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Analysing recent trends in Indian income tax disputes

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The increasing sophistication of India's taxation system has led to complexity across tax treaty benefits, permanent establishments, transfer pricing and more, say Sanjay Sanghvi and Ujjval Gangwal of Khaitan & Co

The Indian economy grew by leaps and bounds over the past several years. Among various factors, a surge in cross-border transactions and increased foreign direct investment played a key role in this growth story.

In line with the evolving economic realities, the Indian government introduced significant reforms and sought to streamline the taxation system through initiatives like the faceless assessments and appeals regime.

That said, complexity in the tax regime persists due to frequent legislative amendments and judicial developments clarifying the position of law.

Tax treaty benefits for Mauritius and Singapore residents

India's tax treaties with Mauritius and Singapore provide, among other benefits, a capital gains tax exemption to Mauritius and Singapore tax residents from the sale of investments made in the shares of an Indian company prior to April 1 2017.

However, entitlement to the exemption has historically been a contentious issue, with Indian income tax authorities (IT Authorities) challenging entitlement on various grounds, such as the taxpayer:

- Being a 'conduit' entity;
- Not being controlled and managed from Mauritius or Singapore;
- Not being the beneficial owner of the income; or
- Not having substance in Mauritius or Singapore.

However, courts have repeatedly held that so long as the Mauritius/Singapore entity holds a valid tax residency certificate (TRC) and the structure is not sham in nature, the benefits should be allowed.

Recently, the Delhi High Court in the case of *Tiger Global International III Holdings vs. Authority for Advance Rulings (ARR)* overturned a negative ruling passed by the ARR. AAR denied benefits under the India-Mauritius tax treaty to a Tiger Global group entity in respect of capital gains earned on the sale of shares of a Singapore company (deriving substantial value from India) to the Walmart group.

The Delhi High Court followed the established principles laid down by the Supreme Court in *Union of India vs Azadi Bachao Andolan* and held that a TRC issued by the Mauritius authorities constitutes a valid proof of tax residency and beneficial ownership. It further ruled that a TRC may only be disregarded in the event of fraud or the structure being a sham (with the burden of proof being on the IT Authorities).

That said, entitlement to tax treaty benefits continues to remain a hotly contested issue in India. Of note is the stay granted by the Supreme Court in January 2024 on the Delhi High Court's ruling in the case of *Blackstone Capital Partners,* where the High Court granted capital gains exemption by relying on the TRC issued by Singapore tax authorities.

Attribution of profits and permanent establishments (PE)

Attribution of profits to a PE in India has been a controversial issue in cases where the main entity has incurred losses at a global level. In this regard, there have been conflicting judicial rulings.

On the one hand, the Delhi High Court in the case of *Nokia Solutions* and *Networks OY* held that in case of a global loss, the Indian PE of a foreign company would not be liable for Indian income tax.

However, a Full Bench of the Delhi High Court in the case of *Hyatt International Southwest Asia Ltd* held that, under a tax treaty, a PE is treated as a separate and distinct entity from the foreign company to which it belongs.

Therefore, a PE would be required to pay tax on profits that are attributable to such PE in India notwithstanding the losses that the enterprise may have suffered at a global level.

This approach by the Delhi High Court also addresses BEPS concerns by limiting the ability of a multinational corporation to use global losses to offset local profits, ensuring a fair contribution to India's tax base. It also aligns with the OECD's principles of taxing profits in the source country based on its local operations regardless of its global profits or losses.

Recharacterising transfer pricing (TP) related transactions

There have been several controversies concerning characterisation of compulsorily convertible debentures (CCDs) from a TP perspective, particularly while evaluating the deductibility of interest payments on such CCDs.

IT Authorities have often sought to recharacterise CCDs as equity shares, thereby disallowing interest expenditure on them. In particular, IT Authorities have placed reliance on Indian exchange control regulations that deem CCDs as equity instruments rather than debt.

That said, several tax tribunals ruled in favour of taxpayers and held that CCDs should be treated as debt until conversion. Courts have also held that TP proceedings should be limited to benchmarking international transactions and determining the arm's-length price, rather than recharacterising the transaction itself.

Invoking the general anti avoidance rule (GAAR)

Indian GAAR provisions provide IT Authorities with broad powers to address abusive arrangements of taxpayers that are undertaken with the main purpose of obtaining a tax benefit.

In a recent ruling of *Ayodhya Rami Reddy Alla v. PCIT*, the Telangana High Court upheld the applicability of GAAR in a case involving 'bonus stripping'. While the taxpayer argued that GAAR should not apply on account of specific anti-abuse rules (SAAR) under the income tax law concerning bonus stripping, the High Court noted from the facts and circumstances of the case that the SAAR in question was not applicable on account of a technicality.

Consequently, the Court ruled that GAAR would be applicable regardless of specific provisions meant to tackle similar mischief. The ruling is pending adjudication before the Supreme Court. This is perhaps the only reported tax case concerning GAAR applicability.

Faceless tax assessment and appeal regime experiences

Currently, the entire mechanism of tax assessments and appeals before the first appellate authority are conducted facelessly (without human intervention), except in certain cases such as those relating to search cases or involving non-residents or foreign taxpayers.

While the faceless regime was introduced with the laudable objective of promoting transparency, it is not free from challenges.

Often, taxpayers are not given sufficient time to respond to notices issued by the faceless assessment unit, with notices frequently sent at night. This gives taxpayers merely three days or less to file a reply, which undermines the principle of natural justice.

Further, there is presently a significant backlog of appeals at the first appellate authority level under the faceless appeal regime, with appeals not getting disposed of despite the filing of written submissions by the taxpayers.

There have also been instances of high-pitched tax assessment orders passed under the faceless assessment regime. This has mainly resulted from the issuance of unreasoned orders and the non-consideration of taxpayers' written responses while making assessments.

Direct tax dispute resolution scheme

In a bid to reduce the backlog of income tax disputes, the Indian government has introduced The Direct Tax Vivad Se Viswas Scheme, 2024, effective from October 2024.

Taxpayers opting for this scheme, subject to several conditions, may obtain immunity from penalty and prosecution. A taxpayer should assess whether it is beneficial to consider the scheme on the merits of pending tax disputes and other relevant considerations.

Final observations

India's taxation landscape is evolving rapidly, with significant reforms aimed at improving transparency and compliance. However, these reforms have also led to an increase in the number and complexity of tax disputes.

As India continues to refine its tax policies and procedures, it is crucial for taxpayers to stay abreast of these developments to navigate the complexity.

In today's environment of high stakes, significant litigation costs and pressure on 'management time', it is imperative for businesses to represent their cases effectively from the outset. This involves filing persuasive and precise written submissions that incorporate all relevant legal arguments, and presenting complete and accurate facts on record at the very first instance.

This strategy ensures that the cases are not sent back or remanded to the IT Authorities for fresh consideration, particularly considering additional or new evidence submitted at the appellate stage.

During a tax assessment, especially in cases involving the interpretation of tax treaties and other contentious matters, a taxpayer should consider requesting a personal hearing with the IT Authorities. This can help them gauge whether the IT Authorities fully understand the matter or if additional submissions are required to substantiate their tax position. Involving senior officers during tax assessments, on a case-to-case basis, should also be considered.

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