

# LEGAL AND PRACTICAL STRATEGIES FOR MANAGING TAX DISPUTES IN INDIA

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In an era of globalization, where foreign entities are looking at rapid expansion and turning to newer markets such as India, entities may find themselves exposed to unexpected tax risks and disputes in jurisdictions with unfamiliar tax systems. A tax dispute can potentially have serious long-term ramifications with respect to both the profitability of the entity and the reputation of the business enterprise. In the Indian context, the last decade has seen an upsurge in tax disputes, with a number of high-profile cases currently being contested at various levels. Multinational companies such as Vodafone, Nokia, Shell, Aditya Birla, and NDTV are all cases in point.

The main causes for the rise in tax disputes are as follows:

- Recent efforts on the part of the Indian tax authorities to widen the country's tax base by emphasizing source-based taxation
- Taxpayers implementing "creative" structures to achieve a tax-effective structure or transaction
- Confusion resulting from lack of clarity on new provisions exacerbated by aggressive interpretations by both taxpayers and tax authorities
- Conflicting rulings pronounced by different appellate forums or authorities across the country contributing to delays or multiplicity of tax disputes

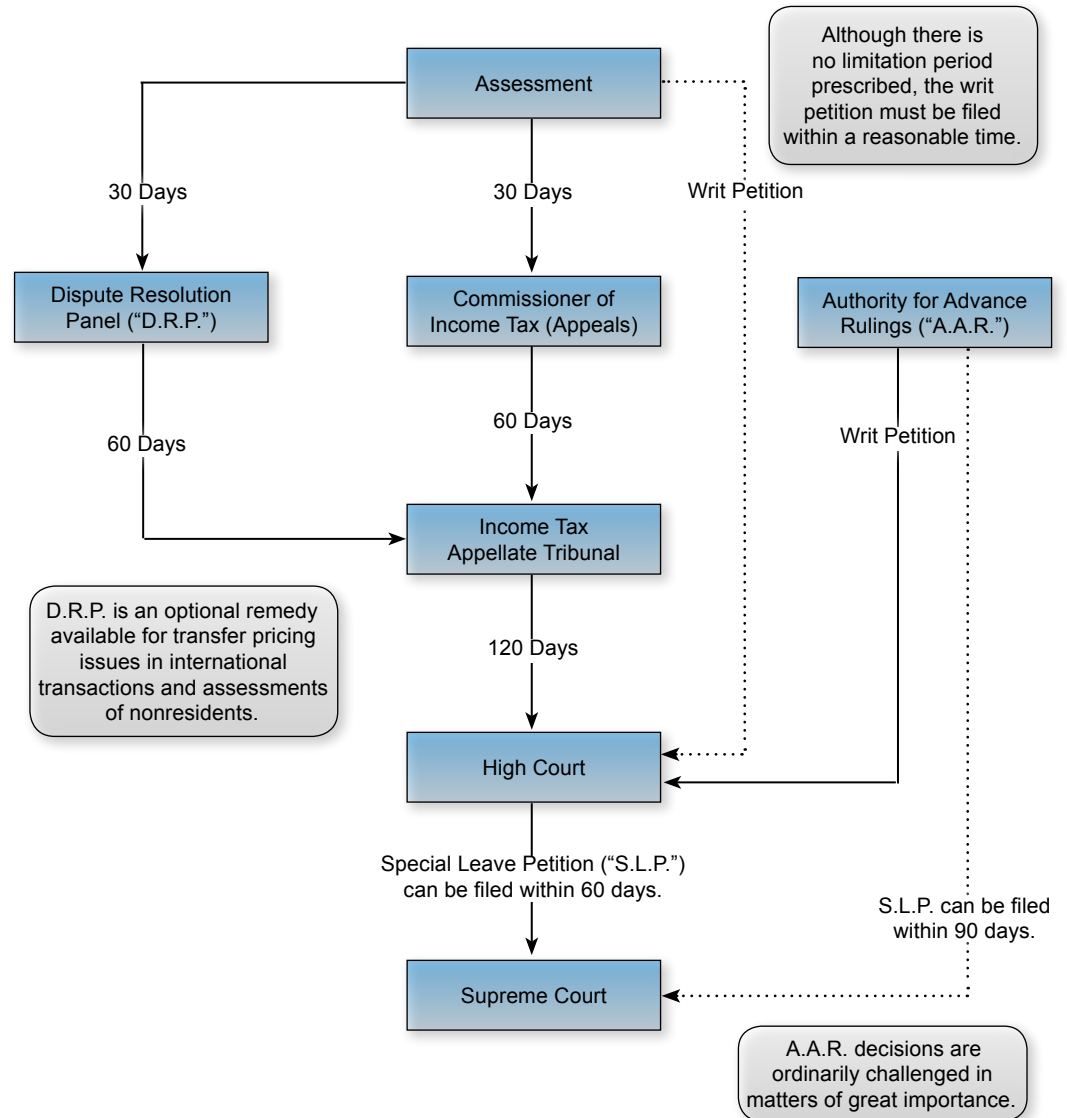
The following high-profile tax disputes and controversies in India have gathered attention in the recent years:

- The \$11 billion *Vodafone* case wherein the question of taxability of indirect transfer of Indian assets was decided by the Supreme Court of India
- The *Nokia* case, which involved taxation of royalty payments from Nokia India to its Finnish parent company, wherein the Income Tax Department issued a notice to Nokia's subsidiary in India and froze its assets
- The *Shell India* and *Vodafone* cases involving the application of transfer pricing provisions regarding the issue of shares and the alleged under-valuation of shares to avoid tax in India<sup>1</sup>
- The Aditya Birla-AT&T deal involving the question of an "indirect transfer" of Indian assets and the application of the India-Mauritius Income Tax Treaty
- The recent *NDTV* case where the Income Tax Appellate Tribunal ("I.T.A.T.") collapsed the entire multi-jurisdictional corporate structure created by NDTV and taxed certain amounts received by it as unexplained income

<sup>1</sup> This issue has been resolved following the Bombay High Court's decision in *Vodafone* and the Indian government's support for the decision.

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The diagram below provides an overview of the appeals process in India and the timelines for filing such appeals or objections:



*"The last decade has seen an upsurge in tax disputes, with a number of high-profile cases currently being contested at various levels."*

## DEVELOPING PROPER STRATEGIES FOR EFFECTIVE HANDLING OF TAX LITIGATION

The importance of enlisting sound tax counsel to develop effective legal strategies and mitigate tax disputes cannot be overemphasized. Such strategies can be beneficial both before and after a transaction is effected. Unless handled properly, litigation can be a long-drawn and expensive affair in India.

### Preventing Tax Disputes

Some of the key steps that could help avoid tax litigation are set out below:

- Vet transactions from an income tax perspective to ensure compliance with all applicable laws and legal "do-ability."
- Appropriately draft legal documents and vet prospective structures from tax

perspective to avoid unnecessary litigation or disputes going forward. With the introduction of the General Anti Avoidance Rules (“G.A.A.R.”), it is important that the commercial intent behind each transaction is immaculately captured in the transaction documents.

- When undertaking a transaction such as an acquisition, merger, slump sale,<sup>2</sup> or share sale, ensure that all relevant documents and evidence are preserved, including supporting evidence with respect to the valuation of the assets involved.
- Take a proactive approach by making the best use of the forums available for speedy dispute resolution (e.g. approach the Authority for Advance Ruling (“A.A.R.”) for a determination on the taxability of a transaction).
- Make appropriate disclosures in tax returns at the outset to bring relevant facts and legal documents on record and lay the foundation for a strong defense of the taxpayer’s position. This can also help to avoid the application of penalties, if the taxpayer’s claim is not accepted in a tax assessment.
- When undertaking international transactions with related parties, a taxpayer should make a reasoned determination of how it will handle transfer pricing aspects of the transactions. Choices include (i) preparation of a competent transfer pricing study prior to undertaking the transaction, rather than as an afterthought, (ii) utilization of the Advance Pricing Agreement (“A.P.A.”) mechanism, as discussed in detail below, or (iii) adherence to the prescribed safe harbor rules.
- Consider obtaining a “tax insurance policy” to safeguard against any potential future tax demands.

### **Handling Tax Disputes**

When tax disputes arise, it is critical that the taxpayer arrange for proper and effective representation before the tax and appellate authorities and that all key facts, arguments, supporting evidence, and relevant documentation are put forth in a comprehensive manner. It should be noted that the High Courts and the Supreme Court generally decide on questions of law and not questions of fact. Further, they do not routinely permit the introduction of additional evidence. There should also be timely compliance with official procedures and follow up to push for speedy resolution of disputes.

## **UTILIZING FORUMS THAT FACILITATE DISPUTE RESOLUTION**

Under Indian income tax laws, the following forums facilitate dispute resolution.

### **A.A.R.**

This forum is primarily available to nonresidents and foreign companies. An advance

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<sup>2</sup> A slump-sale involves the transfer of one or more undertakings as a result of the sale for a lump-sum consideration without values being assigned to the individual assets and liabilities.

ruling can be obtained for a completed transaction as well as for a proposed transaction, but not for a hypothetical transaction. An A.A.R. ruling is binding on the tax authorities and the applicant. Consequently, it provides certainty regarding the tax position in India for a nonresident or foreign company. However, in several instances, the High Courts and the Supreme Court have entertained challenges against advance rulings by way of a writ petition or a special leave petition (“S.L.P.”) under the Constitution of India.

It may be noted that the prerequisite for filing an application before the A.A.R. is that the question raised by the applicant must not be pending before any income tax authority, appellate tribunal, or court.

The benefit of approaching the A.A.R. is that potential proceedings before a tax officer are usually put on hold from the date of the application until the date of the ruling. Consequently, the tax authorities may not assert, or demand payment of, a tax liability while A.A.R. proceedings are under way.

While the provisions prescribe a time limit of six months, within which the A.A.R. will pronounce its ruling, of late the A.A.R. has been taking between two or four years to issue its ruling. Factors contributing to this delay include a vacancy in the office of the chairman and a backlog of cases. One hopes that this situation will soon improve and the A.A.R. will revert to the prescribed timeframe.

### **A.P.A.’s for Transfer Pricing Matters**

Globally, as well as in India, transfer pricing disputes account for a major portion of all tax litigation. With a view to reduce such litigation, the Indian government has introduced a framework for A.P.A.’s between the tax authorities and certain specified taxpayers who enter, or propose to enter, transactions with associated enterprises outside India. An A.P.A. is an agreement between a taxpayer and the tax authority on an appropriate and mutually agreed upon transfer pricing methodology for a set of transactions over a fixed period of time.

An A.P.A. will be valid for the period of years specified in the agreement, subject to an upper limit of five consecutive tax years. A rollback provision is also available, so that the A.P.A. is applicable to past years as well. The A.P.A. is binding only with respect to the specified transaction. The A.P.A. ceases to be binding if there is any change in law or facts bearing on the subject matter of the A.P.A.

An A.P.A. provides the following benefits to the taxpayer:

- Certainty with respect to the international transactions covered in the agreement
- Low annual reporting costs
- Flexibility in developing pragmatic and workable solutions for complex transfer pricing issues owing to the joint endeavors of the taxpayer and the tax authorities
- Excellent returns on the time and effort invested in negotiating the original A.P.A. when the agreement is renewed
- Reduction in risks and costs associated with transfer pricing audits and litigation over the term of the A.P.A.



As of July 31, 2017, the tax department entered into 171 A.P.A.'s, which include 12 bilateral A.P.A.'s and 159 unilateral A.P.A.'s.

### **Withholding Tax Authorization**

An action taken with the consent of the tax authorities is generally protected from litigation going forward.

If a payor or a recipient believes that a proposed payment is not taxable in India, or is taxable at a reduced rate, the tax authorities may be approached for authorization. Where the tax authorities issue a reduced rate or zero tax withholding certificate, the payment can be effected without deducting tax or with tax deducted at a reduced rate.

This mechanism can reduce the possibility of later disputes. However, the withholding certificate is not a conclusive determination of the recipient's tax position. The tax authorities usually reserve the right to make a final determination when assessing the taxpayer's return for the relevant period.

### **Dispute Resolution Panel ("D.R.P.")**

The D.R.P. is another mechanism formulated by the Indian government to facilitate expeditious resolution of tax disputes. The D.R.P. consists of a collegium of three commissioners of income tax who adjudicate matters concerning adjustments proposed by the tax officer in tax assessments of foreign companies and cases involving transfer pricing adjustments.

A taxpayer who objects to adjustments proposed in a tax assessment may submit those objections to the D.R.P. The D.R.P. considers the objections and, after hearing both sides, gives necessary directions to the tax officer, who is obliged to frame the tax assessment based on the directions of the D.R.P. The D.R.P. is required to provide its directions in a timely manner.

### **Mutual Agreement Procedure ("M.A.P.") Under Tax Treaties**

This is a special mechanism for dispute resolution provided under Indian's multilateral tax treaties. The M.A.P. applies to cases where an action or a proposed action leads to double taxation of income or to tax that is not in accordance with the relevant tax treaty. On receipt of a taxpayer's application for the M.A.P., the competent authority of the taxpayer's country of residence will take up the disputed matter with the competent authority of India to discuss the issues and attempt to arrive at a resolution.

Resolution under the M.A.P. and resolution under domestic laws can be carried out simultaneously, and the taxpayer may choose to accept or decline the resolution reached by the competent authorities.

## **TRIGGERING LITIGATION – TAXPAYER BEWARE!**

### **G.A.A.R.**

One cannot discuss Indian income tax provisions without examining the impact that will arise from the introduction of G.A.A.R. Moving to a "substance" over "form"

approach, the introduction of G.A.A.R. from April 1, 2017, is expected to change the landscape of taxation in India.

G.A.A.R. may be invoked by the tax authorities where the main purpose of an arrangement is to obtain a tax benefit. The G.A.A.R. provisions empower the tax authorities in India to declare any such arrangement as an “impermissible avoidance arrangement.” On this basis, it may disregard entities in a structure, reallocate income and expenditures between parties to the arrangement, alter the tax residence of entities and the legal situs of assets, and treat debt as equity or vice versa. By doing so, the tax authorities may even deny tax benefits conferred under a tax treaty.

Accordingly, taxpayers must ensure that there is commercial substance behind every transaction or structure in order to mitigate risks. A taxpayer may also approach the A.A.R., for determining whether a particular proposed transaction would be free from attack under the G.A.A.R. provisions.

### **Transfer Pricing**

Transfer pricing has always been a subject of heavy litigation in India – the controversies in the *Vodafone* and *Shell* cases being only recent examples.

Indian transfer pricing provisions are fast evolving as the Indian government endeavors to protect the country’s tax base. Along these lines, Finance Act 2017 introduced two international practices to the Indian tax landscape: thin capitalization norms and secondary adjustments.

Even with risk mitigation and dispute resolution mechanisms such as A.P.A.’s and safe harbor rules, India has experienced a substantial increase in transfer pricing disputes in recent years. As India’s role in the global economy and presence of the international stage continues to grow, a further increase in transfer pricing related disputes is expected.

### **“Indirect Transfer” Tax Provisions**

The indirect transfer tax provisions were introduced in 2012 with retrospective effect, to negate the effect of the Supreme Court’s ruling in *Vodafone*. Under the indirect transfer tax provisions, gains on a transfer of an interest in entity (which includes a foreign corporation) are liable to tax in India if the foreign entity derives “substantial value” from assets situated in India, subject to benefits available under tax treaty, if any.

For the purpose of determining whether a foreign entity derives substantial value in India, certain threshold limits are provided, based on the values of the asset and the foreign entity. Consequently, tax disputes are anticipated with respect to the application of the indirect transfer tax provisions to specific transactions.

### **Place of Effective Management**

In 2016, the test for corporate residency of foreign companies moved from control and management being situated wholly in India to place of effective management (“P.O.E.M.”) in India. The determination of P.O.E.M. is a factual determination, based on substance over form, taking a holistic approach on a year-to-year basis. Considering the subjective nature of the guidelines issued for determining P.O.E.M., disputes are likely to arise.

*“Moving to a ‘substance’ over ‘form’ approach, the introduction of G.A.A.R. from April 1, 2017, is expected to change the landscape of taxation in India.”*

## **Valuation Norms**

By reason of recently introduced provisions, a minimum fair market value test is to be fulfilled by the acquirer of assets situated in India, as well as the transferor of equity shares in India. The fair market value of equity shares is to be computed by a hybrid mechanism based on the asset composition of the company. For the purpose of valuing equity shares, the fair market value of any downstream investments, onshore or offshore, are also to be taken into consideration.

In addition, ambiguity exists with respect to the application of accepted valuation norms to instances such as the conversion of instruments or a bonus issue of shares. Considering the complexities that may arise in obtaining a valuation of this nature and the ambiguity surrounding the application of these provisions, taxpayers should seek sound legal advice prior to entering into any such transaction.

## **Implementation of B.E.P.S. Provisions**

Over the past few years, India has begun adopting provisions under the O.E.C.D.'s B.E.P.S. initiative, including the equalization levy and thin capitalization norms. It is expected, that India will steadily adopt many concepts under the B.E.P.S. Action Plan, leading to further changes in the Indian tax regime.

India has already signed the O.E.C.D.'s Multilateral Instrument ("M.L.I."), in line with the B.E.P.S. Action Plan. The M.L.I. seeks to amend the existing network of more than 3,000 bilateral tax treaties between the signatory countries. With the ratification of the M.L.I. by each new country, existing tax treaties between India and the signatory jurisdiction will stand amended. The potential impact of the M.L.I. will require careful study, and advice should be sought prior to entering any transaction.

## **CONCLUSION**

Given the adversarial nature of tax assessments and the costs involved in tax dispute resolution, it is preferable to conduct one's business so as to ensure that cause for a dispute does not arise in the first place. However, litigation may become inevitable owing to the nature of the transaction, the stakes involved, or the conflicting views of the tax authorities.

The government has the responsibility to ensure that disputes are addressed with a sense of urgency and without delayed or frivolous appeals. This may be accomplished through the creation of stringent guidelines to ensure pro-taxpayer rulings are challenged only if they are demonstrably perverse or apparently erroneous. Additionally, the government may establish a mechanism to hold tax authorities accountable for frivolous or vexatious tax demands. The merits of a case should be the guiding factor in determining if a tax dispute moves forward, not merely the quantum of tax or the stakes involved in the matter.

In this challenging, high-stakes environment, the best possible strategy for managing tax disputes involves maintaining proper and robust documentation, capturing the commercial substance of the transaction in legal documents, carefully drafting legal submissions to the judicial authorities, bringing all the relevant facts to the fore at the first possible instance, and acquiring effective and persuasive legal representation.

