies Act, 1956. The key objection of the tax authorities in such cases is that these schemes are intended to avoid the applicable taxes.

Prior to 2014, such objections by the tax authorities were rare. However, they have become more frequent since then. This is, in part, the effect of the circular issued by the Ministry of Corporate Affairs in January 2014 mandating all Regional Directors (RD) to seek inputs/comments in all cases of arrangement/compromise or reconstruction/amalgamation undertaken in accordance with section 391-394 of the Companies Act, 1956 from the tax authorities and other sectoral regulators. The RD is required to issue a notice to the tax authorities seeking their comments on any such Scheme. In the case that no response is received from the tax authorities within 15 days of the notice, it is to be presumed that there are no objections to the scheme. Interestingly, the (not yet notified) provisions relating to schemes under the Companies Act, 2013 provide for companies to serve notice to tax authorities while seeking approval from the High Court. This was fast forwarded in the Companies Act through the circular.

The year 2015 saw quite a few instances of schemes being objected to by the tax authorities/RD on the grounds of alleged tax avoidance. However, in most cases, the courts proceeded to sanction the schemes, with the caveat that the sanctioning of the scheme by the court, did not in any way bind the tax authorities as far as determining the tax implications of the transaction are concerned. A few notable decisions/schemes are discussed below.

A buy-back undertaken by Capgemini India Private Limited via a scheme under section 391 read with section 100 to 103 of Cos Act was opposed by the RD on the grounds that the buy back could be effected only under Section 77A of the Companies Act, 1956/Section 68 of Companies Act 2013 and that if the scheme were to be sanctioned as such, it would result in the evasion of tax (buy-back tax as envisaged under Income-tax Act on the distributed income) and an outflow of foreign exchange. The Bombay High Court, while approving the scheme, held that a company could at its own discretion buy-back its shares, either by following the procedure prescribed under section 77A of Companies Act, 1956 or by following the procedure prescribed under section 391 read with section 100-104 of the Companies Act, 1956. The High court further held that merely the fact that a buyback under section 391 of the Companies Act, 1956 would not attract income tax and did not amount to it being a device to evade tax.

Similarly, the RD opposed the Scheme of Amalgamation filed by Casby Logistics Private Limited with the Bombay High Court on the grounds that the idea behind the framing of the scheme with a retrospective appointed date was to defeat the provisions of income tax law, and that it was a device to evade taxes and bypass provisions with respect to capital gains tax, transfers for inadequate consideration, revised returns, tax demands and assessment proceedings. The High Court, while approving the Scheme held that the tax authorities were not bound by the appointed date (as provided for in the sanctioned scheme) while deciding the validity of revised returns, or while carrying out pending or future assessments of the petitioners. In effect, the High Court invalidated the retrospective appointed date. The court, interestingly, also held that the RD was entitled to raise tax-related objections in a scheme of amalgamation even when no objections had been received from the tax authorities.

Likewise, another interesting Scheme of Arrangement was filed by Sterling Holding Resorts (India) Limited (SHRIL), Thomas Cook Insurance Services (India) Limited (TCISIL) and Thomas Cook (India) Limited (TCIL) with the Bombay High Court to inter alia approve the demerger of an undertaking of SHRIL on a going concern basis and its transfer and vesting in TCISIL. The consideration for such demerger was to be made good by TCIL, the parent company of TCISIL, through the issue of shares to shareholders of SHRIL. The RD opposed the scheme on two grounds: (a) that the scheme was against the provisions of the Income-tax Act, 1961 (IT Act) having regard to the definitions of ‘demerger’ and ‘resulting company’ as envisaged in the IT Act, and (b) the section 394 of the Companies Act, 1956 required that only a transferee company (viz TCISIL of the present case) could allot shares towards consideration for a transfer, and not any other person (viz TCIL). The Bombay High Court while approving the scheme, held that the court was in no manner accepting that the scheme, as framed, complied with the provisions relating to demerger within the meaning of the IT Act and it was open to the tax authorities to assess the company as such. On the matter of the Companies Act, the High Court held that the consideration for transfer could be in any legitimate form, that
the transferor company was entitled to accept for the transfer as long as such consideration was not against the public interest or illegal.

In another instance, the Official Liquidator while giving his report in relation to the merger of Ranbaxy Laboratories Limited and Sun Pharmaceutical Industries Limited opposed the scheme on the grounds that the scheme was designed to set off “carry forward accumulated losses and unabsorbed depreciation” in the transferor company against the profits of the transferee company, which was prejudicial to the interests of the revenue and the public at large. The Punjab & Haryana High Court, while approving the scheme, inter alia stated that a case where it was legally permissible for the transferor company to carry forward and set-off all the losses, it was entitled to the benefit as long as the IT Act did not put any restrictions on it.

However, there have also been instances where a proposed scheme was not approved by the High court on account of tax reasons. In this regard the Bombay High Court’s decision in the case of India Seamless Enterprises Limited (ISEL) is notable. Here, ISEL, under a scheme of arrangement under section 391-394 read with section 100-104 of Companies Act, 1956, proposed to gift shares held by it in another listed company to its shareholders by charging the book value of the investment against its share premium account. The tax authorities opposed the scheme on the grounds that it had significant past tax liabilities and open assessments and that ISEL had not sought prior approval from tax authorities to gift such an investment to its shareholders as mandated under section 281 of the IT Act. The RD also opposed the scheme on the grounds that the proposed arrangement involved the distribution of dividend in kind by the company to its shareholders, which was not permissible under section 123 read with section 205 of Companies Act, 2013. The High Court took cognisance of the oppositions filed by the tax authorities and the RD and rejected the scheme on those grounds.

These trends indicate that the tax authorities are increasingly questioning the way M&A deals are being structured with a view to clamping down on alleged tax avoidance motives. At some level, such an approach by the tax authorities may warrant re-consideration. The objective of the tax authorities should be confined to determining the tax outcomes of transactions, if necessary by invoking specific or general anti-avoidance rules at the time of assessment. It is somewhat incongruous for them to step in and seek to pre-emptively block companies from engaging in transactions only because of their potential to cause loss to the revenue. Given that the courts themselves have in many cases accepted this principle, there may not be a need to give the tax authorities a role in deciding whether or not transactions should be permitted.

However, the circular remains in force for now, and until it is withdrawn, taxpayers can expect the revenue to weigh in on whether their transactions ought to be sanctioned. This will require taxpayers to demonstrate commercial rationale, not only at the time of tax assessments but also at the time of undertaking the transaction.
Transfer pricing – the road ahead

The Indian Transfer Pricing (‘TP’) journey can be mapped from section 42(2) of the erstwhile Indian Income-tax Act, 1922. Effective from 1st April 2002, the TP provisions have been incorporated in sections 92 to 92F of the Income-tax Act, 1961.

Since then, India has witnessed aggressive tax audits by the revenue authorities, especially in the last few years where the Arm’s Length Price (ALP) has been questioned in a large variety of transactions. The TP adjustments made in the last two audit cycles aggregated to over USD 17,266 million. Major adjustments were made on account of the creation of marketing intangibles, the valuation of share issues, the imputation of notional interest on financial transactions, corporate guarantees, comparability-related issues, etc. Though TP adjustments were made across all business sectors, major adjustments in Financial Year 2014-15 could be seen in IT/ITES, FMCG, automotive, pharma & chemicals and investment & financial advisory sectors (refer to the table below for certain other interesting statistics on TP).

The year 2015 also saw two major victories flowing to Vodafone on account of TP disputes, one involving the issuance of shares and the other involving the transfer of its options and call centre business to Hutchison’s Indian subsidiary. The decisions on both these issues were extremely significant as they involved the interpretation of key TP provisions. In respect of the issuance of shares to foreign shareholders, the High Court held that TP provisions would not be attracted in the absence of there being any income chargeable to tax. The ratio of this decision was followed for other taxpayers such as Shell, where a similar issue was at stake. In a first of its kind, one also saw the government coming forward and stating that it would not appeal against the High Court’s order, thus sending a positive signal to the investor community at large.

The other decision inter alia pertained to the applicability of TP to income arising on the transfer of business between two domestic entities. The Income Tax Department’s contention was that the company (Vodafone India Services Pvt. Ltd.) had structured the deal with another India-based entity of Hutchison with the intention to circumvent the TP norms. Accordingly, they sought to apply the deeming fiction in section 92B(2) to bring the transaction within the scope of TP provisions. However, the High Court rejected this contention and held that the TP provisions were not applicable in this case.

In another landmark decision, the Delhi High Court in the case of Maruti Suzuki India Limited laid down important principles on the issue of advertising, marketing and promotion (AMP) expenses incurred by licensed manufacturers. Here, the tax authorities had contended that Maruti Suzuki India had incurred excessive expenditure on AMP in India, leading to benefits for its overseas parent in respect of the intangibles (brand, trademark) owned in India by the Japanese auto major, Suzuki. The High court held that the AMP expenses so incurred by Maruti Suzuki India did not constitute an “international transaction” for income-tax purposes and thus not attract TP provisions. It also held that the use of a “bright line test” was inappropriate for determining the existence of an international transaction and making a pricing adjustment. This decision will have a significant impact on other cases, and will enable taxpayers to avoid/mitigate the rigors of TP adjustments on account of AMP expenses through maintaining proper documentation, intercompany agreements, detailed analysis of the business model, etc.

With a view to reducing TP litigation and providing certainty to taxpayers, the Indian government in recent years has introduced measures like safe harbour rules, Advance Pricing Agreements (APAs), etc. The APA scheme was introduced in FY 2013-14 and enables taxpayers to enter into APAs for a period of five years. A rollback mechanism was subsequently introduced with effect from 1st October 2014 to...

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enable the APA to also apply for the preceding four years. According to recent newspaper sources, approximately 580 APAs have been filed so far, of which 39 (of which 2 were bilateral APAs) have been concluded by the government with taxpayers from diverse sectors such as IT, ITES, investment advisory and other service sectors.

What lies ahead?

The TP landscape in India is expected to change substantially over the next year:

• The government is committed to conclude a large number of APAs in the near future to foster a stable tax environment and certainty. Currently, it is understood that a number of unilateral as well as bilateral APAs with the competent authorities of the UK, US, Japan etc. are at an advanced stage of negotiations.

• Bilateral APAs can be entered into only when there exist specific provisions under the Double Taxation Avoidance Convention (DTAC) with the contracting countries. However, it is recommended that even where specific provisions are not contained in Article 9(2) of the DTAC, the government should take measures to enable taxpayers to file bilateral APAs. These initiatives on the part of the government will go a long way in providing a stable tax environment to foreign investors doing business in India.

• Some changes to the existing TP regulations could also be made in the forthcoming budget 2016 on account of Action Plan 13 issued by the OECD/G20 as a part of its BEPS project. Action Plan 13 deals with TP documentation and Country-by-Country (CbC) reporting, and recommends the preparation and filing of a master file, CbC reporting, etc. The implementation of the recommendations may potentially increase the documentation/compliance burden for eligible taxpayers.

• Upon the implementation of the action plans of the BEPS report, the onus will be on the taxpayer to substantiate/document various important value-creating functions and to show whether such functions have been appropriately remunerated in the country in which they are carried out. Taxpayers will also have to adhere to the ‘substance over form’ principle.

• India joined the Multilateral Competent Authority Agreement on the automatic exchange of financial account information on 3rd June 2015. As of now 94 countries have committed to exchange information on an automatic basis from 2017 onwards. The exchange of information will enable the Indian Government to obtain the Master file, CbC, and all the information that can be accessed by the tax officers of the other countries. This may lead to an increase in TP litigation unless the information obtained through this medium is shared with field officers on a selective basis and after providing strong filters.

• The Finance Act, 2012 has extended the TP regulations with effect from financial year 2012-13 to certain specified domestic transactions. The benchmarking of the aforesaid specified domestic transactions is untested by the Indian revenue authorities as yet, as the first audit cycle in respect of these transactions will start next year.

The TP audit is a fact specific exercise, and accordingly, there should be conscious and continuous efforts on the part of taxpayers in preparing/maintaining the relevant documentation during or upon conclusion of the international transactions. Robust documentation will prove to be the most effective tool to alleviate the potential TP adjustment by the revenue authorities, saving tax costs and prolonged disputes with the revenue authorities.
The past few years have seen several tax controversies across the world. With large multinational corporations being seen as not paying their fair share of taxes, (either by shifting their base to low/ nil tax jurisdictions or by means of aggressive tax planning), affected governments are increasingly focussing on addressing this issue. This has resulted in the global political leadership (under the aegis of the G20 and the OECD) taking note of base erosion and profit shifting techniques and stepping up to the task of trying to plug them.

“BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis and create more and better opportunities for all. But beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide”.

- OECD Secretary General

The BEPS project initiated by the OECD is a direct outcome of these concerns. In many ways, it represents the single most important multilateral initiative in the field of international tax in recent memory. The objective of this project is to revise the prevailing international tax rules so as to eliminate gaps and mismatches that enable the erosion of tax bases through artificial means and the shifting of profits to no-or low-tax jurisdictions.

The OECD released an action plan on BEPS in 2013, which identified 15 action plans based on the three fundamental pillars of coherence, substance and transparency. The final output released by the OECD in October 2015 consolidates the work on all of the 15 action plans in the form of a comprehensive BEPS package.

India’s role in the BEPS Project

In addition to OECD member-countries, members of the G-20 (including India) were actively involved in the BEPS project on an equal footing. Other developing countries were also engaged extensively in the project through various consultation mechanisms.

BEPS is considered as having a detrimental effect on the Indian economy due to its negative impact on tax revenue. It has been noted that the problems associated with BEPS are exacerbated in an Indian context due to India’s heavy reliance on revenue from corporations (including multinationals), which is dependent upon international tax rules. Among the various actions addressed by BEPS, India has identified challenges posed by the digital economy, artificial avoidance of Permanent Establishment (PE) status, treaty abuse and transfer pricing as being particularly relevant. The OECD recommendations are to be implemented in the coming years through either amendments to domestic law or through a multilateral instrument that would have the effect of amending multiple bilateral treaties.

What to expect

To some extent, the concerns highlighted by the BEPS reports have already led to a clampdown by tax authorities in several countries on aggressive structures. India too, has over the last few years, taken cognizance of these issues and responded through a series of policy measures including strengthening the norms for treaty benefits (e.g. by making Tax Residency Certificates mandatory), the introduction of POEM and GAAR (with effect from 1 April 2017), and the notification of Cyprus under section 94A, etc.

The Indian government is also said to be closely studying the recommendations of the BEPS project and is expected to undertake possible legislative steps to implement some of its recommendations.

Additionally, the multilateral consensus aimed at curbing treaty abuse (Action 6) under the aegis of the BEPS project is likely to provide a fillip to India’s efforts in this direction. In particular, the use of favourable treaty jurisdictions such as Mauritius, Cyprus etc. in both inbound and outbound, which investments could be impacted on if a Limitation of Benefits (LoB) clause (setting out the conditions subject to which a resident of a treaty country will be eligible to claim treaty benefits) forms part of the treaty (either as an outcome of bilateral negotiations or as part of the proposed multilateral instrument).

Similarly, the adoption of Country-by-Country (CbC) reporting (Action 13) is likely to increase the documentation/compliance burden for enterprises in India in the initial years of implementation. The availability of the CbC and the master file of multinational corporations to the tax authorities could potentially augment the litigation on transfer pricing, as enterprises may be called upon to justify the value created as compared to other companies for similar transactions.

The limiting of the scope of exclusions in Article 5(4) to only those activities that are ‘preparatory’
and ‘auxiliary’ in scope (Action 7) could see existing business models become liable to tax in India under the new regime. One can also expect closer scrutiny of structures to ensure that there is no artificial fragmentation or splitting up of contracts to artificially mitigate the PE exposure.

Another potentially significant outcome could be India levying withholding tax on payments for digital services (Action 1), which could have far-reaching implications for Indian companies from a withholding and gross-up perspective, coupled with tax credit challenges. Also, issues on whether a website constitutes a PE or not may be back in the limelight given the discussion around this in the BEPS report.

Action 15 aims to develop a multilateral instrument (scheduled to be open for signature by 31 December 2016) to modify bilateral tax treaties so as to avoid the need for the simultaneous renegotiation of thousands of bilateral tax treaties. India is a member of the ad hoc group constituted for the development of the multilateral instrument. Once this is brought into force, it will prevail over several of India’s treaties as regards key aspects such as LoB, PE definition, etc.

Key takeaways
Changes to the international tax framework as a result of BEPS are now seen as inevitable. The recommendations made as part of the BEPS project speak volumes on the growing global consensus to shift to a tax system which is based on coherence, substance and transparency.

With India’s increased participation in global trade, both as a consumer and a supplier of goods and services, these changes will have a far reaching impact on businesses having cross border operations. Many of the fundamental rules of international tax that have so far been taken for granted are likely to undergo a radical change. These include access to relief under treaties, the formation of PEs, the availability of interest deductions, transfer pricing policies, etc. It is therefore extremely important for businesses to keep abreast of potential changes and develop an appropriate strategy to deal with their many implications.
Open doors – impact of new foreign investment norms

The Finance Minister was recently quoted as saying that “FDI is an additionality of resources and it is required if the cycle of economic activity has to take off”. This shows the importance that the government attributes to foreign investment in India. According to the Department of Industrial Policy and Promotion, the total Foreign Direct Investment (FDI) inflows soared by 24.5 per cent to US$ 44.9 billion during 2015, as compared to US$ 36.0 billion in 2014. FDI into India through the Foreign Investment Promotion Board (FIPB) route shot up by 26 per cent to US$ 31.9 billion in the year 2015 as against US$ 25.3 billion in the previous year, indicating that the government’s effort to improve the ease of doing business and the relaxation in FDI norms are beginning to yield results.

2015 saw a plethora of regulatory changes. It started with the Finance Act, 2015 splitting the primary responsibility for prescribing rules and regulations governing capital account transactions between the Reserve Bank of India (RBI) and central government by amending the Foreign Exchange Management Act, 1999. The RBI was given the responsibility to oversee debt instruments while the responsibility for other capital account transactions was cast on the central government. Prior to this amendment, the RBI had the primary responsibility for all capital account transactions. In the year gone by, both the RBI and central government have made a spate of very important policy announcements in their respective spheres.

On the FDI front, the opening up of multiple sectors, particularly real estate, construction and retail, and the easing of investment norms for Non-resident Indians (NRIs), will go a long way in attracting foreign investment into India. This will undoubtedly contribute to the needs of the hour viz. the growth of the economy and job creation. The reforms liberalising foreign investments into LLPs is also an important one, and will hopefully help end the somewhat arbitrary distinction between companies and LLPs from an FDI perspective.

For the first time, a definitive policy framework for foreign investments in Securities and Exchange Board of India (SEBI) regulated investment vehicles such as Alternate Investment Funds, Real Estate Investment Trust and Infrastructure Investment Trusts has been introduced. This will bring much-needed clarity to foreign investors and domestic fund managers and will help in attracting FDI in the domestic fund industry. In particular, deeming the investments of such domestic investment funds to be at par with domestic investment regardless of the extent of foreign investment, so long as they are sponsored/managed by Indian-owned and controlled sponsors/investment managers, is a positive step. This will encourage fund management activities in the country and attract Indian origin fund managers to relocate to India and set up and manage domestic funds.

With the opening up of foreign investment in SEBI regulated investment vehicles, the onus of diligence in completing KYC formalities has shifted from the Foreign Investment Promotion Board (FIPB) (which would typically verify each foreign investor before permitting FDI) to the sponsors/investment managers of the domestic investment vehicles and SEBI. One hopes that the sponsors/investment managers will be adequately equipped to take up this important responsibility.

The regulatory developments in respect of NRI investments are also extremely encouraging. Treating non-repatriation investments (investments whose sale proceeds cannot be sent outside India without prior RBI approval) at par with domestic investments is a logical step. Similarly, regarding entities (companies, partnership firms and trusts) that are owned and controlled by NRIs as eligible entities for investing on a non-repatriation basis at par with domestic investors will go a long way in alleviating the regulatory hindrances that NRI investors have faced in the past. Up to 2003, NRIs were permitted to invest in India through entities, (owned to the extent of at least 60 per cent by individuals of Indian nationality or origin residing outside India) and by treating them as a distinct class of investor known as Overseas Corporate Bodies (OCBs). The status of OCBs as an eligible class of investor under various routes/schemes available under Foreign Exchange Management Act was de-recognized from September 2003, following a review of the investment activities of OCBs in India carried out by the RBI on the basis of the recommendations of the Joint Parliamentary Committee on Security Market Scams.

The opening up of sectors such as construction development through the removal of conditions relating to obtaining prior FIPB approval for non-resident to non-resident transfers and meeting minimum capitalisation conditions within six months will also go a long way in kick-starting stalled/ fund-starved projects by bringing in fresh foreign investment. Another sector that has greatly benefited from the reforms seems to be the defense industry, in which the existing twenty odd conditions have been reduced to four coupled with putting the sector on an automatic route for foreign investment up to 49 per cent.
The hotly-debated retail sector has also seen some reforms with entities engaged in *Single Brand Product Retail Trading* (SBRT) now being permitted to undertake retail trading through e-commerce. Furthermore, Indian brands have been expressly permitted to sell their goods via wholesale and retail including e-commerce. Entities undertaking SBRT of products and having ‘state of the art’ and ‘cutting edge’ technology may see a relaxation in the 30 per cent local sourcing requirements on a case-by-case basis. Also, entities engaged in wholesale cash and carry trading are now permitted to undertake SBRT, on the condition that FDI norms for both businesses are separately complied with and separate books of accounts are maintained.

All of these regulatory changes are broadly in line with the stated aim of the foreign investment reforms proposed by the present government, which is to ease, rationalize and simplify the process of foreign investment in India.

The issue of *rupee denominated bonds* to foreign lenders (the aptly named “Masala Bonds”) with limited end-use restrictions, no cap on interest costs, etc. has also been permitted. This by itself is a path-breaking development, and will make it easier for Indian businesses to raise funds globally. In a first of its kind notification, the Central Board of Direct Taxes has clarified that the tax treatment for such rupee denominated bonds will be at par with prevalent scheme for foreign currency denominated debt instruments and appropriate changes to this effect will be incorporated in the budget 2016.

This has been followed up by an overhaul of the existing *External Commercial Borrowing* (ECB) framework by the RBI. A three-track approach has been proposed - Track 1 (short-term), Track 2 (long-term) and Track 3 (rupee-denominated). The overarching principle of the new framework is to liberalize and encourage ECB denominated in Indian and foreign currency with fewer restrictions on end uses and higher all-in cost ceilings for long term foreign currency borrowings. The policy has also mooted a more liberal approach to rupee-denominated ECBs where the currency risk is borne by the lender. Long-term lenders, such as insurance companies, pension funds, sovereign wealth funds are proposed to be included in the expanded list of overseas lenders with only a small negative list of end-use restrictions applicable in the case of long-term ECB and rupee-denominated ECB.

All in all, the developments of the last few months could boost India’s attractiveness for FDI (which according to the World Economic Forum’s Global Competitiveness Index currently stands at 55 out of 140 countries). In turn one can expect a cascading effect, which will boost the “Make in India” initiative sooner rather than later, and may quite possibly end up having a much greater impact on the Indian economy than the original reforms of 1991.
Indirect taxes - trends and outlook

2015 was a year of missed opportunities on the indirect tax front, with a lot being said and assured but little being accomplished. Increased tax collections coupled with a promise to bring transparency and the introduction of the Goods and Service Tax (GST) by 1st April 2016 set the tone for the new year. The introduction of the new Foreign Trade Policy 2015-20 was aimed at trade facilitation through streamlining incentive schemes and ending disputes by bringing clarity on various issues.

However, with the increase in demands by the tax authorities on minor issues resulting in further litigation, the objective of bringing predictability and improving the ease of doing business in India still remains elusive. The inability on the part of the government and the opposition to agree on the GST Bill was also a big let-down.

To meet revenue needs, the budget 2015-16 increased the effective rate of service tax to 14 per cent. This was coupled with a further increase of 0.5 per cent by way of the imposition of the Swachh Bharat cess with effect from November 2015, thereby making services more expensive in India. Simultaneously, exemptions were withdrawn to streamline the law and prepare for GST. Little progress was made on procedural simplifications and clarity on taxability during the year. Instead, the focus on minor issues and the raising of industry-wide demands on transactions involving no consideration or ascribing consideration where none exists continued during the year.

On the other hand, a positive initiative by the Supreme Court led to the formation of a special tax bench to reduce the number of pending matters. This effort helped settle various long standing disputes (pending since 2005) relating to the valuation of goods under customs and excise on account of the addition (inclusion) of various pre-and post-delivery/import charges.

Duality of taxes has always been a major point of litigation in India. In the case of M/s. Larsen and Turbo Ltd. vs. CCE [2015-TIOL-187-SC-ST], the Apex Court reiterated the principle of service tax and Value Added Tax being mutually exclusive and put to rest the debate on whether service tax was leviable on services provided under a works contract prior to their introduction in the service category of ‘works contracts’ under the Finance Act, 1994. The court held that prior to such entry coming into force, only simpliciter service contracts would be liable to service tax and not composite indivisible works contracts. Similarly, in the context of the simultaneous levy of service tax and customs duty on transportation charges, the Supreme court in CCE vs. United Shippers Ltd. [2015-TIOL-172-SC-ST-LB] held that as such charges were part of an import transaction subject to import duty. Another landmark judgment of the Apex court was delivered in the context of Local Body Tax, in Sadexo SVC India Pvt. Ltd. vs. State of Maharashtra and Ors. [2015-TIOL-293-SC-MISC], in which it was held that ‘meal vouchers’ are not goods for the purposes of levy of Local Body Tax or octroi. Here again the bench stressed that the contract between the parties was a service contract and not a contract for the sale of goods, and that such coupons only operated as a payment mechanism following authorisation of from the Reserve Bank of India.

Another set of judgments indicate the thoughtfulness of the judiciary in relation to issues arising due to lacuna in law. In Shabina Abraham and Ors. vs. CCE [2015-TIOL-159-SC-CX], the dispute related to whether assessment proceedings could continue against a taxpayer even after his death. Here, the court held that in the absence of specific machinery provisions to proceed against dead persons, the legal heirs of the deceased could not be brought within the ambit of the law on the basis of presumptions.

The question of whether anti-dumping duty could be collected for the interregnum period by the central government retrospectively, was answered in the negative in the case of CC vs. G. M. Exports [2015-TIOL-209-SC-CUS]. This judgment remedies the inequitable outcomes arising out of the payment of anti-dumping duty along with interest during the interregnum period, especially as the delay in imposing the final duty is often caused at the central government’s end. In fact, the Supreme court in various judgments also reprimanded the tax authorities for their apathy towards proper investigation, leading to a lack of evidence in support of the revenue’s case. In spite of these efforts of the judiciary and the measures of the ministry to reduce pending litigation, the number of disputes remains extremely high.

The ushering in of the new Foreign Trade Policy streamlined various export incentives available to exporters by instituting a single scheme called the Merchandise Export from India Scheme for goods exports and the Service Export from India Scheme ("SEIS") for service exports. A welcome move in the new policy is the allowance of the set-off/credit or drawback of duties paid by debit to the scrips. More importantly, the new policy brings clarity on the issue of the availability of SEIS to a foreign brand by extending the benefit to all service providers located in India. However, the dispute with the Department on the foreign brand issue under the erstwhile policy has ended on a negative note for the erstwhile policy has ended on a negative note for the exporters using a foreign brand. Despite the conflicting decisions by the Bombay High court (Namdan Hotels Pvt. Ltd. vs. UOI) and the Delhi High Court (Yum Restaurants (I) Pvt. Ltd. vs. UOI) on this issue, the SLP filed before the Supreme Court by the exporters has been dismissed. Given that the Directorate General of Foreign Trade had itself been granting licenses since 2004 without any dispute, a sudden reversal of its stance may be unjustified and could undermine the stability of the overall policy.
YEAR IN REVIEW: 2015

About Dhruva

Dhruva is a boutique tax and regulatory services organisation, working with some of the largest multinational and Indian corporate groups.

We bring a unique blend of experience, having worked for the largest investors in India, advising on the largest transactions and on several of the largest litigation cases in the tax space. We work closely with regulators on policy issues and our clients on tax advocacy matters. We believe in thinking out of the box, handholding our clients in implementation and working to provide results.

Key differentiators:

- Strategic approach to complex problems
- In-depth, specialised and robust advice
- Strong track record of designing and implementing pioneering solutions
- Trailblazers in tax controversy management
- Close relationships with the government coupled with a long history of involvement in policy reform
- Technical depth and quality

Our team comprises of nine Partners and over 120 professionals located in Mumbai, Ahmedabad, Bengaluru and Delhi.

Dhruva Advisors is a member of the WTS Alliance, a global network of selected firms represented in more than 100 countries worldwide.

Our recognition

DHRUVA ADVISORS HAS BEEN RECOGNISED AS A TIER 1 FIRM IN THE INTERNATIONAL TAX REVIEW, WORLD TAX GUIDE 2016 TO THE WORLD’S LEADING TAX FIRMS, IN THE FIRST YEAR OF ITS EXISTENCE

Dhruva Advisors was founded by Dinesh Kanabar, the firm’s chief executive officer, in November 2014. Kanabar was the deputy CEO of KPMG India and the chairman of its tax practice. He comes recommended by the market for his skills in corporate tax and cross-border structuring. The firm began with four partners and about 25 employees. It has flourished to nine partners and more than 80 employees in six months. Dhruva Advisors is a member of the WTS Alliance, a global tax network.

The key industries the tax team advises include financial services, IT and IT-enabled services (ITES), real estate and infrastructure, telecommunications, oil and gas, pharmaceuticals, chemicals, consumer goods, power, as well as media and entertainment.

DHRUVA ADVISORS HAS ALSO BEEN RECOGNISED AS A TIER 2 FIRM IN INTERNATIONAL TAX REVIEW, WORLD TRANSFER PRICING 2016 TO THE WORLD’S LEADING TRANSFER PRICING FIRMS

frame. The reluctance of the Supreme Court to interfere only makes this problem worse. However, on a positive note, the judgment of the Bombay High Court in Tata Teleservices Ltd. vs. UOI [Writ Petition No. 233 of 2013] is worth a mention. In this decision, the Supreme Court came to the rescue of exporters and construed the term ‘group company’ beneficially to include companies with indirect control.

GST yet again took up substantial time of the government this year but with no concrete results. The government showed alacrity by pursuing the GST Bill in every parliamentary session. However, with discord between the government and the opposition continuing, the introduction of this tax is once again likely to miss the desired date of roll-out. Recent press reports suggest that the NDA government has reached out afresh to the opposition to strike a compromise to enable the passage of the constitutional bill to implement GST and to advance the upcoming budget session, if required. India Inc. keenly awaits the next move of the political parties.

Nevertheless, the coming budget is likely to see the government taking some concrete steps to move closer to the GST regime, with the alignment of tax rates to the recommended standard rate of 16.9 per cent to 18.9 per cent and the broadening of the tax base. However, any increase in taxes without corresponding liberalisation on the availability of set-offs could adversely impact service businesses in India.
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