

CHAPTER 4

SECTORAL ANALYSIS

Foreign Institutional Investors

Telecom Payments

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Recommendations



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Sectoral Analysis

Ambiguity in the classification of incomes in respect of Foreign Institutional Investors and Telecom Companies are leading to inconsistent assessments. Our earlier study on the shipping sector had also shown that inadequate co-ordination across various governmental bodies and weak controls within ITD plague the taxation in this sector and, which provide an unintended advantage to non-resident shipping industry over the domestic industry. Each sector deals with revenue streams that challenge the application of Income Tax Act. The ITD is yet to evolve an effective mechanism to provide clarity in these “green field areas” of taxation to mitigate the risk to revenue.

4.1 The taxation of payments to non-residents involves monitoring the tax liability of assesses operating in different sectors of the economy. We selected three sectors to seek an assurance that the ITD is alive to the new challenges in these sectors.

Foreign Institutional Investors

4.2 As on 31.12.2009, there are 1651 Foreign Institutional Investors (FIIs)⁴⁷ registered in India. FIIs can participate in the primary and secondary capital markets and acquire shares/debentures of Indian companies through the stock exchanges in India.

4.3 Classification of income earned by FIIs as capital gains or business income has been a contentious issue. The preferred option of the tax payer FII would depend on the tax residency of the FII and the applicable DTAA. FIIs operating through Mauritius, Singapore, UAE and Cyprus would prefer their incomes to be treated as capital gains as against business income. This is because these countries exempt capital gains from tax while the DTAAs with these countries provide that the capital gains will be taxed only in the country where the assessee is resident. On the other hand, a FII resident in other countries would prefer to have its income treated as business income since it will be liable for taxation only if it has a PE, i.e., a physical existence, in India. When operating without a PE, it can escape taxation.

4.4 The departmental instructions do not provide clarity on this issue. The ITD circular of 2007 had directed that while ordinarily trading in shares would yield capital gains and not business profits, the AO must use his judgment to segregate the stock holding of the FIIs into those for ‘investment’ and those as ‘stock-in-trade’. But

⁴⁷Source Securities & Exchange Board of India (SEBI)

a FII operates in India within the ambit of permission granted by SEBI, which is for investment activities and not for business. We are therefore of the opinion that income of FIIs must be treated as capital gains regardless of whether the FII categorizes its stock holding as investment or stock-in-trade. Simultaneously, the Department needs to safeguard the loss of revenue in respect of the FIIs operating from Mauritius, Singapore, UAE and Cyprus who are going out of the tax net on account of the DTAA provisions.

Charge: DIT (IT), Delhi, AY: 2005-06, Assessee: ITF Mauritius

The assessee made 27 remittances of ₹ 190 crore to Mauritius. Since the remittance was treated as capital gains, no tax was deducted at source. We found that the assessee was a sub-account⁴⁸ of a foreign institutional investor-Venus Capital Management Inc⁴⁹, a tax resident of USA. If the beneficial owner was from USA and capital gains is taxable in India under the Indo-US DTAA, the grounds for exempting the remittance from TDS by treating the company as a resident of Mauritius, is not clear.

4.5 We found that FIIs use this ambiguity to get advance rulings⁵⁰ for treating gains from capital markets as business income. ITD had argued for their treatment as capital gains in AAR but had not appealed against these rulings. The department went further and applied the AAR ruling to other assessments (although AAR was for a particular transaction), resulting in under-charge of tax of ₹ 87.8 crore in 5 cases⁵¹. ITD accepted our opinion and levied ₹ 40.3 lakh in one case⁵²; replies on the other cases were awaited.

4.6 In respect of those assessments of FIIs where the income was treated as capital gains, we found errors in 7 cases⁵³ in Mumbai charge that led to under-charge of tax of ₹ 23.6 crore. ITD accepted our opinion and rectified two assessments. One case is illustrated:

Charge: DIT (IT), Mumbai, Maharashtra; AY: 2006-07

Assessee: Platinum Asset Management LTD. (A/C Platinum Asia Fund)

The loss of ₹ 93.3 crore arising from speculative activity to the assessee was incorrectly set-off against taxable short term capital gains resulting in short levy of tax of ₹ 10.6 crore including interest.

⁴⁸ Sub-account includes those foreign corporates, foreign individuals, and institutions, funds or portfolios established or incorporated outside India on whose behalf investments are proposed to be made in India by a FII.

⁴⁹ Registration No 2006514. The Company is registered with the Securities & Exchange Commission in the United States as a Registered Investment Advisory Company in 2000.

⁵⁰ In order to provide the facility of ascertaining the Income-tax liability of a non-resident, to plan their Income-tax affairs well in advance and to avoid long drawn and expensive litigation, a scheme of Advance Rulings has been introduced under the Income-tax Act, 1961. The Authority for Advance Rulings (AAR) consists of a Chairman who is a retired Judge of the Supreme Court and two members of the rank of Additional Secretary to the Government of India, one each from the Indian Revenue Service and the Indian Legal Service.

⁵¹ Name of Assessee and nature of assessment: Prudential Assurance Co Ltd(Scrutiny), Indivest Pvt Ltd,18 sub accounts of Fidelity Group(Annexure)Summary, BNL Global Emerging Markets(Summary), Prudential Pension Ltd(Summary)

⁵² Prudential Pension Ltd

⁵³ Platinum Asset Management Ltd A/c Platinum Asia Fund; A/c Platinum International Brands Fund; A/c The Platinum Master Portfolio; Carlson Fund Equity; Tennessee Consolidated Retirement System; Bank of America Singapore Ltd; Citicorp Investment Bank (Singapore) Ltd.

Telecom Payments

4.7 Increased trans-country travel has introduced complex revenue sharing arrangements between

Table 6: Forex payments towards telecom usage

| | ₹ in crore | | | | |
|--|------------|---------|---------|---------|---------|
| Year | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| | 3547 | 3298 | 1285 | 3589 | 3459 |
| <i>Source: RBI Monthly Bulletin March 2009</i> | | | | | |

telecom companies. A phone call between subscribers to two different networks usually means that both networks require a payment for carrying the call. The charges include:

- *Roaming charges:* Charge paid by the local telecom company for extending the connectivity service to its customer in the foreign country
- *Termination charges:* Since the originator of the call pays the full cost, the network from which the call originates pays the termination charge to the network on which the call terminates
- *Connectivity charges:* Charges payable by the local telecom company to the foreign service provider for usage of the network elements for origin, transit and termination of calls
- *Bandwidth charges:* The charge for signal transmission through satellite transponders for uplinking and downlinking⁵⁴ of signal and data.

4.8 The disputes have arisen on whether these payments to foreign telecom companies are liable to TDS in India. This has led to conflicting approaches within ITD. The Department has not issued clarificatory orders to remove ambiguities or approached the higher courts to overrule prejudicial AAR rulings.

4.9 In the recent past, the Income-tax Appellate Tribunals (ITAT) have provided greater clarity on the taxability of telecom payments. ITAT, Hyderabad held (October 2008) that connectivity charge was paid for use of equipment and not a 'rendition of service'; hence, it falls within the ambit of royalty. A special Bench of ITAT constituted to resolve two⁵⁵ conflicting decisions of the Delhi ITAT also held (October 2009) that bandwidth charges also fall within the ambit of 'royalties'. It is interesting to note that the Department before the AAR (in the case of Dell International Services Pvt Ltd⁵⁶ and in the case of Cable & Wireless India Private Limited⁵⁷) had also contended that services provided by telecom companies were in the nature of technical services liable for taxation in India as fees for technical services. Nevertheless, conflicting approaches continue within ITD.

⁵⁴ Uplinking is the portion of the communication link used for transmission of signals from an earth terminal to a satellite. A downlink is the inverse of an uplink

⁵⁵ Asia Satellite Telecommunications Co. Ltd. v DCIT(2003)85 ITD 478(Delhi ITAT) and DCIT v Pan Am Sat International Systems Inc.(2006) 9 SOT 100(Delhi ITAT)

⁵⁶ Authority for Advance Ruling vide a ruling dated 18th July 2008 AIT-2008-236-AAR has held that amount of fixed monthly recurring charges payable under Agreement, for the circuit between America and Ireland and for the circuit between Ireland and India is not liable to be treated as fee for included services or royalty under DTAA between India and USA.

⁵⁷ AAR No 786 of 2008. The AAR has held that in carrying telecom signals, Cable & Wireless Networks India Private Ltd UK had not provided any managerial, technical or consultancy service, nor is it providing the services of its technical or other personnel to the applicant and hence the same is not taxable as fees for technical services. The arrangement between Cable & Wireless Networks India Private Ltd and Cable & Wireless Networks India Private Ltd, UK was for rendition of services and telecom services were standard services.

Charge: CIT I Chennai, Tamilnadu, AY: 2004-05 to 2006-07

Assessee: Aircel Cellular Ltd

The assessee was exempted by ITD from TDS on remittances towards roaming charges. The tax along with interest amounting to ₹ 4.7 crore was not deducted at source. The AO justified the exemption on the ground that payments made were for services rendered abroad and would not fall under the ambit of 'royalty' or 'fees for technical services'.

Similarly, TDS of ₹ 12.8 crore was not deducted (by **Dishnet DSL Limited** for three AYs 2003-06) though the certificate issued to the assessee clearly stated that bandwidth charges were classifiable under 'fees for technical services' and hence, tax was deductible

4.10 Our checks on C&Us threw up 5 other cases where remittances aggregating to ₹ 172.5 crore were made without deducting TDS of ₹ 19.8 crore.

Shipping sector

4.11 A non-resident shipping company is taxed on a presumptive basis (whereby 7.5 per cent of the charges received by the company will be taxed). The master of the ship is required to submit tax returns before setting sail from the Indian port. Alternatively, he could undertake to submit tax returns within 30 days and collect a no-objection certificate (NOC) from ITD before the journey. ₹ 20879 crore and ₹ 30103 crore were remitted to non-residents engaged in shipping during 2007-08 and 2008-09 respectively.

4.12 Our earlier study on taxation of the shipping sector⁵⁸ had raised concerns on tax evasion in the absence of effective co-ordination between various government authorities. We referred our findings to the Departments of Revenue and Shipping in the Government of India; an assurance that the risks have been addressed is yet to be received. Our main findings were:

- *The ITD's records on the number of ships leaving Indian ports were substantially lower than that in the records of the Port Trusts. There was wide variation between ITD's data and of the Customs authorities on the tonnage carried in these ships. Such reconciliation was also important to segregate domestic cargo (cargo that will be offloaded within India) from those that embark in foreign seas. DTAA relief can be claimed only for international cargo;*
- *We found instances where ships were cleared for voyage without having applied for NOC or filed tax returns; and where NOCs were issued without proper documentation or proof of payment of TDS;*
- *Relief under DTAA's should be based on the provisions of the specific DTAA and after clearly establishing the nationality of the freight beneficiary. The labyrinthine trails of ownership and of transactions make this process difficult. Foreign ships obtain NOCs by invoking nationality of the flag or the shipper or the charterer or the sub-*

⁵⁸ Review on exemptions, deductions and allowances to shipping and related sectors : Performance Audit Report No.25 of 2009

charterer or the owner of the ship- whichever is most beneficial. We found several instances of incorrect relief leading to tax evasion;

- *It is logical that a taxpayer can claim relief under DTAA if he is liable for taxation in the country of residence⁵⁹. We found that there was no consistency in the taxation of shipping profits arising to residents of countries where there is no tax on shipping income.*

4.13 In 3 cases⁶⁰ in Kolkata, Mumbai and Chennai charge, there was an undercharge of ₹ 14.5 crore owing to incorrect treatment of shipping income. One case is illustrated below:

Charge: DIT (IT), Mumbai, Maharashtra: AY 2006-07

Assessee Delmas France

The assessee carried out operation through a PE in India and therefore its income from shipping activities was brought to tax in AY 2001-02. However, the same was not done in AY 2006-07 resulting in escapement of income of ₹ 4.1 crore and short levy of tax of ₹ 2.3 crore. Department accepted the observation and initiated remedial action (February 2009).

Recommendation

- *We recommend that sectoral studies may be conducted by ITD to identify the avenues of revenue leakage as well as flag ambiguities in emerging areas;*

The CBDT stated that sectoral studies are an ongoing process and suggestions in the report have been noted.

⁵⁹ AAR ruling in the case of Cyril Eugene Periera also held that “a taxpayer cannot claim relief from a non-existent burden of double taxation (which would be the case, if he is not liable to pay tax in the country). DTAA is meant only for the benefit of taxpayers who are liable to pay tax twice on the same income”.

⁶⁰ Delmas France(Mumbai DIT (IT) charge), Diamond Shipping Company Limited(CIT Kolkata charge) and Bengal Tiger Line India (Pvt) Ltd. (BTL India) (CIT-I, Chennai)