April 11, 2012

Indian Union Budget Finance Bill 2012
Tax Provisions

Executive Summary

The Finance Bill in the Union Budget released by India on March 16, 2012 and slated for enactment in May contains a series of proposed tax measures that raise serious concerns for U.S. and other investors. If enacted, they are liable to have a significant negative effect on investment into India. They also raise serious tax treaty issues for the United States and have substantial implications for the U.S. fisc. The U.S. Treasury Department is strongly urged to join other Governments and numerous business associations in expressing concerns to senior Indian officials at the earliest opportunity.

The proposals of greatest concern to U.S. investors include the following:

Procedural and due process issues:

- Substantial periods of retroactive application – over two dozen provisions would rewrite the law with retroactive effect, in some cases up to 50 years.
- Violation of res *judicata* by reversing many decided cases.
- Discretion granted to India's Central Board of Direct Taxes to define tax treaty terms unilaterally, with effect to the date of entry into force of the treaty.
- Tax collection and refund provisions – purporting to legitimize against any challenge all assessments and collections of Indian tax on indirect share transfers, notwithstanding judicial judgments or orders.
- Withholding agent obligations – granting authority to require the payor of any sum to a nonresident to withhold Indian tax, regardless of whether the sum is taxable in India under the law.
- Treaty certification requirements – conditioning all treaty relief on obtaining a certificate from residence country tax authorities, containing whatever information India chooses to require.
- Extended statute of limitations – extending from 6 to 16 years the statute of limitations for assessing tax on income in relation to assets outside India.

Substantive proposals:

- Indirect stock transfers – subjecting to tax any nonresident's transfer of shares in a non-Indian company if the stock directly or indirectly derives its value substantially from Indian situs assets, without regard to, *inter alia,* the nature of those assets or

the size of the shareholding, without defining "substantially", and without regard to international norms which allocate taxing jurisdiction over such gains to the country of the transferor or of the situs of the transferred shares.

- Expansion of royalty definition on software – contravening a long series of Indian court rulings and much international precedent by characterizing income from any transaction in computer software (including sales of "shrink wrap" software products) as royalty income subject to withholding.

- Expansion of royalty definition on satellite and other transmissions – purporting to treat all payments for transmissions by satellite, cable, or optic fibre as royalty income subject to withholding, again in contravention of numerous Indian court decisions and widespread international norms.

- GAAR – introducing a very broad "general anti-abuse rule" which threatens to deny treaty benefits unless taxpayers can prove a negative, and which could supersede negotiated treaty conditions on eligibility for relief.

In addition to their effects on investors, these proposals have the following significant implications for the United States:

- They represent a dramatic effort to unilaterally change the negotiated balance of benefits under the U.S.-India Treaty, perpetuating the trend of disrespect for the obligation to apply the Treaty in good faith.

- They are likely to have substantial revenue implications for the U.S. fisc, from the foreign tax credit implications of both the greatly expanded (and retroactive) Indian tax claims and the effective neutering of the Indian courts of law as a vehicle for challenging unjustified tax assessments by the Indian tax authorities.

- They represent unprecedented claims of taxing jurisdiction over non-residents of India, and do so based upon policy arguments that are fundamentally inconsistent with internationally recognized norms and principles.

The growing chorus of concern over these proposals has included communications to Indian officials from trade associations representing every corner of the world's business community and from the Indian business community as well. The U.K. Chancellor of the Exchequer has expressed his concerns to senior officials during face-to-face meetings in India, and many other governments are known to be in the process of preparing communications. To date, Indian officials have not responded meaningfully, instead trying to characterize the concerns as illusory beyond a small number of cases they describe as abusive, as eleventh-hour complaining, or as designed to thwart their efforts to prevent India from turning into a "tax haven". Unless they can be convinced to reevaluate these ill-considered proposals, the very real consequences will be a serious blow to India's attractiveness as a place for investment and increased disputes and revenue costs for both taxpayers doing business with or within India and those taxpayers' home country governments.

Introduction

The Finance Bill in India's Union Budget 2012, announced on March 16, proposed a series of unanticipated tax measures that raise serious concerns for U.S. and other investors. They have severely shaken the confidence of the international business community in India's respect for the rule of law, due process, and fair treatment of investors. If enacted in their current form in early May as predicted, they are likely to have a markedly negative effect on cross-border trade and investment into India, as companies reevaluate the costs and benefits of investing there. While every country has a sovereign right to decide its own tax policy, these proposals conflict with international norms and would exacerbate the unresolved difficulties that the United States and others already are encountering with Indian tax assessments that violate many of India's treaty obligations. They raise serious tax treaty and other issues for the United States as a major trading partner of India and would have substantial implications for the U.S. fisc.

Indian officials have asserted incorrectly that the proposals are consistent with international standards and practices, including those of the United States. Now that U.K. Chancellor of the Exchequer Osborne has visited India to raise U.K. concerns in person and numerous U.S. and other trade associations have written to senior officials on these issues, a failure to express legitimate U.S. concerns at this juncture could be taken as a signal of acquiescence in the proposed legislation and would set an undesirable precedent for the future. India can be expected to continue to advance such arguments, and its policy agenda of increased taxation at source, if not challenged now by its major treaty partners. Lest silence be interpreted as concurrence, we urge the U.S. Department of the Treasury to take the opportunity to raise these concerns in discussions regarding the U.S.-India financial and trade relationship with Finance Minister Mukherjee and other senior Indian officials at the earliest opportunity (*e.g.*, if possible, during next week's annual World Bank/IMF meetings in Washington).

This briefing paper provides background on the proposed measures, their implications for the United States, the efforts of the U.S. and global business community to dissuade Indian officials from enacting the proposed measures; and reactions thus far to such efforts.

Proposals of greatest concern to U.S. investors

1. Procedural and due process concerns

Substantial periods of retroactive application. The Finance Bill contains some two dozen provisions that would apply with retroactive effect, for periods of up to fifty years. Business opposes retroactive provisions imposing taxes as a matter of general principle because of the adverse business and economic impact of such retroactive changes on closed transactions and other legitimate expectations regarding the applicable tax treatment of past periods and, in the case of fund investments, because of the severe administrative difficulties they create. It is true that other governments have from time to time enacted retroactive tax provisions, but these are much more limited and targeted in scope than the proposals now pending in India. A survey of current practice in major

trading countries indicates that, while retroactive tax legislation is constitutionally prohibited in some countries (*e.g.*, Brazil, Russia, and Venezuela), in other countries where it can occur it is generally used sparingly, often in accordance with published principles, in limited specified circumstances only, and not to reverse decided court decisions for particular taxpayers.

The Indian Finance Minister has been quoted in recent press reports as having indicated that none of the proposed retroactive provisions will be applied more than six years back. The six-year period is an apparent reference to the general period of limitations on notice and assessment under Indian law. As explained below, the Finance Bill itself proposes, in Section 149 of the Income Tax Act, 1961 (the "Act"), to expand the general six-year period to sixteen years in cases involving income related to foreign assets. Even a six-year or sixteen-year period of retroactivity would be a matter of concern. In any event, Indian counsels have noted that the statements of the Finance Minister would not be binding on Indian tax authorities. It is unclear at this point whether the tax authorities would feel themselves thus restricted in applying legislation that provides for retrospective effect stretching back up to half a century and asserts even the right to reverse decided court cases.

Violation of *res judicata* in reversal of many decided cases. Although presented as clarifications, many of the retroactive changes proposed by the Finance Bill are in clear reaction and contradiction to numerous recent rulings and judgments rendered by Indian courts and tribunals that have been unfavorable to the authorities. Indeed, part of their stated purpose is to reverse those holdings. This violates the universal legal principle of *res judicata*. We have not been able to identify other instances in any country in which retroactive legislation has been used to reverse final and binding court decisions in favor of particular taxpayers.

The most prominent of the judgments that certain proposals appear designed to reverse is the very recent Supreme Court ruling in the *Vodafone* case,[1] which held that there was no ambiguity in Indian tax law at it stood at the time of the Vodafone transaction in question and that no income (including capital gain) arising from an overseas merger or acquisition between two non-resident companies involving a transfer of shares of a foreign company is taxable in India even if the transfer has the indirect effect of changing control of a company in India (unless, of course, such a transaction is a sham or a "colourable transaction" lacking any commercial substance). With their effective date of April 1, 1962, the proposed changes could affect numerous transactions, potentially including cases involving AT&T, General Electric, Kraft-Cadbury, E-trade, Fosters, and Sanofi-Aventis that are currently pending in various forums in India, as well as a reported 400 other transactions under investigation by the Indian tax authorities.

The provisions of the Finance Bill relating to the definition of "royalty" appear designed to nullify a number of other recent rulings and court decisions, including those involving Lucent Technologies, Motorola, Intelsat, Asia Satellite Telecommunications, Ericsson, Factset Research Systems, Infosys Technologies, ISRO Satellite Centre, and TV Today Network.

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[1] *Vodafone International Holdings B.V. v. Union of India*, (2012) 341 ITR 1 (SC).

The reversal of decided cases raises very serious concerns for U.S. (and other) investors in India. They are effectively deprived of due process in India if legislation can be enacted at any point to reverse even past court decisions. They are unable to have confidence that the independence of the Indian judiciary will be respected and uncertain regarding the reliance that may be placed on final decisions of the courts of law in India. Reversals after the fact may make it impossible for investors to ascertain with any confidence their final tax liabilities and obtain effective relief from double taxation. This creates a high barrier to the cross-border trade and investment that double tax treaties were negotiated to promote.

CBDT discretion to define treaty terms. Section 90(3) of the Indian Income Tax Act (the "Income Tax Act") currently provides that any term used but not defined in a tax treaty shall, "unless the context otherwise requires, have the meaning assigned to it" in a notification issued by the Central Government. The Finance Bill would seek to "clarify" Section 90(3) by indicating that where a term is used in a tax treaty but is assigned a meaning in a notification from the Central Government, then the meaning assigned to such term "shall be deemed to have effect" from the date on which the treaty came into force.[2]

This provision is of concern for a number of reasons. First, it is not clear that the meaning that might be assigned to a treaty term under this provision would be a meaning derived from the use of that term in Indian domestic law, or whether it might simply be a meaning chosen by the Central Government to apply for purposes of the treaty. It should be noted that under Article 3(2) of the U.S.-India Treaty (the "Treaty"), a State may, "unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 27 (Mutual Agreement Procedure)", interpret an undefined treaty term by reference to the meaning that the term has "under the law of that State for the purposes of the taxes to which the Convention applies". However, this does not grant blanket authorization to write unilateral domestic law definitions applicable specifically for treaty purposes. Indeed, if a party to the Treaty perceives that there are doubts about the proper interpretation of a treaty term, Article 27(3) provides that "the competent authorities of the Contracting States shall endeavour to resolve [those doubts] by mutual agreement." Efforts to develop unilateral interpretations are inconsistent with that approach.

In addition, it is not clear under the proposed new wording whether India would consider itself bound to refrain from using a domestic law definition where the context otherwise requires. As noted in both the OECD and UN Commentaries on Article 3(2), "a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention."

Finally, it is also worth noting that courts have hesitated to allow one State to alter the balance of a treaty unilaterally by enacting new definitions of undefined treaty terms after the conclusion of the treaty.[3] Moreover, even if Article 3(2) of a relevant treaty

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[2] See Clause 31(c) of the Finance Bill.

[3] See, *e.g.*, *The Queen v. Melford Developments, Inc.*, [1982] 2 S.C.R. 504 (Canada); Hoge Raad, September 5, 2003, BNB 2003/379c* and 381c* (Netherlands).

contains language which allows reference to the domestic law meaning of a term from time to time, States are supposed to respect the principle of good faith in their treaty application and not enact unilateral legislation which clearly alters the balance of benefits.

Tax collection and refund provisions. Clause 113 of the Finance Bill is a free-standing provision which in rather stunning terms purports to legitimize all pre-enactment assessments (and related past or future collections) of Indian tax on income from transfers of shares in foreign companies with underlying Indian assets, saying that they "shall be valid and shall be deemed always to have been valid and shall not be called in question *on the ground that the tax was not chargeable or any ground*" (emphasis added), that this shall be the case "notwithstanding anything contained in any judgment, decree or order of any Court or Tribunal or any authority", and that "there shall be no liability or obligation to make any refund whatsoever". This provision could arguably permit the Indian tax authorities to resurrect previous tax demands on Vodafone and would purport to permit the authorities to retain amounts previously deposited by other assessees in connection with pre-enactment indirect share transfers, with no obligation to refund those amounts even if directed by a court or tribunal to do so. The breadth of the language also calls into question taxpayers' ability to challenge improper assessments on any number of grounds other than geographic jurisdiction (*e.g.*, procedural barriers, computational errors, etc.).

Withholding agent obligations. Section 195 of the Income Tax Act provides that any person responsible for paying to a nonresident or a foreign company any interest or any other sum chargeable to tax is required to withhold tax from the payment at the applicable rates in force. Clause 75 of the Finance Bill would amend Section 195 of the Act in two respects. First, it "clarifies", with retroactive effect to 1962, that this withholding obligation applies to both resident and nonresident payors, and in the case of nonresidents whether or not the payor has any residence, place of business, business connection, or any other presence in India. This change appears aimed at legitimizing the withholding obligation the Indian tax authorities unsuccessfully asserted against Vodafone in the share purchase which took place outside India (and perhaps also other companies in similar circumstances). Second, the Finance Bill would extend the withholding obligations by providing that the Central Board of Direct Taxes is authorized to publicly designate a class of persons or cases in which a person making a payment of any sum to a nonresident will be required, *whether or not such sum is chargeable to tax under the Act*, to apply to the Assessing Officer for a determination of the "appropriate proportion of [the] sum chargeable" and will be required to withhold tax from the amount so determined by the Assessing Officer. The Finance Bill suggests that the Assessing Officer would be able to require withholding on amounts even if they clearly are not chargeable to tax under the Income Tax Act. Such a provision gives the tax authorities essentially unfettered discretion and, together with the tax collection and refund provisions described above, could lead to great difficulties in obtaining refunds of unwarranted tax withholdings.

Treaty certification requirements. Section 90 of the Income Tax Act authorizes India's Central Government to enter into tax treaties with other countries. Clause 31(c)

of the Finance Bill would amend Section 90 prospectively by introducing the requirement that any nonresident to whom a tax treaty applies will be entitled to claim relief under the treaty only if he obtains from the Government of the relevant treaty country "a certificate, containing such particulars as may be prescribed, of his being a resident" in that country. While it is recognized that treaties do not lay down rules concerning each country's procedural requirements for allowing the substantive relief provided by treaty, this provision raises concern on a few grounds.

First, India's reputation for imposing bureaucratic hurdles to the realization of treaty benefits and for adopting unorthodox interpretations of treaty provisions creates a concern that this seemingly innocuous procedural requirement could develop into a serious obstacle to fully legitimate treaty entitlement claims.

Second, the provision provides no guidance on the format of the residency certificate that must be obtained or the nature of the information it must contain, leaving all of that to the discretion of the Central Board of Direct Taxes. Experience has shown that overly burdensome requirements in connection with certificates of residence can have severely detrimental effects on the effective ability of taxpayers to access the treaty benefits to which they are entitled, the ability of financial intermediaries to process the required documentation in a cost-efficient way, and the ability of residence country governments to minimize both unjustified foreign tax credit claims and the potentially significant costs of producing the required certificates.[4]

Third, to the extent that the provision suggests that the certificate will be required, but not sufficient, to claim residency for treaty entitlement purposes, it would conflict with the decision of the Indian Supreme Court in the *Azadi Bachao Andolan* case, in which the Court upheld the validity of an Indian Government Circular which provided that a certificate of residence issued by the tax authorities of an India treaty partner constituted sufficient evidence for accepting the status of residence.[5]

16-year statute of limitations. Pursuant to Section 147 of the Income Tax Act, if an Assessing Officer has reason to believe that any income chargeable to tax has escaped assessment due to the taxpayer's failure to file a return, he may assess the tax, but only if he first issues a notice to the taxpayer requiring him to file a return for the relevant year within a specified period. Section 149 of the Income Tax Act currently provides that the notice to file a return may not be issued more than six years after the end of the assessment year in question. Clause 62 of the Finance Bill would amend Section 149 of the Income Tax Act by extending the six-year limitation to sixteen years in cases where taxable income in relation to any asset (including financial interest in any entity) located outside India has escaped assessment. This change is proposed to apply both prospectively and retroactively to any assessment year beginning on or before April 1, 2012. In other words, this provision would allow the Indian tax authorities to bring

[4] See, *e.g.*, the discussion of these problems in the OECD's "Report of the Informal Consultative Group on the Taxation of Collective Investment Vehicles and Procedures for Tax Relief for Cross-Border Investors on Possible Improvements to the Procedures for Tax Relief for Cross-Border Investors" (January 12, 2009), available at http://www.oecd.org/dataoecd/34/19/41974569.pdf.

[5] *Union of India and another v. Azadi Bachao Andolan,* 2003-(263)-ITR-0706-SC (October 7, 2003).

assessments against nonresidents for indirect share transactions dating back to 1996 at a minimum, even if the 1962 effective date of the indirect share transfer provision discussed below were not given full effect in practice.

2. Substantive proposals

Although the following changes are described in the Finance Bill as clarifications, they are substantive changes in law which would impose burdensome new tax liabilities.

Indirect stock transfers. Section 5 of the Income Tax Act provides that a nonresident of India is taxable on any income which "accrues or arises or is deemed to accrue or arise" to the nonresident in India. Section 9(1)(i) deems income to arise or accrue in India if it accrues or arises, whether directly or indirectly, through the transfer of a capital asset situated in India. In its January 2012 decision in the *Vodafone* case, the Supreme Court of India squarely held that a nonresident's transfer of shares in a non-Indian company did not give rise to income deemed to arise or accrue in India under Section 9(1)(i), even if the non-Indian company held shares in an Indian company.

The Finance Bill proposes to amend Section 9(1)(i) to overturn the Supreme Court's decision by specifying that stock in a foreign company "shall be deemed to be and shall always be deemed to have been" situated in India if the stock "derives, directly or indirectly, its value substantially from the assets located in India".[6] This amendment is proposed to have retroactive effect from April 1, 1962.

The Finance Bill does not describe what is meant by deriving value "substantially" from assets located in India (*e.g.*, it is not known whether that might mean ninety-five percent, fifty percent, ten percent, or some other amount). It appears to cover potentially both direct investment shareholdings and portfolio shareholdings (including stock exchange-traded shares) in foreign companies with underlying Indian assets. The Finance Bill, therefore, would introduce a significantly broader scope for source basis taxation of nonresidents' capital gains by India than would be allowable under the OECD or even under the UN Model Tax Convention.[7] It would also involve significantly broader source basis taxation of nonresidents' capital gains than India had previously staked out through the positions it entered on the OECD Model Tax Convention.[8]

The Finance Bill also proposes to make further changes to buttress the new claim to tax indirect stock transfers. It proposes to amend Section 2(14) of the Income Tax Act to provide that "property" includes any management or control rights in an Indian company transferred outside India.[9] It would also amend Section 2(47) of the Income

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6 See Clause 4(a) of the Finance Bill.

7 Article 13(4) of the OECD and UN Model Tax Conventions allows a country to tax a nonresident's gain from the alienation of shares in a foreign company only if more than 50 percent of the value of the company's property consists directly or indirectly of real estate situated in the taxing State.

8 In its published positions on the OECD Model, India reserved the right to tax gains from Indian shares, reserved its position on Article 13(4), and did not reserve its position on Article 13(5), which prohibits source State taxation of gains not enumerated in the preceding paragraphs.

9 See Clause 3(i) of the Finance Bill.

Tax Act to specify that a "transfer" of an Indian asset includes indirect transfers effected through the transfer of shares in non-Indian companies.[10]

Expansion of royalty definition -- software. Section 9(1)(vi) of the Income Tax Act provides that a nonresident of India is generally taxable on a royalty payable by a resident of India. It defines "royalty" to include the transfer of all or any rights (including the granting of a license) in respect of any copyright, literary, artistic or scientific work.

The Finance Bill proposes to amend Section 9(1)(vi) to provide that this definition "includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a licence) irrespective of the medium through which such right is transferred".[11] This change is proposed to be retroactive to June 1, 1976, and it would have the effect of characterizing all payments for software, including payments for shrink wrap software, as royalties subject to withholding tax at source.

This change would conflict with a long series of rulings from Indian courts and tribunals, which have held that a distinction must be drawn between transfers of copyrighted articles and transfers of copyright rights.[12] Under those rulings, which are consistent with both the provisions of U.S. Treas. Reg. §1.861-18 and with OECD guidance, a supply of software which does not convey copyright rights (*e.g.*, the right to copy and exploit commercially) is properly characterized as a non-royalty sale of a copyrighted article. While the Indian judiciary's views have not been completely unanimous on this question, and the Supreme Court of India has yet to rule on the characterization of software payments under Section 9(1)(vi), the Finance Bill's changes would be contrary to the weight of prevailing authority, would preempt judicial resolution of the question, and would put characterization under Indian law squarely in conflict the prevailing international view and the view of the majority of Indian courts and tribunals.

Expansion of royalty definition – satellite and other transmissions. Section 9(1)(vi) of the Income Tax Act includes within the definition of taxable royalties amounts paid for "the use or right to use any industrial, commercial or scientific equipment", as well as the use of any "secret formula or process".

The Finance Bill would amend Section 9(1)(vi), with retroactive effect to June 1, 1976, to specify that "the expression 'process' includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret".

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[10] See Clause 3(iv) of the Finance Bill.

[11] See Clause 4(b) of the Finance Bill.

[12] See, *e.g.*, *DIT v. Ericsson Radio System A.B.,* ITA 504/2007 (Delhi High Court, 2012); *Dynamic Vertical Software India (P) Ltd.*, 332 ITR 222 (Delhi High Court, 2011); *GE India Technology* (2010) 13 ITLR 152 (Supreme Crt India, September 9, 2010).

These changes would conflict directly with prevailing international norms, which treat payments to satellite operators from their customers as non-royalty business profits.[13] They would also conflict directly with a whole series of Indian court decisions.[14]

Similarly, the treatment of payments for transmission by cable or optic fibre as royalties conflicts with international norms. There, too, payments for access to the capacity of cables or optic fibre are typically respected internationally as non-royalty business profits.[15]

Finally, the changes to Section 9(1)(iv) would also specify that the term royalty also includes "consideration in respect of any right, property or information, whether or not (a) the possession or control of such right, property or information is with the payer; (b) such right, property or information is used directly by the payer; (c) the location of such right, property or information is in India."[16] The intent of this proposed treatment of payments "in respect of" information as royalties, regardless of whether the payor possesses or controls the information or even uses the information directly, is ambiguous, raising the question of whether some might seek to construe it to apply to online software transactions, including transactions in which software is provided as a service.

GAAR provisions. U.S. investors also are seriously concerned about the very expansive scope of the proposed general anti-avoidance rule (GAAR) and its broad treaty override provisions. India is not the only country that has opted to introduce a GAAR, but the version that it has proposed appears designed in large part to target perceived "treaty shopping" by overriding treaty provisions. The GAAR provisions vest broad discretionary powers in the income tax authorities without any checks and balances on the exercise of such power. Its scope is much wider than that of existing GAARs or

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13 See, *e.g.*, paragraph 9.1 of the Commentary on Article 12 to the OECD Model Tax Convention, which provides: "Payments made by customers under typical "transponder leasing" agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 2: these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition (they cannot be viewed, for instance, as payments for information or for the use of, or right to use, a secret process since the satellite technology is not transferred to the customer)."

14 See, *e.g.* *Asia Satellite Telecommunications Ltd*. [TS-29-HC-2011 (DEL)]; *TV Today Network Ltd.* [TS-584-ITAT-2011 (DEL)]; *Intelsat Corporation* [TS-93-ITAT-2011 (DEL); *ISRO Satellite Centre* TS-82-AAR-2009; *New Skies Satellites NV*, (2009) 12 ITLR 409 (ITAT).

15 See, *e.g.*, paragraph 9.1 of the Commentary on Article 12 of the OECD Model Tax Convention ("As regards treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties, the characterisation of the payment will depend to a large extent on the relevant contractual arrangements. Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of payments for services, to which Article 7 applies, rather than payments for the use, or right to use, ICS equipment. … Similar considerations apply to payments made to lease or purchase the capacity of cables for the transmission of electrical power or communications (*e.g.* through a contract granting an indefeasible right of use of such capacity) or pipelines (*e.g.* for the transportation of gas or oil).")

16 See Clause 4(b) of the Finance Bill.

proposed GAARs in most countries. Additionally, the GAAR provisions shift the entire burden of proof from the tax authorities to the assessee to show that there is no "impermissible avoidance arrangement", creating the potentially impossible burden of proving a negative..

The "tax benefit" required for application of the GAAR is defined to include, among other things, "a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or … an increase in a refund of tax or other amount under this Act as a result of a tax treaty."[17] A number of the proposed GAAR provisions would authorize Indian tax authorities to deny the benefits of the U.S. Treaty with India to U.S. entities receiving income from India in any situation the Indian tax authorities characterize as an "impermissible avoidance arrangement", even if such entities fully satisfy the Treaty's specific requirements for benefits such as the beneficial ownership provisions in Articles 10 (Dividends), 11 (Interest), and 12 (Royalties) and the limitation on benefits provisions in Article 24 (Limitation on Benefits), and even if the Indian tax authorities' characterization is related to factors of the type that were directly taken into account in the negotiation of those specific Treaty provisions.

In his 2010 IFA General Report, *Tax treaties and tax avoidance: application of anti-avoidance provisions,* and in remarks at the December 2011 International Tax Conference in Mumbai, Prof. Dr. Stef van Weeghel questioned why few countries have chosen to include specific limitation on benefits provisions in their treaties to address treaty-shopping concerns, despite the fact that other countries began including such provisions several decades ago.[18] Even more puzzling is the fact that some countries, such as India, have included limitation on benefits provisions in some of their treaty agreements — including, in the case of India, the Treaty signed in 1989 with the United States — while choosing to omit such provisions from other treaties they have negotiated. We would suggest that, where specific limitations on benefits, beneficial ownership requirements, or other limitations on the availability of benefits are specified in the treaty, their scope should not be subject to unilateral expansion by one of the treaty partners through the application of GAAR provisions. In any event, it seems that where a country includes provisions limiting the availability of benefits in some treaties but not in later treaties, it should at a minimum be precluded, by negative inference, from applying to the former treaties GAAR provisions that it may subsequently enact to target perceived treaty-shopping.

Implications for the United States

1. Treaty overrides

The proposed Indian tax measures discussed above would have substantial negative consequences for the U.S. fisc as well as for U.S. investors. Several of the

[17] See new Section 102(11)(c), (d), proposed by Clause 40 of the Finance Bill for addition to the Income Tax Act.

[18] International Fiscal Association, Cahiers de droit fiscal international, Volume 95a (2010), page 49.

proposed measures are inconsistent with India's specific obligations to the U.S. under the Treaty. Taken together, the proposals would unilaterally change the negotiated balance of benefits under the Treaty, in disregard of India's obligation under international law to apply its treaties in good faith. In addition to the loss of reciprocal benefits, the U.S. would be obligated under its domestic law in many cases to provide unilateral relief from double taxation for the additional Indian taxes imposed. It is highly unlikely in the current climate that such concerns could be addressed satisfactorily by the Competent Authorities under the Treaty's mutual agreement procedures.

It is important to appreciate the context in which the Indian proposals have been introduced. They come at a time when India has already begun systematically violating numerous provisions of its Treaty with the United States, both in the positions taken by the Indian tax administration in domestic assessment, appeals, and litigation proceedings and in the positions taken by the Indian Competent Authority in cases under the Treaty's mutual agreement procedure article. For example, Indian tax authorities routinely assert the existence of a permanent establishment in India on grounds not permitted by the Treaty, such as the mere fact that an Indian subsidiary is related to a U.S. company, the maintenance of a liaison office in India that conducts purely preparatory or auxiliary activities, the mere performance of services by an Indian company for a related U.S. company, the assertion that the U.S. company could have done business in branch form in India but has chosen to incorporate a subsidiary company, unproven assertions regarding the presence in India of employees of the U.S. company that the company is expected to rebut, or even a general "virtual projection PE". Indian tax authorities have been taking similarly expansive and unfounded positions in asserting royalty withholding tax obligations, and have even sometimes asserted the right to tax royalties that they deem to be attributable to an Indian PE on a gross basis at domestic law rates of withholding, rather than on the net basis prescribed by the Treaty. For the past several years, the Indian Competent Authority has supported such positions and refused to acknowledge that they are inconsistent with India's obligations under the Treaty. Other major treaty partners of India are known to be encountering similar issues.

In a long series of cases, the Indian courts and tribunals have generally rejected such arguments and held these interpretations to be inconsistent with India's treaty obligations as well as domestic law provisions. For example, as noted above, a series of recent decisions have held that consideration received for computer software products and for transmission by satellite did not constitute royalty income subject to withholding. There have also been decisions ruling against the finding of a permanent establishment in situations such as the above.[19]

The Finance Bill proposals seek to codify and extend some of these treaty violations. For example, the royalty provisions would amend Indian domestic law with retrospective effect to provide that a payment for the transfer of any right to use computer software products constitutes a royalty. This proposed change to the characterization of

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[19] See, *e.g., Kolkata v. Assistant Director of Income Tax (International Taxation)-II (117 TTJ 792) (Cal); Western Union Financial Services Inc v. Assistant Director of Income Tax (291 ITR 176)(Del)*; *IAC v. Mitsui and Co. Limited (39 ITD 59) (SB)(Del)*; *Motorola Inc. v. DCIT (95 ITD 269)(Del).*

payments for software products does not, as asserted, constitute a mere "clarification" of Indian domestic law. It directly contravenes the confirmation by a majority of India's courts and tribunals that the royalty provisions of Indian treaties and domestic law do not apply to payments for "shrink wrapped" software and other copyrighted software products. It is also contrary to the specific international guidance on such transactions that has been developed since 1992 at the OECD and in the domestic legislation of many countries, including the United States. Although the proposed legislation does not expressly state that this provision overrides the royalty provisions of India's tax treaties, and those treaty provisions do not defer generally to the provisions of domestic law, some may maintain that such a change in the domestic law definition of the term royalty affects the interpretation of that term under treaties as well.[20]

The proposed expansion of the royalty definition seeks to have a similar overriding effect on the taxation of consideration for transmissions by satellite, again reversing a number of recent Indian court decisions to the contrary.

As another example, use of the new general anti-avoidance rule (GAAR) provisions to deny treaty benefits in the broad, discretionary manner proposed would be fundamentally inconsistent with the specific limitation on benefits and beneficial ownership provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 24 (Limitation on Benefits) of India's Treaty with the United States. The application of the GAAR rules in this manner would constitute an impermissible unilateral amendment of the Treaty.

Even the Finance Bill proposals that do not directly contravene the plain text or current judicial interpretation of specific provisions of the Treaty would significantly upset the negotiated balance of benefits under the Treaty. This would be contrary to the legitimate expectations of the United States at the time the Treaty was negotiated and ratified. Such changes would violate India's obligations to apply its treaties in good faith under customary international law, as reflected in the Vienna Convention on the Law of Treaties[21] and in the above-referenced OECD and UN Commentaries on Article 3(2).

For example, the asserted right to tax gains on indirect transfers back to 1962 is inconsistent with India's domestic law as in effect when the Treaty was signed and ratified by the United States more than two decades ago. While the Treaty does not explicitly limit either State's right to tax gains realized by residents of the other State and simply confirms the right of each State to tax gains in accordance with its domestic law, that agreement was struck at a time when neither India nor any other U.S. treaty partner asserted the right to tax indirect share transfers such as India is now trying to do. The United States has never explicitly sanctioned such a broad taxing right in any of its treaties, and while we have not exhaustively reviewed the many thousands of treaties in force around the globe, we are not aware of any treaty in force anywhere, including any of India's treaties, which does so. India's claim of taxing rights over indirect share transfers is far broader than the provision on the taxation of gains from the disposition of

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[20] Whether this is the case as a matter of law in India would be an issue of treaty interpretation that would, no doubt, generate substantial controversy.

[21] Vienna Convention on the Law of Treaties, Article 26.

shares in real property holding companies found in both the OECD and UN Model Tax Conventions, and it is also far broader than the reach of even the UN Model Tax Convention provision on gains from disposition of substantial shareholdings in local companies, as it would assert jurisdiction to tax gains from indirect transfers even where they do not relate principally to holdings of real property situated in India. Therefore, the proposed legislation would be contrary to the reasonable expectation of the United States at the time the Treaty was signed and ratified that India would not seek unilaterally to tax such gains, or certainly not with retrospective effect. Such a dramatic and retrospective altering of the balance of benefits prevailing under the Treaty bargain severely undercuts the spirit of the Treaty's provisions which require each State to notify the other of significant changes in their taxation laws and authorize each State to terminate the Treaty for future periods upon giving specified notice.[22]

The proposal granting the CBDT broad discretion to define treaty terms with retroactive effect raises similar concerns. It is directly contrary to the indication in both the OECD and UN Commentaries on Article 3(2) that "a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention."

2. Revenue implications

Given the current difficulties in addressing Indian interpretations that are inconsistent with the Treaty in pending cases, it is highly unlikely that the Competent Authorities will be able to resolve differences of view on the proposed measures. It is, therefore, likely that the United States ultimately will be called upon to provide relief from double taxation by allowing foreign tax credits pursuant to the provisions of the Internal Revenue Code and/or the Treaty. As many of the proposed provisions would apply for decades in the past and, in some cases, involve gross-basis withholding taxes, the amounts at issue are likely to be very substantial.

The retrospectivity of India's proposed law changes, and in particular the remarkable insistence on overturning the decisions of specific cases achieved through often difficult, prolonged, and expensive court proceedings, casts serious doubt on the practical effectiveness of judicial proceedings as a means of ensuring that the tax to be paid to India will reflect the correct liability under Indian tax law. United States taxpayers can hardly be asked to pursue judicial remedies to apparently excessive tax claims by a foreign government if that government's unchallenged reaction to a loss in court is to enact legislation overturning the judicial determination, retroactively changing the law. As a country that provides double tax relief through a credit system, the United States should be legitimately concerned when its taxpayers face such potentially crippling constraints on their ability to successfully challenge unwarranted tax assessments from a foreign government, particularly where that government purports to be an upstanding treaty partner of the United States.

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[22] See Articles 2(2) and 31 of the Treaty.

3. Policy implications

Many of the proposed measures in question share one feature: they are designed to expand India's jurisdiction to tax on the basis of source, as defined under Indian domestic law. This is fully consistent with the policy positions currently being advanced by senior Indian officials in the context of discussions at the UN and the OECD. However, the United States has already made unprecedented concessions of source-basis taxing rights to India in the current Treaty and should not countenance a further expansion of such rights on a unilateral basis.

The arguments advanced by senior Indian officials in defense of some of the proposed measures indicate that India is asserting the right to tax income in some situations solely on the ground that it is not taxed by other countries. This "soak up" argument demonstrates a dangerous willingness on India's part to encroach upon the legitimate taxing jurisdiction of other countries over their own residents where that jurisdiction is not being exercised fully by those other countries as a result of their own policy choices. The assertion of this right is particularly troubling where it relates to gain on indirect stock transfer transactions, as such gain generally is not taxed by other comparably situated countries except in some situations involving substantial underlying real property interests.

Discussions with Indian officials to date

A large and growing number of trade associations representing hundreds of thousands of companies around the world have written senior Indian officials to express serious concerns regarding the proposed legislation, including the following of which we are aware and are attaching copies:

- Business Roundtable, the National Foreign Trade Council, and the United States Council for International Business, in a joint letter of March 29 also signed by major trade associations from the U.K., Japan, Canada, and Hong Kong to Prime Minister Singh, with copies to Finance Minister Mukherjee and other Ministers;
- The International Chamber of Commerce and the Business and Industry Advisory Committee to the OECD, which represent business globally, in a joint letter to Finance Minister Mukherjee dated April 3;
- The Tax Executives Institute, in a letter of April 6 to Prime Minister Singh, Finance Minister Mukherjee, and other Ministers;
- Asia Securities Industry & Financial Markets Association (ASIFMA) and the Securities Industry and Financial Markets Association (SIFMA), in a letter to Finance Minister Mukherjee dated March 28;
- The Investment Company Institute and ICI Global, in a letter to Finance Minister Mukherjee dated April 3; and

- The Software Coalition, in a letter to Prime Minister Singh with copies to Finance Minister Mukherjee and other Ministers dated April 10.

Indian business leaders and their advisors have also publicly expressed concerns regarding the proposed legislation, with prominent counsel arguing that its retroactive provisions are unconstitutional.

In addition, U.K. Chancellor of the Exchequer Osborne visited India on March 30 for face-to-face meetings with senior officials to discuss the concerns of the U.K. Government and U.K. companies regarding the proposed legislation, and did a television interview as well. We understand that other governments are also considering engaging on these issues.

Financial institution representatives also have met at least twice in the past week with senior Indian officials in New Delhi to discuss their need for certainty and prospectivity in the application of the GAAR provisions in particular.

The concerns raised in these communications have been reported extensively and, almost without exception, favorably in the Indian and global press. Representative samples of these press reports are attached.

The public responses thus far from Indian officials generally have not been directly responsive.

The most common response has been to attempt to characterize the legislation as aimed exclusively at Vodafone, which it clearly is not, and to focus press attention solely on the Vodafone case.

There have also been suggestions that critics are seeking exemption from all Indian tax and wish India to be a tax haven, which also clearly is not the case. Although India itself has offered certain limited tax incentives to attract software development and other specified business, the Indian tax burden generally is quite onerous. Vodafone alone, for example, has stated that it has paid over $4.8 billion since 2007 in Indian tax unrelated to the transaction at issue in its Supreme Court case.

It has also been suggested that India should feel free and perhaps even called upon to tax a transaction if the other jurisdiction involved chooses not to do so, even if India is virtually alone among nations in asserting tax on the type of transaction at issue.

There have been complaints that concerns were raised at the last minute. This certainly is not accurate for the GAAR provisions, on which Indian officials have received extensive comments from investors in the past several years, prompting India's Standing Committee on the matter to recommend changes that were not adopted. While India has espoused a number of the substantive provisions as their policy or interpretive position for some time, the additional step of trying to legislate them, mainly in retroactive fashion, was not previously signaled, and there was no indication of the procedural changes proposed, so there was no opportunity for comment.

On some issues, there have been suggestions that investors should await future guidance and trust that it will resolve their concerns if they are legitimate. However, the concerns expressed in discussions to date generally have not been acknowledged as legitimate and it has been suggested that the needed certainty cannot be provided.