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Parthasarathi Shome: Taxation: Interpretative & administrative issues

Some reasons for taxpayer cynicism have been recently researched

Parthasarathi Shome January 31, 2016 Last Updated at 21:50 IST

This article on new research in taxation is the second in a two-part series, the first having focused on tax policy (January 20). Though Central Board of Direct Taxes (CBDT) is issuing guidance notes to field officers to improve implementation, cynicism continues among taxpayers. Some reasons for this have been recently researched covering a spectrum of implementation issues. These are examined here.

The first issue is General Anti-Avoidance Rules (GAAR) that Mukesh Butani et al address. GAAR will equip officers to curb tax avoidance with wide and long reach. Effective implementation of the complex GAAR rests on adequate preparation and subordinate legislation which still suffer from lack of clarity on documentation standards and compliance requirements. CBDT should roll out rules and principles of best practices to guide officers to use GAAR only as a last resort. The authors insist that GAAR should not (1) be invoked in cases that are subject to Specific Anti-Avoidance Rules (SAAR); (2) override tax treaty provisions; (3) be invoked in intra-group transactions when there is no tax benefit at the group level; or (4) lead to penal action except very selectively.

The second issue considered by K R Sekar is termed place of effective management (PoEM) in taxing multinational enterprises (MNEs). A bone of contention between an MNE and tax officer is the jurisdiction where MNE management effectively resides for that is where tax should accrue. Mr Sekar addresses lacunae in CBDT's recently proposed definition of PoEM. The explanation that PoEM is where key management and commercial decisions take place for conduct of business is insufficient. He uses a UK judicial case that distinguished PoM which determines residence, from PoEM to be used as a tie breaker in case of possible dual residence. Thus, PoM is not sufficient while PoEM remains the necessary criterion. He also identifies other areas that need clarification, for example, different or same corporate tax rate for parent and subsidiary, treatment of dividends for tax, application of minimum alternate tax (MAT), nature of withholding, and others.

Using Organisation for Economic Co-operation and Development (OECD) guidelines, Mr Sekar recommends modifications. As in corporate law, tax law should also allow consolidation of accounts by an Indian MNE with a foreign subsidiary. Listing in the stock exchange should be a beginning criterion before applying the test to check if there is active business that is associated with PoEM. Shareholder control or participation should not be a sufficient condition for determining PoEM. If Board of Directors meetings occur outside India or decisions are not taken in India, then PoEM cannot exist. Mere existence of receivables from an Indian entity should not comprise assets. For determining passive income, definition of royalty and technical knowhow in a tax treaty should take precedence over domestic law. Capital gains should not comprise passive income. Modern technology enables accounts being maintained in third countries; therefore location of accounts maintenance cannot influence PoEM.

The third issue considered in a two-paper series by K R Girish is on Limitation of Benefits (LOB) that attempts to minimise treaty benefits going to unqualified MNEs but enabled through treaty shopping. He examines international experience, among others, the 1990 India-US Double Taxation Avoidance Agreement (DTAA) that was designed to prevent third countries from treaty shopping and explains how tests for ownership and main purpose of a business, tax base erosion, active business connection, and recognised stock exchange are determined by applying US Model Convention. He discusses the controversial Indo-Mauritius Treaty that allows a residency certificate issued by Mauritian authorities to establish residence there which the Indian authorities are obliged to accept to their discomfiture.

Mr Girish invokes the principle of pacta sunt servanda from the Vienna Convention on the Law of Treaties, 1969, whereby, in case of conflict between tax treaty and domestic law, treaty specification must prevail. Thus, domestic GAAR provisions should not override a treaty. While he concedes that tax abuse may amount to abuse of the Convention itself and thus may not deserve treaty benefits, after weighing the issue, he concludes that the proposed GAAR already led to outflow of funds; hence treaty override is not the correct solution.

The fourth issue considered is selection of tax returns for scrutiny. H P Khincha and S Krishnan analyse whether Indian tax administration is using risk-based assessment that is the global norm. Routine assessment orders covering all taxpayers is to be eschewed. Conceptually, under Section 143 (1) of India's Income Tax Act, return-based refunds can be given without an assessment order. However, what is actual field practice is examined in this paper.

Even in making prima facie arithmetical adjustments, 20 per cent tax addition is made against making incorrect claims. Obviously this provides an incentive to spend time on routine assessments, leaving less time to undertake thorough investigation for selective, risk-based scrutiny. Computer assisted scrutiny selection (CASS) of two per cent of returns annually was introduced in 2003. CASS uses general criteria measuring quantum of specified taxpayer transactions and assigns a risk score to every return. Scrutiny selection is also possible on discretionary basis, say, foreign tax credit claims. Discretion is also used through manual scrutiny selection. For example, for Assessment Year 2015-16, one criterion was the addition to tax of Rs 10 lakh or more in a previous year.

Mr Khincha and Mr Krishnan reveal both CASS and manual selection remain imperfect since they don't utilise industry data. The same taxpayer gets picked for same reason year after year while tax avoidance cases remain ignored for scrutiny. Judicial decisions overwhelmingly favour (70-80 per cent) assesses. Pendency is phenomenal by global standards. In 2013-14, pendency in scrutiny disposal was 60 per cent and that in appeals 70 per cent. They recommend independent multi-member settlement commissions to mitigate the problem.

They also reveal that while corporate assesses increased by eight per cent between 2012-13 and 2014-15, almost 30 per cent of working companies did not file tax returns in 2013-14. They suggest a significant increase in monetary penalties as a deterrent after issuance of notice to both listed and unlisted companies. If they still do not file, prosecution under Section 276CC should follow. These papers are elaborated at International Tax Research and Analysis Foundation, Bengaluru, www.itraf.org.