

23 June 2011

EY Tax Alert

Cooperation on taxation between India and the OECD



Executive summary

India and the Organization for Economic Co-operation and Development (OECD), currently comprising 34 economies, agreed on a three-year cooperation program (Program), starting June 2011, at a high-level meeting concluded recently in New Delhi. At the first international seminar under the Program titled 'Adapting Tax Systems and International Tax Rules to the New Global Environment: A Shared Challenge for India and the OECD', held in New Delhi, the Finance Minister (FM) of India set the tone of cooperation with his speech, calling for strong measures to reverse the trend of illicit outflows from developing countries and exploitation of natural resources through abusive transfer pricing (TP) schemes.

India and the OECD have agreed to strengthen ongoing cooperation on tax-related issues, including enhanced cooperation in dealing with issues relating to TP, promoting better tax compliance and measures to improve the prevention and regulation of cross-border disputes. In the context of this Program, the parties have also agreed to work towards the goal of the possibility of India considering a change in its status to 'full participant' in the OECD's Committee on Fiscal Affairs (CFA).

The recently released document, OECD Economic Surveys - India, June 2011 (Survey), also includes comments on the proposed Direct Taxes Code (DTC) that is expected to be effective from 1 April 2012.

This Tax Alert summarizes the relevant aspects of this Program, the FM's speech and the Survey.

Background

- ▶ India's emergence as a key player in the global economy has been evidenced in the tax area by the country's modernization of its tax administration, its major reform initiatives and its increased involvement in global tax initiatives.
- ▶ India was granted an 'observer status' by the OECD in July 2006 and offered enhanced engagement in May 2007, with a view to possible membership. The Program envisages a change in India's status to 'full participant'. This would enable India to exercise the same rights and obligations as OECD members.
- ▶ India plays a lead role in the Global Forum on Transparency and Exchange of Information for Tax Purposes (as Vice-chair of the Peer Review Group), apart from being an active member in the OECD's multi-stakeholder Task Force on Tax and Development. India has been actively involved and participated in the CFA and its Working Parties since 2006 and has been contributing its officials as experts to various events organized by the OECD.
- ▶ In light of India's growing engagement with and significance in the OECD's taxation agenda, the country's increasing integration into a globalized economy and its commitment to addressing global challenges in tax administration in a rapidly evolving environment, India and the OECD have announced plans to strengthen the ongoing cooperation on tax-related issues, through the Program, that will provide greater opportunities

for structured dialogue and sharing of information.

Objectives of the Program

- ▶ The main objectives of the overall Program are to:
 - ▶ Develop interaction at a high policy level on issues of key common concern.
 - ▶ Build upon existing cooperation between the OECD and India in international taxation initiatives.
 - ▶ Provide a series of opportunities for structured dialogue and sharing of experience and promote informed and coherent tax policy decision-making and tax administration solutions between India, other key emerging economies and OECD countries.

High-level policy dialogue on tax

- ▶ The Program will focus on issues of immediate priority for India, responding flexibly to a changing international environment. The Program is based on a series of focused and tailored high-level events which will involve senior personnel from the Indian Tax Authority, particularly major decision makers in the area of taxation, along with their counterparts from other important emerging and OECD economies. The Program envisages two events per year to be held in New Delhi, each event conducted over two-three days. The proposed topics include exchange of information, tax administration and governance issues, role of taxation in promoting equality, international tax avoidance, TP, exchange of information, government approach to dealing with illicit payments.

India-OECD tax technical development program

- ▶ Through cooperation with key countries that wish to share their views and develop solutions to current international issues, India and the OECD will continue to deliver relevant and effective technical events to tax officials from across India and beyond. It may be noted that such technical events have been happening in the past at the National Academy of Direct Taxes in Nagpur, India.

India's further engagement with the OECD

- ▶ The Program will broaden technical cooperation on tax matters and deepen India's participation in the OECD's CFA and subsidiary bodies, towards the eventual goal of India becoming a 'full participant' in the CFA. This would enable India to exercise the same rights and obligations as OECD members with the CFA, with regard to developing and implementing the CFA's work agenda, and would also recognize the importance of India in the international dialogue on taxation. India intends to extend its cooperation with the OECD's Global Relations Tax Programme by facilitating the participation of Indian officials in OECD events and fostering the participation of Indian experts in such events.

countries and exploitation of their natural resources through abusive TP schemes. The FM emphasized that India has taken steps to simplify and place the administrative procedures concerning taxation, trade and tariff and social transfers on electronic interface, free of discretion and bureaucratic delays. The DTC, which is presently under examination of the Parliamentary Standing Committee, is based on the best international practices and aims to simplify the administration and implementation of direct taxes in India. For Goods and Services Tax (GST), a Constitutional Amendment Bill was moved in the Parliament. The reforms in both direct and indirect taxation issues will provide domestic as well as foreign investors a much simplified taxation regime which would be easy to comply with and which is expected to reduce compliance cost significantly. However, there were challenges, which are highlighted below.

International tax issues and TP

- ▶ International tax issues connected to cross-border transactions are complicated and tedious. These issues range from source of income, characterization of income, attribution of income to source or residence country and taxing right over income. Similarly, TP poses problems with increase in cross-border trade, including within multinational enterprises located in developed, developing and undeveloped countries. The variety of inter-company transactions, increased global business restructuring and location of companies in various tax jurisdictions have brought various challenges to the tax administration on TP rules. This has put arm's length standards and existing TP guidelines under pressure.

- ▶ To meet these challenges, it is understood that the OECD is in the process of revising its existing guidelines and the United Nations is also currently developing a policy manual for developing countries to establish fairer TP practices. This would protect developing countries from eroding their tax bases. India is also strengthening its TP provisions to check misuse of the provisions and efforts to shift profits to another jurisdiction. The OECD TP guidelines on business restructuring would provide helpful guidance for tax administration as well as business.
- ▶ The FM also highlighted the effectiveness of the Indian Tax Authority in the field of international taxation and TP by stating that, in the financial year 2010-11, the Directorate of International Taxation had mobilized tax revenues of INR227b (approximately US\$5.08b) and has made TP adjustments of INR228b (approximately US\$5.11b).

Rise in litigation

- ▶ The rise in disputes in international tax matters is another area of challenge. Due to linkages in global economy, tax disputes have assumed a multilateral character, involving multiple countries. For this purpose, apart from the existing mutual agreement procedure (MAP) under double taxation avoidance agreements (DTAAs), there is also a need for multilateral tax conventions to address the issues of multipolarity/approaches, as the Indian experience shows that non-resolution of disputes leads to unending litigation.

Key points from the FM's speech at the seminar

The FM called for strong measures to reverse the ongoing trend of illicit outflows from developing

Tax havens and exchange of information

- ▶ Tax competition, driven by the presence of tax havens, has created an unhealthy situation that has helped individuals to park substantial undisclosed income outside their countries and, in the process, deny legitimate tax revenues to their countries.
- ▶ The Government of India is committed to vigorously pursuing all the necessary steps in coordination with countries concerned in this issue. India has already initiated the process of renegotiating DTAs with 65 countries to broaden the scope of provisions governing exchange of banking information. Furthermore, India has also finalized 14 Tax Information Exchange Agreements (TIEAs) with jurisdictions and has also completed negotiations/renegotiations of DTAs with 36 countries in the last year.
- ▶ While countries have agreed to end bank secrecy in general, some countries have agreed to do so only from a prospective date and are not willing to exchange past banking information. This puts a question mark on the efficacy of present legal provisions for exchange of banking information. Therefore, there is an urgent need to revisit the existing legal framework developed by the OECD in this regard.

The Survey; comments on the tax policy reforms

The Survey contains some observations on India's tax policy and reforms proposed in the DTC. The key observations are as follows:

- ▶ The Survey acknowledges that the Government of India is pushing ahead with tax reforms.
- ▶ Considering the level of development, there is a case for India to further move its income tax system towards consumption tax, thus, encouraging savings. However, proposals to reduce tax on savings by making contributions to pension schemes and tax-free lump sum withdrawals, are too generous.
- ▶ The decision not to lower tax rate on short-term capital gains and not to introduce any tax on long-term capital gains (LTCGs) is a step backward and could perpetuate tax avoidance via the transformation of income into LTCGs.
- ▶ The replacement of profit-linked deduction with investment-linked deduction will tend to favor capital-intensive operations, thus, reinforcing the bias away from labor-intensive projects.
- ▶ The increase in the minimum corporate tax rate acts as a bias by favoring large, established companies with a large profit base to offset deduction, against start-ups with no existing profits. A better approach would be to eliminate special allowances, such as accelerated

depreciation, and further reduce the basic corporate tax rate.

Comments

In recent times, international tax evasion, implementation of high standards of transparency and exchange of information have been the focus of the political agenda of global economies, including India. Added to this, the shift in tax base, tax havens, TP and the rise in litigation have also been key areas of focus of the Government of India. This recent development suggests that India is actively pursuing cooperation on these aspects.

Additionally, the Program with the OECD is expected to culminate in 'full participant' status for India against India's existing status of 'enhanced engagement' with the OECD. A lot of action and exchange of ideas is expected amongst various tax authorities as part of the Program.

There is also a welcome recognition that taxation has implications that stretch beyond the narrow sphere of revenue-raising into good governance and, ultimately, in the accountability of the State to its citizens.

The Program is an endeavor aimed at further cooperation with OECD economies in sharing information and combating tax avoidance and marks a significant step forward in the direction of tax cooperation. This is also expected to allow the Indian Tax Authority to be better equipped to tackle tax evasion.

Our offices

Ahmedabad

2nd floor, Shivalik Ishaan
Near CN Vidhyalaya Ambawadi
Ahmedabad - 380 015
Tel: + 91 79 6608 3800
Fax: + 91 79 6608 3900

Bengaluru

"UB City", Canberra Block
12th & 13th floor
No.24 Vittal Mallya Road
Bengaluru - 560 001
Tel: + 91 80 4027 5000
+ 91 80 6727 5000
Fax: + 91 80 2210 6000 (12th floor)
+ 91 80 2224 0695 (13th floor)

Chennai

TPL House, 2nd floor
No. 3 Cenotaph Road Teynampet
Chennai - 600 018
Tel: + 91 44 6632 8400
Fax: + 91 44 2431 1450

Hyderabad

205, 2nd floor
Ashoka Bhoopal Chambers
Sardar Patel Road
Secunderabad - 500 003
Tel: + 91 40 6627 4000
Fax: + 91 40 2789 8851

Oval Office, 18, iLabs Centre
HITECH City, Madhapur
Hyderabad - 500081
Tel: + 91 40 6736 2000
Fax: + 91 40 6736 2200

Kochi

9th Floor, Abad Nucleus
NH-49, Maradu PO
Kochi -682304
Tel: +91 484 3044000
Fax: +91 484 2705393

Kolkata

22 Camac Street
Block 'C', 3rd floor
Kolkata - 700 016
Tel: + 91 33 6615 3400
Fax: + 91 33 2281 7750

Mumbai

14th floor, The Ruby,
Dadar, Mumbai - 400 028.
Tel: + 91 22 6192 0000
Fax: + 91 22 6192 1000

6th Floor, Express Towers,
Nariman Point,
Mumbai - 400 021
Tel: + 91 22 6657 9200
Fax: + 91 22 2287 6401

Block B-2, 5th Floor
Nirlon Knowledge Park
Off. Western Express Highway
Goregaon (E), Mumbai - 400 063.
Tel: + 91 22 6749 8000
Fax: + 91 22 6749 8200

NCR

Golf View Corporate Tower B
Near DLF Golf Course Sector 42
Gurgaon - 122002
Tel: + 91 124 464 4000
Fax: + 91 124 464 4050

6th floor, HT House
18-20 Kasturba Gandhi Marg
New Delhi - 110 001
Tel: + 91 11 4363 3000
Fax: + 91 11 4363 3200

4th & 5th Floor, Plot No 2B, Tower 2,
Sector 126, NOIDA 201 304
Gautam Budh Nagar, U.P. India
Tel: + 91 120 671 7000
Fax: + 91 120 671 7171

Pune

C-401, 4th floor Panchshil Tech Park
Yerwada (Near Don Bosco School)
Pune - 411 006
Tel: + 91 20 6603 6000
Fax: + 91 20 6601 5900

Ernst & Young Pvt. Ltd.

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit

www.ey.com/india

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Ernst & Young Private Limited is one of the Indian client serving member firms of Ernst & Young Global Limited.

Ernst & Young Pvt. Ltd is a company registered under the Companies Act, 1956 having its registered office at 22, Camac Street, Block C, 3rd Floor, Kolkata- 700016

© 2011 Ernst & Young Pvt. Ltd.
All Rights Reserved.

Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young Pvt. Ltd. accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.