Direct Taxes Code Global Think Tank

International Dimensions of the Direct Taxes Code Bill, 2010

Comments and Recommendations

Convened By

Nishith Desai Associates

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Dedicated to Shri. Nani Palkhivala*, a visionary whose contribution to Indian tax legislation and jurisprudence is a continuing source of inspiration.

"The law and levy of income-tax are directly related to economic factors, and are conditioned by social and political forces, by industrial and commercial considerations. The interpretation of such a law must necessarily be inspired by the principle of growth."

* Nanabhoy "Nani" Ardeshir Palkhivala (1920 – 2002) is regarded as India's greatest constitutional and tax lawyer. He was part of the Committee that drafted the 12th Report (1958) of the Law Commission of India which laid the foundation for the present Income Tax Act of 1961. He was also Indian ambassador to the US from 1977 - 1979.

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October 20, 2011

Shri Yashwant Sinha, M.P.
Chairman, Parliamentary Standing Committee on Finance
New Delhi, India

Dear Sir,

Sub: Comments and Suggestions of the Direct Taxes Code (DTC) Global Think Tank convened by Nishith Desai Associates

At the outset, we express our gratitude to the Hon'ble Chairman for granting us the opportunity to present our comments, views and suggestions in relation to the legislative proposals contained in the draft Direct Taxes Code Bill, 2010 ("**DTC**" or "**Code**") and the accompanying discussion papers ("**Discussion Papers**").

We appreciate the efforts of the Hon'ble Finance Minister and the Central Board of Direct Taxes ("**CBDT**") for their mammoth initiative of undertaking a reform of India's direct taxation framework. We also commend some of the Government's recent measures in tackling the menace of black money. In many ways, the DTC represents an ambitious attempt at refining the form and structure of the Income Tax Act, 1961 and Wealth Tax Act, 1957. It also introduces a number of new concepts and terminology borrowed from taxation laws in other jurisdictions. The notable aspects of the DTC including simplification of language in certain legal provisions, consolidation of sections and streamlining of tax rates deserve our sincerest appreciation.

On a deeper scrutiny of the text of the DTC, however, we find a number of ambiguous provisions, conceptual and drafting errors, inconsistencies and other infirmities that are antithetical to a progressive tax regime. Apart from these substantive aspects, our most fundamental concern lies in the manner in which India, as a modern democratic nation, has embraced the process of tax reform and the extent to which the DTC has translated its stated objective into reality.

In this cover letter we seek to provide a background to the Report of the Global Think Tank ("**Report**") and highlight specific concerns which are relevant from a broad policy perspective. Annexed to this letter is a summary of the key comments and recommendations in relation to specific provisions of the draft Code, followed by the more elaborate Report.

1. Background to the Global Think Tank

While the task of re-drafting the entire law on direct taxation of a country such as India is indeed a formidable one, to review such a law and analyze its broader implications is equally challenging. Therefore, with a view to provide more impactful comments and suggestions we have narrowed our focus to examining specific provisions of the DTC that shall impact the international business community.

The members of the DTC Global Think Tank convened by Nishith Desai Associates have significant expertise and experience in international tax policy and include renowned academicians, jurists, public policy experts and industry leaders from developed and developing countries. We are not lobbyists and do not seek to represent the concerns of a specific industry or interest group. The Report seeks to provide an objective assessment of legal, constitutional and international law implications of specific DTC proposals.

2. A Short Window of Opportunity to Attract Foreign Capital

The comments and recommendations in this Report have been presented against the background of the following recent developments which require immediate consideration at the highest levels:

i. India witnessed a 31% drop in foreign direct investment ("**FDI**") in the year 2010. FDI fell from USD 35.6 billion in the year 2009 to USD 24.6 billion in the year 2010. However, FDI in China increased by 11% from USD 95 to USD 105.7.[1]

ii. India has clocked the highest rise in the latest worldwide tax misery index.[2]

1. UNCTAD, World Investment Report, 2011.

2. Jack Anderson, 2009 Tax Misery & Reform Index, Forbes Magazine.

iii. India's rank in the worldwide corruption perception index has fallen from the 84th position in 2009 to the 87th position in 2010. China's rating however improved from the 79th position to the 78th position.[3]

iv. The 2011 Trust Barometer concludes that India's informed public has most trust in business and least trust in Government.[4]

v. The findings also indicate that the degree of trust reposed on the Government is least in India when contrasted with other countries in the Asia-Pacific region.[5]

Developments of this nature undermine a country's competitive advantage as a preferred investment destination. Today, transnational corporations are choosing not to invest their vast cash resources due to the financial instability prevailing across major economies around the world. This is the best time for India to attract foreign capital. Such a window of opportunity may be short lived with the US and various European countries working hard towards reviving their economies through rapid pace reforms. India should not miss this limited opportunity and the time is ripe for a second phase of liberalization and globalization.

3. Four-Fold Policy Considerations

Considering the role played by a country's fiscal policy in a nation's overall growth and development, we have identified the following four-fold objective which provides broad direction to the comments and recommendations in this Report:

i. Developing a robust, stable and sustainable fiscal policy that will set benchmarks on a global basis;

ii. Enhancing India's participation in international trade and investment flows;

3. Transparency International, Corruption Perceptions Index, 2010.

4. 2011 Edelman Trust Barometer, India Findings, February 3, 2011.

5. *Id*.

iii. Facilitating India's emergence as a superior and responsible economic power in global affairs; and

iv. Increasing welfare to the common man and the average taxpayer.

The achievement of these inter-linked objectives should, in our view, create multiple trickle-down effects including a boost in GDP growth, increased employment generation, inflow of sophisticated technology and global best practices, maximizing productivity of domestic firms and incentivizing the growth and expansion of Indian transnational enterprises. This will also provide further impetus to the process of globalization of the Indian economy, the benefits of which, as suggested by economists such as Amartya Sen[6], should be shared among all stakeholders including the common man.

As an illustration, increased FDI in the clean energy sector accompanied by transfer of next generation technology, will help India become more energy self-reliant thereby providing a degree of insulation against fluctuating global crude oil prices. In addition to countering fuel-related supply side inflation, it will also result in capital investment and employment generation in less developed areas of the country. Trickle-down benefits of this nature would, however, diminish if India offers a legal and tax regime that is not conducive to the inflow of foreign capital and technology.

It is imperative that the fiscal policy underlying the proposed DTC should be integrated with such broader macro-economic and social objectives. In our view, such integration is lacking in the DTC since the pre-dominant focus is on revenue maximization without due consideration of broader economic, legal, constitutional and international law implications.

4. Need for Clear Direction

We believe that all legal reform has to be directed towards the achievement of specific national goals.

Curiously, we find that there were no publicly notified terms of reference for developing and drafting the DTC and Discussion Papers. We also take note of the conspicuous absence of

6. *See*, Amartya Sen, How to Judge Globalism, THE AMERICAN PROSPECT, Volume 13, Number 1 : January 01,2002.

public policy experts, lawyers, economists, accountants, statisticians and expert draftsmen in the DTC policy formulation and drafting exercise. This may be discerned from the lack of any clear overarching direction, macro-economic or social context or guiding policy underlying the DTC's framework. In addition, we are also concerned with the extremely limited scope of the new Code as reflected in the Discussion Papers and the DTC's statement of objects and reasons.

While introducing the DTC, the Discussion Paper states that: "*the Code is not an attempt to amend the Income Tax Act, 1961; nor is it an attempt to 'improve' upon the present Act. In drafting the Code, the Central Board of Direct Taxes (the Board) has, to the extent possible, started on a clean drafting slate.*" On the basis that legal reform is a continuous process, this approach makes it difficult to independently review the Code and assess whether it represents a change in the right direction. In our view, it is not prudent to completely disconnect the DTC from the earlier law and over half a century of political deliberations and jurisprudence that have shaped India's tax regime and its linkages with the Indian Constitution and the international legal environment.

The Hon'ble Finance Minister in his foreword to the DTC Discussion Paper stated that the DTC seeks to *"ensure efficiency and equity by eliminating distortions, introducing moderate levels of taxation and expanding the tax base."*

While these are noble objectives characteristic of an evolved tax system, we believe that the same has not been reflected in the text and spirit of the draft Code placed before Parliament. It seems that the statement of objects and reasons of the DTC has undergone a change, as evident from its limited scope: "*revise, consolidate and simplify the language and structure of India's direct tax laws.*" The DTC (neither in the preamble nor the statement of objects and reasons) does not make any mention of important policy considerations such as equity, efficiency and certainty.

If consolidation and simplification of specific provisions are the only significant changes introduced by the DTC, questions may be raised with respect to the need for a new tax law, and whether the more appropriate step is to thoroughly review the flaws in the existing regime and make necessary amendments based on certain clearly defined policy goals.

5. Best Practices in Legislating a Taxing Statute

We are of the view that the steps taken by the CBDT towards the drafting of the DTC do not conform to global best practices or even the standards laid down by the Law Commission of India around half a century back. In our view, the DTC does not represent well conceived and sustainable fiscal policy.

Policy making is an art, especially since it is influenced by the skill, discipline, imagination and creativity of the law maker and the legislative draftsman. For this reason, in India, the task of critically analyzing existing statutes and proposing amendments has been conventionally delegated to the Law Commission of India. The present Income Tax Act, 1961 is a product of extensive analysis by a Committee of the Law Commission comprising of legal luminaries and expert draftsmen such as Nani Palkhivala, GN Joshi, Satyanarayana Rao and MC Setalwad. Countries such as the US, UK, Australia and Canada have advanced and institutionalized processes for evolving, evaluating and reviewing fiscal policy, engaging in meaningful public discussions and drafting the text of the law. In this regard, useful suggestions have also been made by the Organization for Economic Cooperation and Development ("**OECD**") and International Monetary Fund.

The Discussion Paper should serve as an architectural blue print on the basis of which the nation can rationally debate and conclude on the effectiveness and desirability of each DTC proposal. It should necessarily be both detailed and comprehensive and explain the broad revenue, economic and social goals that India seeks to achieve through the new fiscal policy. This should be followed by an analysis of the deficiencies in the present tax regime and the difficulties in achieving the stated goals. The Discussion Paper should then explain the basis for the fiscal proposals and the intended impact. We should adopt the best practice of using revenue estimates and statistics to understand the projected quantitative impact of each proposal. The Discussion Paper should also present both sides of each policy and the available alternatives, and critically analyze relevant judicial decisions, economic theories and international trends.

The proposed policy should also be fully integrated into the nation's legal and constitutional scheme. The Discussion Paper would have to necessarily delve into aspects such as the implications of other statutes, issues of constitutional validity and impact of international law.

The process of drafting should commence only once there is a degree of finality and consensus on the policy to be adopted. The object is not to rush to a conclusion that may temporarily suit the revenue, but to arrive at the appropriate fiscal policy in a rational and logical manner. For this reason, there should be sufficient co-ordination and dialogue among various ministries in the Government and between the revenue and taxpayers.

We understand the urgency with which the government is seeking to enact a new Direct Taxes Code. However, considering the grave ramifications of promulgating an inadequately analyzed tax code for a country, the size of India, we recommend that the task of drafting formal Discussion Papers and laws such as the DTC are entrusted to a Law Commission comprising of experts in the field of law, economics, statistics, public policy, accountancy and legislative drafting. A well researched, objective and thoroughly debated policy draft would allow both taxpayers and the Parliament to make meaningful choices in a systematic and thorough manner.

6. Tackling the Heart of Corruption

While it is important to establish systems that will detect, punish and deter persons from engaging in corrupt practices[7], it is also important to look into the core factors that give rise to corruption. The simple yet powerful formula proposed by the economist, Robert Klitgaard is that corruption is a result of monopoly, discretion and lack of accountability[8]:

$$\mathbf{C} = \mathbf{M} + \mathbf{D} - \mathbf{A}$$

(Corruption) (Monopoly) (Discretion) (Accountability)

7. As recently noted by the Allahabad High Court, "This country has now reached a stage where we find level of corruption running in several thousand of crores and going to even lakhs of crores. *Mithilesh Kumari v. State of UP,* 2011 (1) ADJ 40.

8. *See*, Robert Klitgaard, *International Cooperation Against Corruption*, FINANCE & DEVELOPMENT, March 1998.

Noting the link between discretion and corruption, the Indian Supreme Court observed that "Absolute discretion, like corruption, marks the beginning of the end of liberty."[9] In order to tackle corruption at its roots, it is necessary to impose sufficient safeguards against executive discretion and the arbitrary exercise of power conferred under law.

At several points in the DTC, we are especially concerned with the wide discretionary powers provided to the tax department without any corresponding guarantee of accountability. Ambiguous drafting and interpretation issues can also lead to unreasonable application of the provisions at lower levels and harassment of the marginal taxpayer.

In light of the extent of systemic corruption in India, we are most concerned with the proposed general anti-avoidance rules ("**GAAR**") which provide unfettered powers to the Commissioner of Income Tax ("**CIT**") to disregard transactions, rearrange, recharacterize and reallocate income streams (even on the basis of perception) and effectively create a charge of tax in the case of certain 'impermissible avoidance arrangements'. The proposed GAAR provisions ignore the fundamental difference between tax planning and tax evasion which has been settled over more than a century of common law jurisprudence and which has attained a good degree of certainty in India. The definition of 'impermissible avoidance arrangement' is so vague and inclusive that it may cover several legitimate cases of tax planning. Further, unlike conventional standards, the burden of establishing non-applicability of the GAAR provisions has been solely imposed on the taxpayer without any obligation on the CIT to put forth even a *prima facie* case.

The ambiguities in the GAAR provisions and the wide discretionary powers provided to the CIT are likely to result in their arbitrary interpretation and enforcement. Apart from affecting larger enterprises and MNCs doing business with India, the GAAR provisions will also have an adverse impact on other taxpayers including civil society organizations and ultimately the common man who will have limited or no means of planning his economic affairs without being threatened with arbitrariness, harassment and corruption.

9. *Union of India v. Sankalchand Himatlal Sheth*, AIR 1977 SC 2328.

For these reasons and others relating to violation of constitutional and international law norms discussed in our Report, we believe that proposals such as the GAAR provisions should not be introduced in their current form since they are not in the long term interest of the country and do not conform with the four-fold objective identified by us.

7. A Commitment to Certainty

> "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular…The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality…is not near so great an evil as a very small degree of uncertainty."
>
> \- Adam Smith[10]

Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial for taxpayers to make rational economic choices in the most efficient manner. Uncertainty, on the other hand, results in huge economic costs both for the taxpayer and the Government. Economists have suggested that policy uncertainty forces businesses to adopt a cautious stance in terms of investments, expansion plans, product development and hiring strategies.[11] Such responses spread across an industry can severely thwart economic recovery processes and growth prospects.

Certainty is also integral to rule of law. Vague laws and the resulting uncertainty inevitably lead to misuse and arbitrary exercise of executive power, and therefore conflict with the Indian constitutional guarantee of equity, fairness and reasonableness.

10. Adam Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, at Para 2, Part Third, Book V.

11. For example, *see*, Scott R. Baker, Nicholas Bloom and Steven J. Davis, Business Class: Policy *Uncertainty Is Choking Recovery*, BLOOMBERG, Oct 6, 2011.

It is necessary for the Government to commit itself to the cause of certainty and stability in India's tax policy. Such commitment unfortunately is not reflected in India's approach to the DTC. Much uncertainty has been generated due to factors such as the limited policy analysis behind the DTC proposals, reliance on ambiguous legal standards and definitions, conferral of excessive discretionary and law making powers on the executive, limitations in the advance ruling framework and inadequate taxpayer education on the implications and rationale behind the key fiscal proposals. This in contrast with the transparent approach of most developed countries in matters of fiscal policy.

The commitment to certainty should permeate every aspect of the tax reform process from policy formulation to legislative drafting to implementation of laws. This will boost taxpayer confidence and significantly improve tax compliance. It is also a stepping stone towards a trust based taxation regime.

8. Shifting to a Trust Based Taxation Regime

Trust is a valuable social asset and forms the basis of democracy. The theory of trusteeship espoused by Mahatma Gandhi has application in all facets of governance, whether in corporate management or the tax administration system. Management experts such as Charles Handy have suggested that distrust will only result in each individual thinking of his personal interests and neglecting the broader interests of the enterprise. Applying these principles to tax policy, we are of the view that distrust can have a negative long term impact on voluntary compliance. Distrust also goes against the spirit of 'enhanced cooperation' between taxpayers and tax administrators that is advocated by the OECD.

From the broad scheme of the DTC, we observe a pervading sense of distrust against both the Indian judiciary as well as taxpayers in general. The Discussion Paper suggests that the judiciary has played a role in the complex structure of the present income tax law. It also overrides several long standing precedents laid down by the Supreme Court without any analysis of the rationale or reasoning used therein. The blatant disregard for judicial precedent is a matter of grave concern especially in cases where Courts have tried to reconcile the law with constitutional norms and international law commitments. It also goes against the spirit of separation of powers which is part of the basic structure of the Indian Constitution.

The lack of trust is also evident in the proposed GAAR provisions which question the fundamental principle that a taxpayer is entitled to legitimately plan his economic affairs with the aim of minimizing his tax burden within the four corners of law. Other regressive aspects of the GAAR provisions including the excessive discretionary powers provided to the CIT, absence of any time limits for invocation of such powers and onerous burden of proof imposed on the taxpayer are bound to create much uncertainty and hardship for the average taxpayer. Such provisions will create further tension in the existing adversarial environment characterized by the large backlog of cases at the tax tribunals and appellate Courts.

It is important to recognize that tax compliance is not a one-way street. If a Government distrusts its people and increases transaction costs through onerous compliance requirements, ambiguous legal standards and litigation, people are likely to reciprocate by distrusting the Government, which will create an atmosphere of distrust, suspicion and non-compliance.

For a trust based taxation regime, it is imperative that the DTC recognizes and guarantees each taxpayer certain basic rights including: (i) enforcement of tax laws in a fair, equitable and non-arbitrary manner, (ii) non-retroactive imposition of taxes, (iii) certainty and stability, (iv) guarantee against double taxation and good faith interpretation and enforcement of tax treaty provisions; and (v) efficient redressal of tax disputes within a reasonable time frame.

We believe that while "taxes are the price we pay for civilization"[12], civilization cannot sustain itself without trust. A shift to a trust based tax regime will significantly facilitate the achievement of the four-fold objective highlighted above.

We have annexed herewith, our Report analyzing some of the key provisions of the DTC

12. Dissenting decision of Justice Oliver Wendell Holmes (US Supreme Court) in *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87 (1927).

affecting the broader international business community, many of which also have a direct impact on the average taxpayer and ultimately, the common man. Also annexed is an executive summary of our key comments and suggestions.

We once again thank the Hon'ble Chairman for providing us this opportunity to express our views and extend our full support towards any further steps or initiatives to be taken in the drafting and finalization of the new Code.

For your kind consideration of our Report, we shall remain forever obliged.

Yours truly,

Nishith M. Desai

Convener, DTC Global Think Tank

Copy to: 1. Hon'ble Prime Minister, Government of India

2. Hon'ble Finance Minister, Government of India

Encl: As above

Summary of Views, Comments and Recommendations

1. Best Practices in Legislating a Taxing Statute

i. This preliminary chapter contains our comments on the process of tax reform and India's approach to the DTC, which is in stark contrast to global best practices in legislating a taxing statute.

ii. There are three major issues with the present approach to the introduction of the DTC:

a. Drafting of the text of the new law had commenced before finalizing, through informed public debate, the basic principles underlying the new tax regime. There were no published terms of reference in relation to the drafting of the DTC or discussion papers.

b. Conclusions with respect on the utility and effectiveness of each proposal in the DTC have been made without the backing of in-depth and comparative legal, economic and statistical analysis

c. The DTC approach has abandoned the well-established convention of referring an important piece of legislative reform to an independent Law Commission of experts.

iii. The haste with which the Government has proceeded with the enormous task of completely rewriting the direct taxes legislative framework is also a matter of concern. It may not be feasible to enforce the DTC provisions from the financial year, 2012 itself if the Indian Parliament is expected to thoroughly scrutinize each proposal and analyze their overall ramifications.

iv. India should adopt some of the global best practices in legislating tax policy, a few which have been discussed in the Report:

a. Policy making process requires detailed deliberations on issues relating to the country's economy, its institutions, and policy settings in order to identify priorities, develop an effective set of policies and monitor progress. The OECD has identified key legal and macro-economic questions to be addressed in any fiscal reform process.

b. UK has expressed its commitment towards stability in law, simplicity, transparency, prospective law making and institutionalized public consultation.

c. Australia has institutionalized a system of comprehensive regulatory impact analysis examining the trade-offs between different policy options to ensure that the most efficient and effective regulatory option is chosen by establishing a systematic and consistent framework for assessing the potential impact of Government action.

d. The US Joint Committee on Taxation undertakes 10 year projections of the revenue impact of each fiscal proposal, based on scientifically simulated models that factor in taxpayer behavior as well as economic, demographic and social trends. The estimates are prepared by a team of senior economists, accountants and lawyers, and are subjected to a two tier quality-control process.

e. High standards of policy analysis were set by the 1958 Report of the Indian Law Commission involving detailed analysis of judicial precedent, comparative international legislations, scholarly writing, implementation challenges and constitutional aspects.

f. The International Monetary Fund has made useful recommendations on the use of plain English in tax law drafting. A properly organized tax statute devoid of legal jargon with clear yet simple writing style and limited use of ambiguous, subjective terminology will enhance understandability for the average taxpayer.

g. UK has set up an office of tax simplification to review tax laws on an ongoing basis and make proposals for simplification. The proposals will be reviewed by a Joint Parliamentary Select Committee on Taxation.

v. Many of the changes suggested in the DTC will create serious implementation and interpretation challenges and taxpayers and revenue officers would require sufficient time to adjust to the new and radically different tax regime.

vi. India should not rush through the DTC exercise. The DTC has the potential to become India's most successful experiment with tax reform. It presents an opportunity to adopt global best practices, rectify some of the deep-rooted flaws in its existing tax system and create a robust, fair, equitable, efficient, transparent and stable tax regime.

2. Evolving Appropriate Policy for Residence and Source Based Taxation

i. India should evolve a stable and sustainable international tax policy aimed at achieving objectives such as economic growth, revenue and certainty. It is also necessary to reconcile such policy objectives with standards laid down under the Indian Constitution, international law and applicable tax treaties.

ii. Recent trends in India suggest the lack of clear guiding policy on international tax matters:

   a. Increasing reliance on ambiguous standards and high degree of subjectivity in India's application of source and residence rules.

   b. Conflicting positions on international tax matters taken in India's reservations on the OECD Model Convention, the existing law, treaty provisions and in the proposed DTC

   c. Disconnect with industry understanding especially in rapidly evolving sectors such as e-commerce as well as satellite broadcasting.

   d. Disregard for international law principles such as nexus, economic allegiance, respect for treaty commitments and uncertain interpretation and enforcement of legal / treaty provisions.

   e. Undermining judiciary's positive role in furthering the cause of certainty in the application of international tax rules on the basis of constitutional and international law principles.

f. Adversarial approach of the tax department which is in conflict with the OECD-recommended, 'enhanced cooperation' between taxpayer and the State.

g. Economic distortion resulting from uncertain application of source and residency rules, economically inefficient behavior as well as increased cost of compliance, enforcement and litigation.

iii. India's approach to source and residence does not seem to be backed by any clear policy level macro-economic strategy. For instance, 8 years ago, the Indian Government defended the Mauritius tax treaty before the Supreme Court considering the significant influx of foreign capital invested through Mauritius. Today, however, several well established and legally / treaty compliant structures for inbound investment have been challenged resulting in extreme uncertainty for investors.

iv. Changes in India's international tax policy are not subject to sufficient discussion, analysis, justification or notification of underlying legal or economic rationale. This is in contrast with global best practices, some of which have been discussed in the Report:

a. Treaties tabled before the Australian Parliament are accompanied by a National Impact Analysis examining foreseeable economic, environmental, social and cultural implications; obligations imposed; direct financial costs; domestic implementation issues; and the nature of consultation that has occurred.

b. The US Model Income Tax Convention and treaty technical explanations reflect the prevalent tax treaty policy of the US and the underlying policy rationale. The model convention is used as a starting point in bilateral treaty negotiations between the US and other countries.

c. Memorandum on Dutch tax treaty policy recently published by the Dutch finance ministry explains in clear terms the major policy positions endorsed by the Netherlands as well the legal and economic considerations.

3. Constitutional Limitations: Certainty, Non-arbitrariness, Nexus & Respect for Treaty Commitments

i. This chapter examines important principles of Indian constitutional law that are relevant to an analysis of some of the international tax proposals in the DTC.

ii. Legislative certainty is a constitutional norm. A taxpayer is entitled to clear notice of the specific situations which will give rise to tax liability under the law. Vague laws and the resulting uncertainty inevitably lead to misuse and arbitrary exercise of executive power, and therefore fall foul of the requirements of Article 14 of the Indian Constitution which guarantees equity, fairness and reasonableness.

iii. The fundamental right to equality guaranteed under Article 14 of the Constitution of India also acts as a bar against arbitrary or unguided exercise of discretionary powers conferred upon authorities by a statute.

iv. Excessive delegation of core legislative powers (including the power to prescribe the conditions resulting in tax liability) without laying down adequate policy standards or guiding principles are violative of Article 14 of the Constitution.

v. The principle of territorial nexus is an integral part of India's constitutional scheme and the Parliament cannot enact laws or impose taxes in relation to persons, aspects or causes that do not have any real nexus with the territory of India.

vi. The directive principles of State policy in the Indian Constitution oblige the Indian Government to respect international law and treaty commitments. These directives are considered binding and enforceable if viewed in light of the fundamental rights guaranteed under the Constitution.

vii. The constitutional infractions of specific DTC proposals such as General Anti Avoidance Rules (“**GAAR**”), taxation of offshore services and offshore share transfers are separately discussed in the Report.

4. International Dimensions : Norms of Sovereignty and Comity of Nations

i. This chapter examines important principles of international law that are relevant to an analysis of some of the international tax proposals in the DTC.

ii. Global economic interdependence has led to an erosion of traditional concepts of sovereignty giving rise to notions of sovereign responsibility and accountability.

iii. Sovereignty implies that while a State has exclusive competence over its own territory, it has an obligation to respect the sovereign rights of other States.

iv. Fiscal sovereignty and tax jurisdiction are not absolute. A State may levy taxes on persons who are outside the territory of that State only if there is a real link or nexus between the State and the person.

v. The Indian Supreme Court has clearly held that the State is required to exercise its sovereign authority in a judicious and reasonable manner that would promote public welfare. It has to respect the sovereign rights of other States and, in the absence of sufficient nexus, refrain from excessive extra-territorial law-making in order to protect the interests of international comity and harmony.

vi. International comity refers to the respect sovereign nations afford each other by limiting the reach of their laws. It demands for a reasonable exercise of fiscal jurisdiction in a manner that gives due recognition to the sovereign rights of other States.

vii. Bilaterally and multilaterally negotiated treaties restrict and apportion fiscal jurisdictional rights between sovereign States with the object of avoiding double taxation and preventing fiscal evasion.

viii. The Vienna Convention, which has achieved the status of customary international law, provides that every treaty is binding between the contracting States and must be performed by them in good faith.

ix. The OECD has also expressed strong reservations against treaty override and unilateral breaches of international obligations. Conflicts with tax treaty obligations should be resolved by negotiating appropriate amendments or protocols and not by way of unilateral overriding legislation.

x. It is necessary that the DTC observes a reasonable exercise of fiscal jurisdiction based on respect for treaty obligations and the legitimate expectations of contracting parties.

5. General Anti-Avoidance Rules ("**GAAR**")

I. The new GAAR regime proposed in the DTC is likely to have the most critical impact on all classes of taxpayers - ranging from multinationals and sophisticated foreign investors to the common man. There are a number of legal and policy level infirmities and issues with the GAAR proposal based on which it has been recommended that the proposal be set aside or, in the alternative, deferred till there is greater consensus on the need for such a statutory measure. Additional recommendations have been provided in page 120 of the Report.

ii. The GAAR provisions do not provide sufficient (if not any) clarity as to the circumstances when the Commissioner of Income Tax may exercise his / her vast discretionary powers to determine and tax 'impermissible avoidance arrangements', thereby making it impossible for taxpayers to plan and make rational economic decisions. The extreme vagueness inherent in the text and substance of the proposed GAAR provisions may give rise to serious issues of constitutional validity.

iii. The broad ambit of the GAAR provisions combined with the lack of sufficient guidance in the DTC would result in arbitrary exercise of discretionary powers and extreme hardship for taxpayers.

iv. Conferral of wide discretionary powers without sufficient policy guidance and accountability will also provide a stimulus for corruption. Economists define corruption as discretion without accountability. Systemic corruption has become one of the biggest problems faced by India today and the Government should adopt necessary legislative and administrative measures which target the root of corruption.

v. The Central Government is also authorized to specify the conditions and manner of application of GAAR. Such delegation of essential law making powers is excessive considering that it extends to both substantive and procedural aspects of the GAAR provisions.

vi. The DTC's approach to GAAR does not respect the well-settled distinction between tax planning, tax avoidance and tax evasion. The GAAR provisions should not be structured or enforced in a manner that the average taxpayer is not able to plan his or her economic affairs with a reasonable degree of certainty.

vii. The non-exhaustive definition of 'commercial substance' and the ambiguous thresholds relating to the sufficiency of risks borne and the validity of the economic choices made by the taxpayer is bound to give rise to immense uncertainty and litigation. The definition of 'round trip financing' is extremely vague and would not be appropriate since it is likely to cover a wide range of business transactions even if there is no element of tax avoidance.

viii. GAAR policy should recognize that foreign tax is treated by businesses as a part of the cost of doing business in a foreign country. Economists agree that it impacts the quantum of returns provided to investors/shareholders as well as the entity's business valuations. In several cases (including most inbound investments from US sources), one of the main objects of the tax mitigation structures is to avoid double taxation rather than to benefit from double non-taxation. The minimization of tax liability, and especially mitigation of double or multiple taxation in a manner that is not prohibited under law, are acceptable business objectives and should not by itself trigger the application of GAAR.

ix. The circular definition of 'bona fide purpose' which refers to abuse or misuse of DTC provisions increases the degree of ambiguity.

x. Courts in India and around the world have evolved and applied a number of anti-avoidance tools to curb abusive arrangements by taxpayers. These tools include: lifting the corporate veil, sham transaction, colorable device, step transaction, conduit, business purpose, etc. There is a good degree of certainty today in India including clear views expressed by the Indian Supreme Court on the application of these principles. The present Income Tax Act (as well as the DTC) also contains a number of specific anti-avoidance rules to counter some of the most popular forms of tax avoidance including treaty shopping, bond washing, revocable transfers, base erosion through excessive deductions, etc. The treaties signed by India also contain various anti-avoidance limitations including beneficial ownership/anti-conduit provisions, limitation of benefits, exchange of information, etc. The Indian tax authorities already possess a wide arsenal of statutory, common law and treaty based anti-avoidance tools which may be deployed to curb abusive taxpayer arrangements. The need for a GAAR may not arise in today's scenario where revenue concerns have to be balanced with the need to boost certainty and investor / taxpayer confidence.

xi. There is no statistical evidence in India suggesting that the proposed GAAR provisions are going to increase revenue collections in a substantial manner. However, in view of the ambiguities inherent in the GAAR provisions and potential for abuse of powers, the enforcement of the new law would definitely trigger a sharp increase in litigation, thereby raising questions as to whether the overall costs of introducing GAAR in India may outweigh the compliance, enforcement and litigation costs.

xii. The GAAR provisions do not specify a statutory de minimis threshold for its application. Conventionally such a threshold is prescribed under the statute based on public consultation rather than being subject to executive discretion / notification.

xiii. The DTC does not prescribe any time period within which the tax department may initiate GAAR proceedings. This may result in application of GAAR provisions in an arbitrary and ad-hoc manner to transactions completed several years ago and would cause immense hardship to taxpayers. Maintenance and collection of reliable evidence and documentary support may also become a challenge and will create significant costs for taxpayers.

xiv. Retrospective application of GAAR provisions to prior arrangements or structures that are valid under the current law will breach the legitimate expectations of taxpayers who may have incurred significant costs while making various economic choices and legitimately managing tax costs.

xv. Although certain forms of treaty override on grounds of anti-avoidance may be tolerated, it is necessary to adopt a cautious approach while doing so especially due to the obligations imposed under the Indian Constitution and international law. Foreign treaty partners would appreciate bilateral negotiation of anti-avoidance clauses within the tax treaty itself in good faith. This will also provide greater certainty for taxpayers.

xvi. The Report also discusses a number of international best practices in GAAR legislation which have not been considered in the DTC discussion papers:

a. UK does not presently have a statutory GAAR. Earlier GAAR proposals were set aside for a number of reasons including undue emphasis on non-statutory guidance. In 2010, the UK Government initiated a study programme to determine whether it is feasible to frame GAAR provisions that would not erode UK's attractiveness for business, ensure certainty and minimize compliance/ enforcement costs. More recently, on September 1, 2011, the UK Government has abandoned its proposed legislation to counter treaty shopping arrangements on the basis that such proposals would create uncertainty for UK businesses and overseas investors.

b. Canadian GAAR jurisprudence focuses on abusive tax avoidance which seeks to frustrate the provisions of the law. Ordinary tax mitigation structures that are within the contemplation of the law / treaty do not attract GAAR.

c. Codification of economic substance in the US does not mark any significant shift from the existing US common law jurisprudence on anti-avoidance, thereby allowing Courts to rely on established precedent. In order to provide certainty, the US Joint Committee has clarified that the provisions are not intended to alter the tax treatment of certain transactions that have been respected under long standing judicial and administrative practice, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages.

d. While New Zealand has been actively enforcing its GAAR provisions, the Inland Revenue accepts that taxpayers are allowed to legitimately manage their affairs to minimize the incidence of tax. It has also expressed its commitment towards certainty by assuring that binding rulings shall be issued to taxpayers in relation to specific tax arrangements.

e. Australia recognizes the seriousness of invoking GAAR powers and assures that its application would require a careful and objective analysis of relevant facts. All GAAR matters are referred to a GAAR panel consisting of reputed businessmen, professionals and senior tax officers. The GAAR panel assists the tax office in the administration of GAAR in an objective and consistent manner.

f. The drafters of the DTC have borrowed the GAAR provisions from the South African tax statute without considering some of the inbuilt safeguards which are relevant from a fairness and efficiency perspective. For instance, in South Africa the primary burden of proving that an arrangement is abusive or lacks commercial substance is on the tax department which has to issue a notice containing proper reasons. Taxpayers are also offered specific safe harbours or shelters against application of GAAR. Further, the statutory provisions are comprehensive and powers have not been delegated to the executive to determine the conditions for applicability of GAAR.

6. POEM as a Threshold for Tax Residence

i. The DTC introduces 'place of effective management' (**"POEM"**) as a threshold for determining the residence of a foreign company. A foreign company having its POEM in India will be taxed on its worldwide income. POEM is determined to be the place where the company's board of directors or its executive directors make their decisions or the place where the executive directors or officers perform their functions (if their strategic/commercial decisions are routinely approved by the board).

ii. Due to uncertainties in the application of the proposal, it is recommended that the DTC should continue with the existing test for residency unless there is statistical evidence suggesting that POEM would increase revenue collections to an extent that is significantly higher than the additional compliance, enforcement and litigation costs.

iii. There are a number of conceptual ambiguities in the POEM test. The definitions provide limited clarity on the meaning of expressions such as 'executive director', 'officer', 'commercial or strategic decisions' and the distinction between making decisions and performing functions. For instance, questions will arise as to whether the definition will cover independent directors or nominee directors appointed by strategic or institutional investors. Further, a contrary position on the scope of POEM has been expressed in the provisions dealing with 'controlled foreign corporations' as well as in India's reservations to the OECD Model Convention.

iv. Since the POEM test applies at any time of the year, a foreign company conducting a single board meeting in India may result in it being treated as an Indian tax resident. Internationally, such a 'snap-shot' approach to residence is not considered appropriate and would give rise to immense uncertainty.

v. It is difficult to reconcile the subjective POEM test with modern organizational management structures characterized by the absence of a traditional centre of management and the use of next generation technology (including video conferencing) allowing for virtual presence across the globe.

vi. There are also difficulties in applying the DTC's version of POEM in the case of various offshore hybrid entities such as limited liability companies, limited liability partnerships, Dutch cooperative associations, Luxembourg SARLs, etc. Many of these entities have complex management systems although they may not have ordinary or executive directors, and hence, application of the POEM test to these entities will give rise to uncertainty and unnecessary litigation.

vii. Conflicting interpretations of POEM in different contracting States may trigger double taxation scenarios. Domestic law definitions of POEM may complicate the application of the treaty tie breaker test. The POEM test should therefore not be incorporated or defined within domestic law since States would be forced to resort to an interpretation that may conflict with meaning of the term as understood in an international tax treaty context. On the other hand, the threshold for residence in the present Indian Income Tax Act leaves little room for ambiguity and minimizes the possibility of double taxation.

7. Business Connection, Permanent Establishment ("PE") and Branch Profit Tax ("BPT")

i. Profits earned by foreign companies from a business connection in India are proposed to be taxed at the rate of 30% (on par with Indian companies). However, foreign companies with a PE in India will be subject to an additional 15% BPT (raising the effective corporate tax rate to 40.5%). PEs are included within the definition of 'business connection'.

ii. It is recommended that there is a need to re-examine the policy reasons for taxing foreign companies at a rate higher than Indian companies in light of issues relating to equity, non-discrimination and efficiency. Branch profits should not be taxed to the extent they are not repatriated to the foreign enterprise. Further, in the interest of certainty, the DTC should adopt a common threshold for taxation of business profits (either business connection or PE) earned by non-residents. The definitions used should be clear and conform to constitutional and international law principles of nexus.

iii. Although 'business connection' is not defined under present law, the DTC provides an opportunity to provide more clarity on the scope of the expression. It should be clarified that 'business connection' refers to real, substantial and systematic or organized course of activity or conduct in India with a pre-determined purpose and not isolated transactions.

iv. The expansive definition of PE in the DTC deviates from international standards and also conflicts with the principle of territorial nexus under the Indian Constitution and recognized under international law. For instance, mere provision of services by a foreign company can give rise to a PE (and attract branch profits tax) even if the services are provided from outside India and no personnel have visited India to render such services.

v. By overriding tax treaties, BPT as proposed in the DTC would create a number of anomalous results which not only generate uncertainty but also create administrative and compliance hassles. For instance, a foreign company may be liable to BPT even if it does not have a PE under the treaty. Likewise a foreign company treated as a resident under the POEM test may still be liable to BPT. There are also ambiguities with respect to the principles of income attribution. Such results may trigger double taxation scenarios with foreign companies facing difficulties in obtaining appropriate tax credit.

8. Taxation of Offshore Technical, Managerial or Consultancy Services

i. Under the DTC (and the current law) fees for technical, managerial or consultancy services payable by an Indian resident to a non-resident will be taxable in India. Further, such fees when payable by a non-resident to another non-resident would be taxable in India if they are in respect of services provided for the purpose of a business in India (or for earning any India-source income). In both cases, the DTC provides that fees for technical services shall be taxable irrespective of whether the services are actually rendered from within India or whether the income has accrued in India.

ii. The taxation of offshore technical, managerial or consultancy services breaches the principle of territorial nexus laid down under the Indian Constitution as well as under international law. It is therefore recommended that the proposal be set aside. Fees paid as consideration for such services may be taxable only if the services are rendered from within India.

iii. Both the OECD and UN approaches endorse the position that a State does not have the right to tax services provided from outside its territory due to the lack of sufficient nexus justifying exercise of taxing rights.

iv. The proposal to tax offshore services will create immense hardships for professionals and service providers, and would also give rise to compliance and administrative challenges. For example, foreign lawyers, accountants and other consultants advising foreign companies in relation to Indian transactions or acquisitions resulting in India source income may be subject to withholding taxes on fees received for services provided outside India. A similar issue may be faced by foreign fund managers or merchant bankers providing management and consultancy services in respect of Indian investments or divestments made by offshore funds. Taxation of such offshore services is inconsistent with international practices and will create difficulties for non-residents in claiming tax credit in their respective countries.

9. Taxation of Offshore Share Transfers

i. The DTC proposes to tax income from transfer of shares of a foreign company by a non-resident, where at any time during 12 months preceding the transfer, the fair market value of the assets in India, owned directly or indirectly, by the company, represent at least 50% of the fair market value of all assets owned by the company.

ii. The proposal to tax share transfers in situations where the legal situs of shares are outside India breaches the constitutional and international law principles of territorial nexus. This proposal is unjustifiably extra-territorial and should therefore be set aside.

iii. Disregard for the corporate form may be possible only in limited situations involving abusive tax avoidance. A blanket statutory rule to pierce the corporate veil is not justified especially in situations where the offshore company has been set up for valid business reasons or for legitimate tax planning purposes.

iv. The proposal also has a number of ambiguities which will create uncertainty for foreign investors along with an increase in compliance and administrative costs. Concepts such as 'indirect ownership of assets' and 'interest in a foreign company' may be subject to conflicting interpretations in light of modern corporate organization structures. Taxpayers who are required to withhold tax on payments made in an offshore share transfer will face difficulties in obtaining details regarding the cost of acquisition of the shares and in determining the fair market value of the assets owned directly or indirectly by the company.

v. Unlike in the Chinese approach, no concessions have been provided for corporate reorganizations such mergers, demergers and intra-group share transfers.

vi. The International Chamber of Commerce has taken a very strong position against attempts by States to tax offshore share transfers on the basis that such extra-territorial law making would create a significant barrier to international trade, merger and acquisition activity and FDI flows.

10. Taxation of Satellite Broadcasting

i. The DTC expands the definition of royalty income to include consideration paid for the "use or right to use of transmission by satellite, cable, optic fiber or similar technology."

ii. The provision is ambiguously worded and is inconsistent with the industry understanding as well as the approach suggested by the OECD. It is therefore recommended that the proposed addition to the definition of royalty income be deleted.

iii. The definition undermines the commercial reality that the transmission through such satellite or optic fiber is a service and does not involve any provision of the right to use any equipment or process. The characterization of such payments as royalty would depend on the terms of use and degree of control over the industrial, scientific or commercial equipment. Indian Courts have consistently maintained this position based on the OECD's approach.

11. Taxation of Foreign Institutional Investors ("**FII**")

i. The DTC provides that all gains arising from the sale of Indian securities by an FII shall be deemed to be in the nature of capital gains income and taxed accordingly. The stated object of the proposal is to overcome 'avoidable litigation' on the characterization of income.

ii. It is recommended that this proposal be set aside since it conflicts with the principle of neutrality. The rules for characterization of FII income should be on par with that applicable to any other investor (domestic or foreign). Characterization would depend on a number of factors including volume, size and transaction frequency which have been recognized by Courts and the Indian tax department in the past.

iii. FIIs such as overseas pension and insurance companies buy and sell securities as part of their core business activity of meeting obligations towards their policy holders. In such cases, FIIs hold their investments as stock-in-trade and the income arising from sale of securities cannot be treated as capital gains income.

iv. The proposal ostensibly seeks to override established (and largely consistent) precedent on FII income characterization that have been decided in favour of the taxpayer. At the same time, in the case of other investors, the tax department has been actively engaged in challenging the tax exemption available on sale of shares on the stock market by treating the income as trading income. The inconsistency in the approach to income characterization clearly does not make for sound fiscal policy.

12. Controlled Foreign Corporations ("**CFC**")

i. The DTC proposes to introduce CFC provisions to tax Indian residents on income earned by certain foreign corporations controlled by such residents.

ii. While the introduction of a CFC regime is in line with internationally accepted practices, there is a need to re-evaluate the timing, relevance and scope of the CFC proposals in the DTC.

iii. The DTC discussion papers do not provide any analysis of the role and relevance of CFC regulations, the underlying economic rationale and the associated compliance issues and costs. There are a number of patent ambiguities in the text of the CFC provisions. The non-availability of foreign tax credit relief would create an unreasonable burden on Indian corporate groups and reduce their competitiveness.

iv. Considering the complex legal and macro-economic aspects involved in structuring a CFC regulation as well as the connected enforcement and compliance challenges, it is recommended that the introduction of a CFC regime is deferred until India undertakes a thorough analysis of all these aspects including the relevant international best practices. The analysis should specifically take into account the following: (i) The existing uncertainty in India's international tax policy; (ii) Current status of India as a developing country and a net-capital importer; (iii) Stringent exchange control restrictions currently applicable in relation to outbound investments and capital account convertibility; and (iv) Drop in outbound equity investments from India as noted in the 2011 UN World Investment Report.

v. A CFC regime should not be introduced if the projected addition to revenue will be substantially offset by increased compliance and enforcement costs. Alternatively, the proposal may be deferred to a time when Indian multinationals mature and outbound investments form a larger percentage of India's GDP.

vi. The proposed CFC provisions does not provide any clarity on the scope of expressions such as 'exercises control', 'decisive influence' 'collective' exercise of influence, and 'indirect' entitlement to shares.

vii. It is also difficult to understand the scope of the active business test. Under the CFC provisions, certain foreign listed entities may also be treated as a CFC. The proposed

CFC provisions do not recognize the internationally accepted approach of excluding passive income derived in the active conduct of a trade or business (Eg: income from certain kinds of stock and securities transactions, transactions in banking, financing or insurance business). The UK CFC regime provides a range of exemptions including an excluded list of countries, a motive test, exclusion of wide range of offshore trading activities and certain types of holding companies. Further in the Japanese and South African approaches, regional headquarter companies are excluded from the definition of CFC. These exemptions should offset the disincentive effect of CFC regulations on outbound investments.

viii. It is also necessary to re-examine the interaction between the CFC provisions and tax treaties signed by India especially since the Indian Constitution places an obligation on the State to respect treaty commitments. For instance, with respect to CFC income, the DTC should incorporate a comprehensive foreign tax credit mechanism which would also take into account any special relief (including tax sparing credits) available under an applicable tax treaty. It would also be useful to consider developments in the European Union ("**EU**") where there is a strong view that, due to the freedom of establishment available to EU members, CFC provisions should only apply in cases of artificial arrangements.

13. Introduce Tax Consolidation and Participation Exemption

i. Modern corporate groups have to continuously re-structure and evolve new strategies based on changing business scenarios, investment opportunities and market cycles. From a tax policy perspective, it is essential that the tax framework facilitates rather than impair or distort the business choices required to achieve these objectives. The DTC presents an opportunity for India to shift towards such a regime.

ii. As part of the overall scheme of tax reform, India should consider introducing a system of tax consolidation or group relief and a participation exemption for the benefit of Indian corporate groups and multinationals.

iii. Tax consolidation regimes are being implemented around the world as Governments develop new methods to improve tax collection, eliminate double taxation, reduce compliance costs, and increase transparency. It is also considered to encourage foreign investment and boost competitiveness of domestic firms.

iv. A consolidation regime would allow Indian groups to elect to be treated as a single entity for taxation purposes. Therefore, to avoid double taxation, internal transactions (such as dividend distributions and specific intra-group transactions) are to be largely ignored while computing income tax. Consolidation also envisages carry forward and sharing of intra-group losses. The Report briefly discusses features of the US tax consolidation and the UK group relief regimes.

v. The object of a participation exemption is to provide flexibility to groups of companies which seek to restructure their holdings to take advantage of emerging global business opportunities. It seeks to eliminate double taxation by providing certain relief or exemption in relation to intra-group dividend distributions or transfer of specific types of group holdings. A participation exemption will increase the efficiency and competitiveness of Indian multinational groups and will also help in balancing some of the disincentive effects of a CFC regime. The Report also briefly discusses features of the participation exemption currently available in the UK, Netherlands and also under the EU Parent Subsidiary Directive.

14. International Tax Arbitration

i. International tax arbitration is viewed as a supplement to mutual agreement procedure ("**MAP**") and aims at providing a more efficient bilateral solution to resolving cross-border tax disputes. Considering the numerous benefits offered by a reconciliatory dispute resolution framework such as arbitration, it is suggested that India should also initiate steps towards negotiating and incorporating an arbitration machinery within its tax treaties.

ii. Conventional dispute resolution processes imposes huge costs on both the taxpayer and the tax department. Insufficient opportunities for reconciliatory, consensual, and informal processes and flexible remedial action, as well as systemic disincentives in terms of costs and delays have made it difficult to resolve tax disputes in an efficient manner. While trying to resolve international tax disputes, the present confrontationist approach has placed additional barriers to the proper implementation of the provisions of the treaties.

iii. In most treaties, the MAP provision generally encourages, but does not impose any positive obligation on the Contracting States to resolve treaty disputes. The MAP framework also suffers from several limitations including delays and lack of taxpayer involvement.

iv. International tax arbitration seeks to streamline MAP proceedings and ensure a more positive and definitive outcome. It allows for significant overall savings in terms of cost and time. Arbitration would also ensure a fair degree of neutrality, reasonableness and due process. Further, there is a greater possibility that the decisions of the arbitral tribunal are based on established principles of international tax law rather than subjective political considerations.

v. With the growing complexity of cross-border economic activities, several countries have begun to acknowledge that arbitration would improve and streamline the existing machinery for resolution of international tax disputes. The Report also briefly discusses the EU and OECD approaches to international tax arbitration.

15. Next Practices : Introduce a Charter of Taxpayer Rights

I. Formal recognition and enforcement of taxpayer rights is a vital step towards increasing transparency and strengthening the trust of taxpayers in the fairness and equity of the tax system.

ii. The citizens' charter prepared by the income tax department is not comprehensive and does not make a single reference to taxpayer rights. The charter is loosely worded and only lists a set of timelines for certain statutory functions, specific expectations from taxpayers and an endeavour to further objectives such as voluntary compliance, better service delivery and nation building. It only aspires to attain certain broad policy goals and does not express any clear commitment towards the realization and protection of taxpayer rights.

iii. It is necessary to consolidate in a single official document and publicize the various rights available to taxpayers as well as the available means of enforcement of such rights. Taxpayers will, as a consequence, develop a greater degree of confidence in the system and this will greatly improve compliance. The Report also briefly discusses interesting measures taken by the US and the UK in protecting taxpayer rights.

iv. As a step towards the protection of taxpayer rights, India should formally introduce a Charter of Taxpayer Rights. The charter should find mention in the DTC's statement of objects and reasons. The DTC may place an obligation on the Government to frame a Charter of Taxpayer Rights and should make it accountable for the protection and effective realization of these rights. The Report also identifies specific taxpayer rights that are especially relevant in the Indian context. Although these rights may not per se be justiciable, they greatly enhance the level of accountability on the part of the Government.

16. Shifting to a Trust Based Taxation Regime

i. The recent developments surrounding the Lok Pal Bill highlight the seriousness of issues such corruption, accountability and transparency in India. The 2011 Trust Barometer concludes that India's informed public has most trust in business and least trust in Government. The findings also indicate that the degree of trust reposed on the Government is least in India when contrasted with other countries in the Asia-Pacific region. The declining levels of trust in India is a matter of grave concern.

ii. The success of a trust based approach in the liberalization of India's exchange control regime provides convincing arguments for adopting similar values in the context of tax reform. This would involve enhanced participation between taxpayers and the tax department, stability and certainty in tax policies, greater transparency, recognition and protection of taxpayer rights and a firm commitment by the Government towards good governance and taxpayer service.

iii. There are several elements in the Government's approach to the DTC that are not conducive to a trust based taxation regime.

  a. Ambiguous definitions and vague statutory language used in the GAAR provisions would make it impossible for taxpayers to legitimately plan their affairs. The absence of sufficient checks and safeguards is a stimulus for corruption and abuse of power. The primary burden of proof has also been imposed on the taxpayer. The application of GAAR is thus bound to give rise to unnecessary litigation and would create much uncertainty and hardship for taxpayers and investors.

  b. The lack of trust is also reflected in the proposed regime for imposition of penalties. The provisions ignore the relevance of taxpayers motives, intention and *bona fides*.

  c. Another matter of concern is the DTC's lack of trust in the role of the Indian judiciary. The DTC without any justification or discussion overrules a number of well-established and well reasoned judicial precedent. This approach fails to recognize the role of the higher Courts in India which have proactively reconciled the law with constitutional norms, thereby ushering the spirit of justice.

iv. Compliance is not a one-way street. Onerous compliance requirements and costs, ambiguous legal standards and litigation risks will create an atmosphere of suspicion, distrust and non-compliance. It is therefore necessary for India to move towards a trust based taxation regime.

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