India’s tax policy quirks – Reflections from a practitioner’s lens

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For several years now, we have heard Governments mulling over a new direct tax code that promises simplicity and tax certainty in India’s income tax laws. While ‘simple tax laws’ is a paradox in itself, the hope was beyond a re-write that was reminiscent of old wine in a new bottle. We all eagerly awaited bold changes that resolved language ambiguities, reflected clear policy statements re: what is covered or not covered and abandoned dated concepts from the bygone British era. The initial drafts of the Direct Tax Code[1] in 2009 and 2010 continued with the income tax act as its base but brought in a host of new international tax rules (that many found fresh) - POEM, GAAR, CFC rules, new source rules on indirect transfers, etc. Once most of these proposed tax measures found their way into the Income-tax Act, 1961[2] through successive budgets, the exercise of a re-write was considered futile. Instead, the idea of battling a new code with new language and new interpretational issues seemed like an ordeal to several tax practitioners, who were not too inclined to rock the boat. Therefore, the idea of a grand detox of India’s income tax legislation was abandoned in 2019 and Indian tax policy continued with its old habits. In this context, this think-piece reflects on some of these quirks that have become common place in India’s legislative process with respect to income taxes, and their impact on tax certainty, simplicity, and equity.

The Retroactive Fix

This has clearly been the most publicized and notorious of India’s tax policy quirks, which reached its pinnacle with the Vodafone case. India’s income tax law is replete with examples where a taxpayer has litigated a tax position successfully before the Indian courts only for it to be overturned through a retroactive law. Finance Act, 2012[3] became a posterchild for the retroactive fix as it overturned the Supreme Court’s decision, which held that India’s source rules did not provide for taxation of indirect transfers. Moreover, the source rules on taxation royalties were also given a retroactive fix the same year to dilute the distinction between copyright and copyrighted article and overrule cases on

[1]The Direct Taxes Code, 2010 (Bill No. 110 of 2010)
[2]The Income Tax Act, 1961 (Act No. 43 of 1961) w.e.f. 1st April 1962.
[3] The Finance Act, 2012 (Act No. 23 of 2012) w.e.f. 1st April 2012.

classification of payments made to satellite service providers. Indeed, India's vociferous assertion of its source-based taxation rights was a welcome policy turn – but the manner in which such rights were asserted through the retroactive fix compromised equity and certainty of her tax laws. Each time a retroactive fix came in, its constitutionality and validity were debated to no avail given the sovereign's wide powers to tax. Therefore, this became a tax risk of doing business in India that had to be factored in. Resultantly, in most transactions now a specific tax clause is written-in in contracts to allocate tax losses arising from retroactive changes to India's tax laws between the parties. Moreover, most investor disclosure documents allude to the retroactive fix as a possible risk of investing into India. While the Government has adopted a more restrained approach off-late, it will take time for taxpayers to believe that the retroactive fix is a habit of the past.

"Catch all" Rules

To legislate far and wide through catch all rules has become more apparent in recent times. This presents a real catch 22 for the policymaker, who looks to cover all unforeseen situations, new business models, transactions, and their iterations under the tax rules for ensuring their dynamism and preserving their integrity. However, on the flip side catch all rules often compromise tax certainty as there is little clarity on what they intend to cover and what they do not. Many a times a policy statement from the Government is also absent. A key example of this is the new rules for the 2% equalization levy. What came out as a makeshift tax on digital businesses pending international consensus, now has a personality of its own. It taxes every foreign business that undertakes or facilitates any part of a transaction (offer, acceptance, payment, provision of services or goods) online to Indian residents or IP users. There are several open questions - would these cover transactions that a foreign business conducts over emails or other communications platform, would it cover payment gateways, ERP systems? How does one discern who owns, operates, or manages a platform? How should compliance be met with billions of digital transactions? What records should the taxpayer maintain? One would even think that the ambiguity may be somewhat intentional to cope with varied ICT business models.

Legacy Issues

The longstanding distinction between revenue and capital receipt that emanated from Britain's "source" based conception of income is a key example of Indian tax policy's adherence to what once was. For long now, Indian tax policy has embraced the "ability to pay theory" to tax income (the inclusion of windfall gains, lotteries, capital receipts such as termination fee under contracts, non-compete fee, etc. in the definition of income are all reflective of this mindset). Yet, instead of making one sweeping amendment to capture all receipts that enhance a person's ability to pay under the conception of income (as was attempted once by the Direct Taxes Bill), tax policy continues to grapple with dated distinctions between revenue and capital receipts (with successive amendments in the definition of income to include individual capital receipts). Similarly, the difference between what is covered as "accrual" under Section 5 and deemed accrual under Section 9 (India's source rules) can only be unearthed after rummaging through pre-independence case law. A clear articulation of source rules for businesses in the new world under one single provision would go a long way in lending more tax clarity.

Teething Phase

In 2012, India legislated a new source rule to tax indirect transfers. However, the tax rules that fleshed out these source rules and were key to their implementation (example, determination of fair value of India assets vis-à-vis global assets, determination of proportionate capital gains etc.) came through only in 2016 (leaving the law uncertain for four years). Similarly, the 2% equalization levy was introduced in a surprise move by Finance Act, 2020[4] but the clarifications and rules to give taxpayers certainty on how to comply are still to come through – another example of the teething phase.

Mind the Gap

On several tax matters, the existing tax legislation is silent – taxation of earn outs, interface of deemed income rules with indirect transfer source rules, tax treatment of redemption premiums and determination of interest rate caps under special withholding provisions, etc. These legislative gaps have been highlighted to the Government by the business and practitioner community on many an occasion. Yet, the ambiguity looms absent a clear policy statement on the tax treatment.

The Flip-Flop

[4] The Finance Act, 2020 (Act No. 12 of 2020) w.e.f. 1st April 2020.

The Mauritius tax treaty claim is a key example of the flip-flop. Every year we hear of a few stray cases where the tax treaty claim is denied on formalistic arguments that ultimately point to lack of commercial substance. For instance, the director of a foreign parent instead of the Mauritian entity signed the investment agreement into India, routing of funds from an overseas bank account that is not in Mauritius, arguments around "permitted transferee", etc. On the other hand, even if these formal standards are met, one would still not be entirely comfortable advising that the treaty benefit would not be denied on some other ground – hence the long-drawn tax indemnities in share purchase agreements. As the Supreme Court articulated in the seminal *Azadi Bachao Andolan*[5] case, the Government circulars on tax residence of Mauritian entities, clearly suggested that the Government had incentivized investment into India through the Mauritius route and in such light, treaty shopping claims would not be relevant. Yet, the Government's flip flop around the Mauritius tax treaty benefit has been apparent especially in large and prominent deals indicating a policy shift. Arguably, the re-negotiation of the India-Mauritius tax treaty (as against tax contests on varied formal grounds) should have been the only way for the Government to withdraw the exemption and announce its policy shift. The application of deemed income provisions under Section 56(2)(x) to share issuances and the series of circulars on this is another example of the flip flop.

Indeed, a re-write of a new tax code would have been a ripe opportunity for the Government to reflect on these quirks. Resorting to some of these quirks may even be inevitable under certain circumstance. However, the hope is that the policymaker consciously addresses and reflects the impact that India's legislative process has on tax certainty and simplicity.

[5] *Union Of India And Anr* v *Azadi Bachao Andolan And Anr* (2004) 10 S.C.C. 1