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Hurdles ahead as govt wants to review taxation of non-residents

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IN 2003, a task force appointed by the finance ministry recommended major reforms in the taxation of nonresidents. These are governed by the domestic law and the Double Taxation Avoidance Agreements that India has with over 70 countries now.

The introduction of anti-abuse rules in the domestic law, controlled foreign corporation regulations, norms on thin capitalisation, allowing tax deduction to foreign banks on bad and doubtful debts, rationalising taxation of royalties featured in the list of suggestions made by the Vijay Mathur panel.

Last year, revenue authorities shortlisted some of the suggestions to be incorporated in the new Direct Taxes Code which is slated to be tabled in Parliament this budget session. An important recommendation which may be accepted by the government is the incorporation of anti-abuse and antiavoidance provisions in the domestic law. It would, however, take at least a year — April 2008 — for the direct tax code to be operationalised.

The panel's recommendation was meant to curb the misuse of the Indo-Mauritius Double Taxation Avoidance Convention (DTAC). There have been allegations of third country entities using the provisions of the DTAC to set up conduit companies in Mauritius and use them as vehicles to invest in India to escape paying tax. This practice is known as treaty shopping. Besides this, some Indian entities also channel (black) money into the country through shell companies in Mauritius.

Mauritius does not tax capital gains from sale of shares. So Mauritiusbased investors do not pay tax on the capital gains arising from sale of Indian equities. The task force held that the benefit of DTAC should be given only to persons who are residents of either or both the contracting states.

India is trying to re-negotiate the tax treaty with Mauritius but has not made much headway so far. Indian tax authorities are keen on the incorporation of the "limitation of benefit (LOB) clause in the treaty. If accepted, the benefit of the treaty will be limited to qualified residents in either of the states.

An alternate option being considered now is the introduction of an anti-abuse clause in the Income-Tax Act to prevent the misuse of treaty benefits. Some tax experts reckon that it may not be feasible to replicate general anti-abuse provisions in India on the lines of those adopted in the US. This is because in the US, treaties and domestic laws are considered at par with each other. Nevertheless, the US Supreme Court has held that for domestic law to prevail there must be an express statement in the body of law, or in its legislative history indicating its intent to do so.

"However in India, the situation is different and the provisions of treaty override those in the domestic law. The mere introduction of general anti-abuse provisions in the domestic income-tax law will not necessarily override the treaty. The international law in the Indian context is on a higher plane than the domestic law. This is more particularly so when read in conduction with Section 90 of the Income Tax

Act, 1961 along with Articles 51, 73 and 253 of the Constitution. The government would have to weigh the impact of such a move on its relationships with its treaty partners before taking a final view. The Supreme Court has clearly recognised in the case of Azadi Bachao Andolan that apart from tax allocation, tax treaties are entered into to encourage mutual trade and investment," according to Nishith Desai, an International Tax Lawyer.

The panel also favoured adopting controlled foreign corporation (CFC) regulations, given the rise in outbound investments and the ability of companies to park profits outside in tax havens. By doing so, these companies defer taxes in India which results in a loss of revenue. Outbound FDI is projected to touch $3 billion this fiscal and could grow substantially in the coming years, with deals such as Tata Steel's acquisition of Corus.

Several developed countries have CFC regulations which helps prevent companies from accumulating profits in low tax jurisdictions. In the US, for example, these regulations apply to US investors who own stock in non-US corporations. It essentially accelerates the taxation of passive income in the hands of US investors.

With Indian companies expanding and setting up operations overseas, the government is also looking at the feasibility of having norms on thin capitalisation. These rules ensure that resident enterprises do not classify a large portion of their equity as debt to claim a deduction on interest earned on profits. In the US, for example, the thin capitalisation rules discourage US companies from having a debt equity ratio higher than 3:1 since in such cases there may be no deduction available on the interest payments.

May be it is early days still to usher in these regulations for Indian companies as it could stifle their efforts to compete with global companies in an efficient manner.