
Note to the participants: The law applicable to the problem would be the Income-tax Act, 1961 (the Act). It has to be assumed that Chapter X-A of the Act i.e. General Anti-Avoidance Rule (GAAR) has come into force and all the corresponding laws pertaining to Chapter X-A would apply to the problem.

Any developments pertaining to Chapter X-A, until the date of the competition and until the date of submission of the memorials, would apply to the problem and the memorials respectively. However, any information/ source that cannot be relied upon by the parties before a court of law shall not be considered as a development such as newspaper articles, opinion of experts, interviews of any persons, etc. In any case, deferral, repeal or omission of Chapter X-A and/ or the corresponding laws from the Act by the Parliament shall not be considered as a development and will not affect the problem. In such a situation, it has to be assumed that Chapter X-A has come into force and would be applicable to the problem.

This problem is on international applications of Indian Income-taxes on outbound investments. The problem is purely for academic purposes and any coincidences of facts are accidental.

BEFORE THE AUTHORITY FOR ADVANCE RULINGS

(INCOME TAX)

NEW DELHI

13th day of May 2013

PRESENT

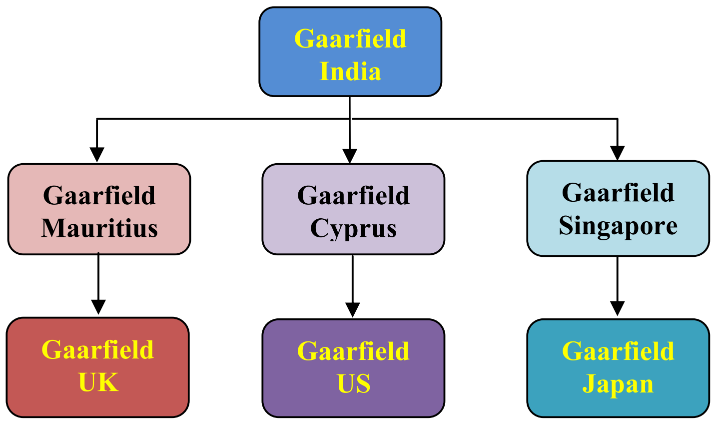
Chairman (Member 1), Member 2 and Member 3

AAR No. 2013 of 2013

1. The applicant, Gaarfield India Tech Ltd Co. or 'the Indian Company' was incorporated in Bengaluru, India according to the Companies Act, 1956 in April 2004 and is having its registered office in Bengaluru, India. The applicant is into the business of software development and has worldwide operations. In order to pay appropriate attention and to manage the activities of its business meticulously, the Indian company had set up various subsidiaries in various jurisdictions. Also, the major markets of the Indian company were in the UK, the USA and Japan. As it was prudent and within law to hold lower tier subsidiaries situated in high taxed jurisdictions through law tax jurisdiction intermediaries and since the Indian Government itself incentivized inbound and outbound investments by entering into tax treaties with various low taxed jurisdictions, the Indian company held all

its ultimate subsidiaries in the UK, the USA and Japan through intermediaries/ intermediary companies in Mauritius, Cyprus and Singapore respectively for which the intermediaries had valid tax residency certificates (TRC) issued by their respective tax authorities.

2. The structure of the Indian company group was as follows:



3. The UK, the US and Japanese companies were actually the real operating companies with several assets, employees, various intellectual properties vested in them, etc. and generated huge income. Whereas, the intermediaries were mere holding companies with no assets lying in them. There were no operations as such in these intermediaries and were mere investing companies solely into their group companies.

4. The background of various transactions and the arrangements of the group structure was as follows:

   A. *<u>Equity and Debt transactions</u>*:

   - Every year the Mauritius, Cyprus and Singapore companies would issue shares to the Indian company. The subscription would range around INR 3000 crores every year in each of the companies. In addition, the Indian company would also invest in the debt securities of these intermediary companies which were at times more or at times less than the share subscriptions.
   - On the debt securities, the interest to be paid by the intermediaries to the Indian company was at Inter Bank Offer Rates of UK and US. The Indian company used to lend money in US dollars, Indian rupees, etc. For currencies other than Indian rupees, the Indian company used to borrow from financial institutions across the world and then would lend to its subsidiaries.
   - Incidentally, whenever there was share subscription or lending of loans by the Indian company to the respective subsidiaries, the respective subsidiaries would subscribe to the shares and would lend loans more or less the same amount to their ultimate subsidiaries in the same year. The ultimate subsidiaries would use the respective funds for their operations. The interest rates at which the intermediaries were lending the

loans to their ultimate subsidiaries i.e. the UK company, the US company and the Japan company were at arm's length according to the laws of the ultimate subsidiaries' jurisdictions.

- Loans were also granted by one intermediary to the subsidiaries of other intermediaries. For example, the Mauritian entity would grant loan to the US entity, Cypriot entity to Japanese entity and Singaporean entity to the UK entity. However, the rates of interest paid by the ultimate subsidiaries in these situations were relatively very high. This led to huge deductions against their taxable income in the UK, US and Japan respectively. However, the Indian company received interests from its immediate subsidiaries at respective Inter Bank Offer Rates on the loans granted by it.

B. *Directors of the global group*:

- There were 10 directors in the board of the Indian company. The Managing Director (MD) of the Indian company was in the board of all the intermediary companies. Additionally, three more directors of the Indian company other than the MD were in the board of each intermediary company respectively and all other directors of the intermediary companies were domestic residents of their countries.
- Apart from the above, two other directors of the Indian company were in the board of the ultimate subsidiaries in the UK, the US and Japan each. All other directors of the ultimate subsidiaries were domestic residents.
- Each of the above directors had voting rights in every decision taken by the respective boards.

C. *Dividend payments among the group*:

- Every year the ultimate subsidiaries would make dividend payments to the intermediaries being their respective parent companies. Not the entire profits lying in the books of the ultimate subsidiaries were declared as dividends but a significant amount was paid regularly. However, the ultimate subsidiaries were under no obligation to make the dividend payments to their parent companies and huge profits were still lying in the books of the ultimate subsidiaries after declaring such dividends.
- The intermediaries however, did not declare any dividends to the Indian company in the recent past and the interest payments alone were the monies paid by the intermediaries to the Indian company.

5. Under these circumstances, GAAR was introduced in India! The tax departments/ Revenue in India had a close watch on most of the major companies in India and their global structures. The tax departments were just waiting for the baton i.e. introduction of the GAAR to rule the roost on taxation of global structures. As Chapter X-A was already in the Act and since it was not further deferred or repealed in the Union Budget 2013 by the Parliament of India; on April 1, 2013 itself thousands of Show Cause Notices (SCNs) under section 144BA of the Act were issued by the jurisdictional Commissioners of Income-tax (CIT) across the country to most of the major companies. A very unpleasant and wary situation prevailed among both the Indian and foreign investors as their businesses which were conducted for several decades could be dampened in a very short

time if the tax department turns out to indiscriminately question every step of the arrangement of these top notch companies. On the other hand, the Government felt that while it was not unconcerned with the development of the country by means of foreign investments, it was worried that Indian international tax system was fragile and it was easy to avoid Indian taxes.

6. In this backdrop, the Indian company was one such company which received a typical Revenue type of SCN, *inter alia*, requiring it to show cause the following:

   a) Since all the requirements under sections 96 and 97 have been fulfilled, why not 'all' the consequences under section 98 of the Act be invoked to the structure of the Indian group company?
   b) To apply each consequence in detail, the CIT required the Indian company to show cause as to *why not disregard all the three intermediaries as accommodating/ connected parties to the applicant group and deem that the Indian company directly held the ultimate subsidiaries and apply those tax treaties?*
   c) Why not 'look through' instead of 'look at' the three intermediaries and deny all tax treaty benefits and apply the Act for each arrangement i.e. dividends, interest, capital gains, tax credits, etc.?
   d) Why not the entire profits lying in the intermediaries be deemed to be the income of the Indian company? The income lying in the ultimate subsidiaries, however, would not be included as they suffer high taxes in their jurisdictions.
   e) Why not the dividends declared by the ultimate subsidiaries to the intermediaries be deemed to be dividends of the Indian company? Also, include certain percentage of huge profits of the ultimate subsidiaries as income of the Indian company by way of 'ad hoc' dividends and be subject to tax in India?
   f) Finally, why not recharacterize certain percentage equity investments into debt investments and add back to the Indian company's profits certain amount of interest income which ought to have been received by the Indian company that was disguised under thin capitalization?

7. As the burden of proof was on the tax department to prove that the Indian company could be subject to GAAR, it listed the following reasons to invoke GAAR:

   a) The interest payments made by the intermediaries to the Indian company were not at arm's length and the interest payments made by the ultimate subsidiaries to their parents' sister companies were not at arm's length and therefore, the group enjoys excessive transfer pricing benefits in India as well as abroad;
   b) The Indian directors hold key and decision making positions in the other companies of the group which in effect helps excessive tax avoidance;
   c) No dividends have ever been paid by the intermediaries to the Indian company so far which strongly presumes that these three intermediaries are set up solely for tax benefit purposes;

d) Excessive and avoidable loans were granted by one intermediary to the subsidiary of the other intermediary only to claim huge deductions on the interest paid by the ultimate subsidiaries; and
e) The group *in toto* has excessive tax avoidance arrangements if step transaction doctrine is applied.

8. The Indian company on receipt of the SCN without replying to it approached the Authority for Advanced Ruling (AAR) under section 245Q though section 245N(a)(iv) mentions that AAR could be approached for the purpose of Chapter X-A (GAAR), only in case of proposed transactions. The rationale for the Indian company to approach the AAR was that since a SCN could be issued on an already existing structure which in effect amounts to retrospectively applying GAAR, then the AAR should be in a position to entertain applications, even otherwise as an exception, on existing structures at least limited to the special provisions like GAAR. Failing which, the taxpayers would be compelled to undergo burdensome protracted litigations. Also, the Indian company felt the AAR has wide powers to determine its own procedure and jurisdictions not only as per the powers conferred under the Act but also as held by the Hon'ble Supreme Court in recent and earlier judgments upholding the wide powers of a Tribunal.

9. The following issues were before the AAR to be resolved as raised by the Applicant and as opposed by the Revenue:

A. Maintainability

On behalf of the Applicant:

- On a harmonious reading of section 245N(a)(iv), the question before the AAR was to determine the applicability of GAAR on the Indian group company on an 'ongoing basis' and therefore, should be maintainable before the Authority
- None of the reasons mentioned in the proviso to section 245R(2) is applicable to the applicant and therefore, its application should not be rejected

On behalf of the Revenue:

- The application is not maintainable for the following reasons:
  i. An application to determine liability under Chapter X-A is restricted only to proposed transactions and not for already existing structures
  ii. Once a SCN had been issued the applicant ought to have taken recourse by replying to it and filing appeal, etc. but cannot approach AAR

B. Applicability of GAAR

On behalf of the Applicant:

- GAAR cannot be applied on existing structures and could be applied only on proposed structures. Applying GAAR on existing structures would amount to retrospectivity which is not the intent of the Parliament as introduced in the Finance Act, 2012. Further, levying any new conditions/ burdens on existing structures/ units which were not prevalent at the time of creating such structures is unreasonable and therefore, GAAR should be applicable only to structures/ arrangements set up after April 1, 2013

On behalf of the Revenue:

- It is a settled principle that tax law has to be applied as on the first day of every assessment year. Since, GAAR has been introduced on April 1, 2013 and since Chapter X-A does not explicitly provide that existing structures are out of GAAR, the applicant's group company would very much be covered under GAAR

C. Issues on merits

1. <u>Accommodating and Connected parties</u>

On behalf of the Applicant:

- None of the consequences as mentioned in the SCN would be applicable to the Indian company as the tax treaties with Mauritius, Cyprus and Singapore were entered into by the Indian Government to incentivize investments into and out of India and further, these treaties have the approval of the Supreme Court of India especially in case of Mauritius.
- The need to set up entities in low tax jurisdictions was not mainly for tax benefit purposes but for the protection under bilateral investment treaties (BIT) and in case of Singapore, it has Limitation of Benefits (LOB) clause in the treaty itself

On behalf of the Revenue:

- All the three intermediaries are accommodating parties and connected parties to apply the treatment under section 99 of the Act
- The setup of intermediaries in Mauritius and Cyprus was not for BIT purpose and the reason given for India – Singapore tax treaty is untenable

2. <u>Combining entire income of the intermediaries and the dividends declared by ultimate subsidiaries as the income of the Indian company</u>

On behalf of the Applicant:

- There is no question of including income of the intermediaries and the dividends declared by ultimate subsidiaries as the income of the Indian company as that is permissible only under a Specific Anti-Avoidance Rule (SAAR) namely, Controlled Foreign Corporation (CFC) regime and since India does not have such a regime, such an act would be ultra vires the statute and impermissible under law

On behalf of the Revenue:

- Since CFC has not yet been introduced such an action could be taken as GAAR has wide powers and only if such a SAAR is present in the Act, it would act as a bar for invoking GAAR

3. <u>Recharacterizing equity into debt & vice versa and excessive loans granted among the group</u>

On behalf of the Applicant:

- Recharacterization is not permissible unless thin capitalization rules are introduced in the Act. Further, there is no violation of debt equity ratio as the loan borrowed is less than the equity capital which is an accepted accounting policy
- The loans granted among the group were for real commercial purposes which cannot be questioned by the Revenue and were all at arm's length. Since, a SAAR like transfer pricing is prevalent, no GAAR would be applicable. In any case, there is no revenue loss to the Indian Government on the loans granted by the intermediaries to the other intermediaries' subsidiaries

On behalf of the Revenue:

- GAAR permits for recharacterization and has resulted in revenue loss due to nonpayment of dividends since inception of the group
- The need for granting loans among lower tier companies was only to help huge deductions in UK, US and Japan which is not acceptable and amounts to round tripping financing

D. Such other issues as permitted by the AAR

The AAR was keen to hear arguments on both sides based on the GAAR guidelines of various countries like Australia, New Zealand, Canada, China, Germany, South Africa, UK, USA, etc. (which were available on their respective tax department/ revenue websites itself!) and especially, based on the draft guidelines submitted by Indian tax authorities upon the Committee constituted on February 27, 2012 and the report submitted by Dr. Parthasarathi Shome Committee on September1, 2012 and such other national and international developments until the date of hearing.