

## Disruption in Income Taxation

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Let us consider in this article **The Disruption in Taxation**. There is an attack on tax evasion (black money) as well as tax planning. And the attack is within India as well as globally. There is tremendous progress & innovation in technology causing disruption in business. Same technology is causing disruption in taxation also. Compliance by Tax Payers, Practice by Consultants and Administration by Tax Department – all are disrupted. The attack on black money covers Demonetisation and GST. However, in this article, we focus on Income-tax only.

A brief understanding of - Threats to Income Taxation and the Causes for the Threats – is presented below.

The attack on tax planning is through several amendments in Income-tax Act and through BEPS. Attack on tax evasion is through sharing of information by banks & Governments. This sharing of information has become practical because of technology.

### 1. Threats to Income-tax:

We have received several **“Wake-up calls”**. Now the Wake-up calls are over and harsh provisions have already been passed into several laws. All these provisions together will give tremendous presumptive powers in the hands of tax administration.

#### 1.1 Legal Amendments:

The **Tax Laws** have been amended and are in the process of further amendments. Transfer pricing with considerable presumptive provisions, is already a serious difficulty. Now GAAR has been passed, POEM has become a law. We already have more than 30 SAARs. Black Money law has serious provisions. BEPS (Base Erosion & Profit Shifting) is making huge provisions amending Double Tax Avoidance Agreements and making it difficult to do tax planning. It will be difficult for tax commissioners as well as tax consultants to understand and apply these provisions.

#### 1.2 Collapse of Banking Secrecy:

Swiss banks and banks in several tax havens provided secrecy to people holding money with those banks. Now with the pressure of OECD & G20, all secrecy has collapsed. All banks, financial institutions and financial intermediaries have to share information about - the beneficial owner and his investments - with the Country of Tax Residence of the investor. All the information about any person's funds available in any bank etc. almost anywhere in the world are available to the Governments where they are liable to pay tax. This is not future. Information sharing has already started.

There were some instruments through which people with black/criminal money could hide their identity. For example - Numbered Accounts; accounts in the name of companies with bearer shares; discretionary trusts where the trustees could change the names of beneficiaries; and so on. All these instruments have collapsed. Banks & financial institutions have to maintain full identity (KYC including copy of passport) of the ultimate beneficial owner. And this information is being shared with the Country of Residence (COR) of the beneficial owner.

### 1.3 Restrictions on Tax Havens:

Tax Haven Governments were actively promoting incorporation of companies and other entities in tax havens specifically to avoid the taxes and other regulations of the Countries of Residence. With the pressures of OECD & G20 and amendment of treaties through Multilateral Instrument (MLI under BEPS programme), these different tax avoidance plans have become next to impossible. All tax havens may lose significant amount of their business.

### 1.4 FEMA to FERA:

Harassment by Enforcement Directors under FERA had become legendary. Their courage in harassing people crossed limits and some officers even harassed members of Parliament. This is when the outcry against Enforcement Department reached top Government authorities. In the year 2000 FERA was replaced by FEMA. Enforcement Directorate powers were clipped and people heaved a sigh of relief.

By Finance Act, 2015, Sections 13 (1A) to 13 (1D) & 37A have been added to FEMA. Section 37-A in short provides that: -

“If the Enforcement Director suspects that any person has any foreign assets, in violation of S. 4 of FEMA, he (ED) - can seize Indian assets of that person equivalent in value to the foreign assets”.

Now consider this provision.

- (i) The ED may merely have a “**Suspicion**”. The law does not require that he should have evidence of violation of S. 4 of FEMA.
- (ii) And the law does not require that ED should serve a notice, should provide opportunity to explain, etc. - before seizing the Indian assets.

The Government may, by internal rules provide for certain safeguards. However, to make such a law giving wide open powers to the regulator and then hoping that there will be internal rules and regulations; amounts to Police Raj. I sincerely hope that if these provisions are challenged before a Court of Law, the Court will strike down these provisions as unconstitutional.

However, very few assesseees have resources adequate to go to a High Court and Supreme Court fighting against Law. Until someone successfully fights against FEMA, rest of the people will suffer under such absurd law.

When a tax consultant advises his client to have assets outside India in furtherance of the tax planning, he must ensure that it does not amount to violation of FEMA. This needs emphasis because I already hear tax planning products that amount to FEMA violations. Those tax payers who get tempted into such tax planning products, are exposed to serious consequences.

Now FEMA has become more draconian than erstwhile FERA. One can imagine the consequences of giving such wide powers in the hands of ED.

### **1.5 Technology:**

Computers, internet and communication systems (mobile telephones and other telecommunication systems) have all made considerable technological progress. And all these technologies have converged. All our communications are easily available to Governments. In case, some reader may not know: all internet service providers (ISP) like VSNL, SIFY etc. are required by law to maintain 100% records of all the communications through their system. Thus, telephone calls from mobile phones, emails, sms etc. ALL are stored with ISP for many years. Whenever, Government wants, this information can be accessed by Government.

### **1.6 Automatic Exchange of Information:**

As a part of BEPS programme about 100 countries have agreed to share tax & finance information. Earlier, there have been Court decisions that Indian Income-tax department cannot make "Fishing Enquiries". It is possible that some people may have black money abroad. Indian Government has no information about such money. Then they cannot even make enquiry. Now, under BEPS, all the Governments including the tax haven Governments are expected to send information about all Indian residents' income and wealth in those countries. It will not be necessary to make enquiry. They will send the information automatically. Several tax havens already officially shared information with Government of India.

Whether the income/ wealth is held in the personal name of the assessee or through any entity (discretionary trust or company etc.) and any number of entities in a series; still the information applicable to the ultimate beneficial owner will reach Government of India.

### **1.7 Departmental Expertise:**

There was a time when tax professionals were ahead of the Income-tax department. Some professionals knew a lot more than the Income-tax Commissioners. Now there are several Income-tax Commissioners who have studied abroad, travelled abroad and worked with OECD/ IBFD. They have

tremendous amount of knowledge of income-tax & international taxation. Commissioners with expert knowledge are now armed with wide deeming provisions under the law.

### **1.8 Judiciary:**

There was a time when, a tax payer and the tax consultant considered the judiciary to be on the side of the assessee. Today things are changing. Some of the tribunal and Court decisions are rejecting the tax planning. Judiciary is demanding substance.

This cannot be said to be an all India trend. Some decisions even now ignore the substance of facts and intention of legislation; and go by the form of paper work.

There is no clear trend in judicial decisions. Still, overall, today one can expect more judgements to be in favour of the department than could be expected five years before.

### **1.9 Benami:**

Consider the Benami Transactions (Prohibition) Act (BTPA). It was suggested in 1973 and passed as a law in 1988. However, it was not implemented till 2016. It is only now after 28 years that the law has become effective in the year 2016. This is a part of the concerted attack on black money. In the past, there was no Political Will to implement the law. Present Government has made it a mission to attack black money & tax avoidance.

### **1.10 Army of laws:**

Within Income-tax Act, we have - more than 30 SAARs, GAAR, Transfer Pricing, POEM etc. attacking black money & tax planning. The attack on black money is not just through Income-tax Act. A list of other laws is: FEMA, Prevention of Money Laundering Act, Benami Transactions (Prohibition) Act, Automatic Information Sharing Agreement - all together attack black money. BEPS which affects Double Tax Avoidance Agreements, attacks tax planning.

This army of legal provisions has been arranged against the tax payer trying to avoid tax. The army includes several deeming provisions. These can be used to terrorise even an honest tax payer.

### **1.11 Convergence of Several Forces:**

Thus, there is a convergence of law, technology, departmental expertise and judiciary. All together are against tax evasion as well as tax planning.

While people will keep trying to find out ways of tax planning; it will be tremendously difficult. It will disrupt the practices of some tax consultants, banks & tax havens.

There have been many cases where people thought it normal to set up discretionary trusts and SPVs in tax havens and to hold black money through such tax havens. Now these people may find themselves being prosecuted.

## 2. Cause of this situation:

**A submission:** For many harsh anti-avoidance provisions, the cause lies in the fact that: Some tax payers avoided taxes by resorting to aggressive tax planning; and the appellate courts upheld the tax avoidance. In India, cases like Vodafone & Azadi Bachao Andolan are illustrations. In Europe, tax avoidance by Google, Apple, Starbucks etc. are illustrations. Parliament had no option but to bring in anti-avoidance provision.

Let us see illustrations to see whether the above submission is correct. These illustrations may also help in getting a perspective of SAAR, GAAR, BEPS, etc.

**2.1** Consider the simplest of the **Specific Anti-Avoidance Rule (SAAR)** – clubbing provision under Section 64. In the olden days, a husband would reduce his tax liability by diverting his wealth to his wife and children. If all the income were to be taxed in the hands of husband only, it would attract tax at a higher rate. By gifting away his wealth – source of income – income is diverted at the source itself. Wife & minor children who may have no / lower income; get the benefits of lower taxes. By making deeming provision u/s. 64 this planning is curbed. Simple tax provision has become a bit complicated.

**2.2** From the simple SAAR, let us see a complex SAAR: Section 9(1)(i) Explanation 5. (Vodafone provisions.) Vodafone did a tax planning and avoided massive tax payment. These facts are too well known. These are briefly stated below. Hutchison, a Hong Kong company held two third shares in Hutchison SR, an Indian company providing mobile telephone services. Hutchison held the shares through a Cayman Island company. Hutchison sold its share to Vodafone, a British Company. Instead of selling the shares of the Indian company, Hutchison sold one share of \$ 1 in the Cayman Island company to Vodafone and then claimed that the shares of the Indian company were never sold. Only the share of Cayman Island company was sold. Hence there was no liability to pay tax in India. I have written articles on this subject saying that this transfer of shares was liable to tax in India even under the law before amendments. Supreme Court of India in the decision on Vodafone held that Hutchison was not liable to pay tax and hence Vodafone was not liable to deduct tax at source. Government of India amended Section 9 and introduced explanations 5, 6 & 7 to Section 9 (1) (i).

Consider the provisions of explanation 5. In simple words, it provides that if the share or any interest – in a foreign company or any foreign entity derives – directly or indirectly – its value substantially from assets located in India; then such share or interest shall be held to be situated in India. The

consequence of this amendment would be that on a transfer of such foreign share etc., capital gains would be payable in India.

This explanation created several controversies. What is meant by “Substantially”? A foreign mutual fund may be holding share in several Indian companies. When the units in the foreign mutual fund are transferred, would they become liable to tax in India? Foreign unit holders may or may not have any idea about the investments made by the mutual fund. How will they pay capital gains tax? All these controversies arose because Hutchison and Vodafone made a tax planning which was contrary to logic and common sense. In trying to cover such tax avoidance within the tax net, Indian Income-tax Act has become complex.

### **2.3 Transfer Pricing:**

The Transfer Pricing provisions in the Indian Income-tax Act had terrorised many tax payers. The provisions require the tax payers to artificially decide a market price (Arm’s Length Price). When any commercial transaction happens amongst associated parties, each and every transaction has to be compared with the Arm’s Length Price (ALP). In reality, we know that there is no standard market price. Even for branded products like toothpastes and readymade garments, individual buyers negotiate the price and get a negotiated price. In several products like diamonds and personal consultancy services, there is no way to determine a market price. In all these situations, tax consultants prepare thousand page reports justifying their assumed ALP. The tax commissioners reject entire reports and assume different ALP. In the process, the tax payers suffer huge tax, interest and penalty.

This entire difficulty has happened because many famous MNCs actually resorted to under invoicing or over invoicing of their products sold amongst associated enterprises. When MNCs resorted to aggressive tax avoidance and called it legal, Governments had no option but to amend the legal provisions and prevent such tax avoidance.

### **2.4 Tug of War:**

When gifts to wife and minor children were covered under Section 64, tax payers came out with the new tax planning of discretionary trust. These trusts were also used for holding assets outside India. One can get into details of such tax avoidance games. However, Indian Government introduced Section 164 under the Indian Income-tax Act and taxed discretionary trusts at the maximum marginal rate.

So, tax payers came out with oral trusts. Again, the law was amended & S. 164A was introduced.

Then the tax payers came out with oral AOP. Multiple HUF was again another idea for tax avoidance. Each and every such planning attracted specific anti-avoidance rules by different sections.

In this tug of war between tax payers and Government of India, Indian Income-tax Act went on becoming longer, more complex and **far removed from reality**.

Under the **Indian Partnership Act**, when a partner contributes his assets to the partnership firm, or withdraws his assets, retires or dissolves the firm – in all the situations, there is no transfer. The reason is that under the Partnership Act, partnership is not a separate entity. It is a relationship amongst the partners. Partners and their firm are not separate.

When the Indian Income Tax Act has been amended, these fundamental principles of Partnership Law have been thrown out. Why Section 45 had to be amended and complex provisions had to be brought in? Because, in Kartikey Sarabhai Case, Mr. Sarabhai formed a partnership firm on day one. Introduced capital asset to the firm on day two. The firm was dissolved on day three and the asset was taken away by another partner. Mr. Sarabhai got cash which was introduced by the other partner. In short, the capital asset was sold by Mr. Sarabhai to a third party through the means of partnership firm and capital gains tax was avoided.

This tax planning was upheld by the Honourable Supreme Court.

Government had no option but to amend Section 45 and bring in deeming provisions in the form of sub-sections (3) & (4).

This is how the Income-tax Act has become complex.

### 3. **BEPS:**

Tax Avoidance through complex planning is not the monopoly of Indian tax payers. In fact, MNCs do massive tax planning through very complex structuring etc.

**3.1** American Multinational Companies like Apple, Google, Starbucks etc. avoided the taxes of European countries like Britain, France & Germany. This caused beginning of a process to control Base Erosion & Profit Shifting (in simple terms – Tax Avoidance). G20 & OECD together have prepared fifteen Action Reports & finalised Multi-Lateral Instrument (MLI).

This MLI will sit on top of about 3,000 Double Tax Avoidance Agreements signed by several countries around the world. Interpretations of existing DTAs will change due to MLI.

This is expected to prevent a lot of Income-tax avoidance that MNCs were indulging in. Even the existing tax avoidance arrangements will be hit when MLI becomes effective.

Now we have ITA which stands modified by DTA.

Then DTA stands modified by MLI.

And MLI is subject to individual country reservations. Interpretation of law itself will be very difficult.

- 3.2 MLI brings in several provisions like:
  - 3.2.1 MNCs and their subsidiaries have to submit – Country by Country reports.
  - 3.2.2 Transfer Pricing provisions have been made tougher.
  - 3.2.3 Treaty Shopping will be very difficult. Even regular foreign investors will have to prove that no treaty shopping, etc. is involved.

Similarly, there are other measures to control tax avoidance.

#### 4. **Conclusion so far:**

Tax provisions have become extremely complex to understand, difficult and costly to comply with. Responsibility for this fact lies squarely with MNCs and other tax payers, their tax consultants and the tax judgements which upheld such artificial tax avoidance.

While the tax consultants and tax payers both have abused the law, we are all aware of the corruption within the tax department. Corrupt officers have harassed tax payers even under the old Income-tax law. The new law will give machine guns in the hands of Income-tax officers and Enforcement Directors.

#### 5. **Way Out:**

Till the year 1973, we had Income-tax @ 97.25% for incomes above Rs. 1,00,000. Wealth-tax was @ 8%. Hence most of the wealthy people had to sell their wealth to pay Income-tax and Wealth Tax or hold their wealth and income as black money. Estate Duty was @ 85% for estate in excess of Rs. 20 lakhs. No sensible person would be able to avoid temptation of black money.

From this high level of taxation, Government of India has come a long way. Estate duty, wealth tax and gift tax have been abolished. Income-tax rates have been brought down under 35%.

Have we responded to Government's positive action by honest payment of taxes? If we do not respond to Government's positive moves, we attract harsh provisions.

The only way out is to actually pay taxes honestly in substance & in spirit. Drop all the tax planning products. Acquire the confidence of Indian Government as well as international associations of Governments and then pray for better laws.

#### 6. **Possible Future:**

Look at the whole tug of war as a global drama unfolding.



6.1 In the past, there have been Governments - in India & abroad, who have passed laws that -

- (i) Curb tax avoidance; and also -
- (ii) Permit specific kinds of tax avoidance.

6.2 When the present Government came in power in the year 2014, there was a move to ban **Participatory Notes** (PNs). When lobbyists complained, the Finance Minister made the famous public statement. "India is not a Tax Haven. Such tax avoidance instruments have to go." In a few months, FM forgot his statement. PNs continued. In the year 2017, SEBI has been successful in bringing some restrictions on PNs.

6.3 **Place of Effective Management** (POEM) provisions in Section 6 (3) of ITA were a big blow on tax planning through tax haven companies. Someone lobbied. And now all foreign companies with turnover of less than Rs. 50 crore are exempted from POEM provisions. The Companies with turnover of more than Rs. 50 crores will most likely have their POEM outside India. New Section 6(3) is far better for tax avoidance than the old Section 6(3). Lobbying has been successful under present Government in frustrating an anti-avoidance measure.

6.4 Tax consultants used to selling tax planning products have already started marketing some products - which they believe; will take care of SAAR, GAAR & BEPS; and help the tax avoidance. These products already look hollow & are likely to crash.

And the Tug of War goes on.

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Pranam

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