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Indian Court delivers important ruling on the interplay between international and domestic tax law

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On April 12, 2016, India's High Court at Madras delivered a landmark ruling in favor of an anti-avoidance provision (section 94A) introduced in the Indian Income Act, in 2011, to enable the Government to notify for tax purposes foreign tax jurisdictions that do not share tax and other financial information with the tax authority. From an Indian point of view, the ruling is a timely inquiry (in the wake of Panama leaks) into constitutional provisions that deal with the power of the executive to enter into tax treaties and the interplay between treaty obligations (sharing of tax information in this case) and domestic tax law.

Section 94A and the notification

Section 94A is titled "Special measures in respect of transactions with persons located in notified jurisdictional area" and provides that the Government may, having regard to the lack of effective exchange of information with any foreign country, notify such country as a "notified jurisdictional area" in relation to transactions entered into by Indian taxpayers. According to the section, transactions carried out with persons located in a "notified jurisdictional area" are deemed to be related-party transactions for the purposes of Indian transfer pricing rules.

In November 2013, the Finance Ministry issued Notification No.86/2013, which classified Cyprus as a "notified jurisdictional area" under section 94A. In an accompanying press release, the Finance Ministry said that the move was necessary as Cyprus "has not been providing the information requested by the Indian tax authorities under the exchange of information provisions of the double tax avoidance agreement." Interestingly, Cyprus is the only tax jurisdiction to be notified under section 94A ever since it was enacted (although some have argued that the provision should have been used to classify Panama and other such jurisdictions).

The writ petition

In October 2014, three Indian resident individuals – T Rajkumar, K Dhanakumar, and T K Dhanashekar (collectively "petitioners") – entered into a tripartite securities transfer agreement, under which a Cypriot company agreed and undertook to sell its shares in an Indian company to the petitioners. Soon after the execution of the Agreement, the tax authority sent out notices to the petitioners asking them to show cause as to why they should not be booked under the rules that require tax deduction and payment at source. The petitioners filed statutory appeals on the merits of the case but alongside moved a writ petition in the Madras High Court challenging the

constitutionality of section 94A as well as the legal validity of the notification (in an attempt to make their case stronger on merits).

Main arguments

The petitioners strenuously argued that section 94A conferred sweeping powers on the government to notify any country as a "notified jurisdictional area" regardless of whether India has entered into a tax treaty with the country in question or not. They argued that the government has an obligation under Article 51(c) of the Constitution – part of the Directive Principles of State Policy – to foster respect for treaty obligations. They also argued that the India/Cyprus tax treaty is virtually a law (under Article 253 of the Constitution) and neither the Parliament can make any law that would go contrary to the treaty provisions, nor can the government take any executive action to annul the effect of the treaty.

Alongside, the petitioners assailed the validity of the notification arguing that the exchange of information clause in Article 28 of the tax treaty itself restricts supply of information or documents that are not obtainable under the laws or in the normal course of administration of either treaty country. In any event, the petitioners argued, the treaty provides for a mutual agreement procedure for resolution of treaty disputes under Article 27 and the government was wrong in taking recourse to section 94A.

The Department of course relied on several articles from the Constitution to substantiate its legislative power to enact section 94A and issue the notification (and take the follow-up measures).

The court's verdict on section 94A

In a well-reasoned judgment, the court dismissed all the contentions raised by the petitioners. To begin with, the court referred to a slew of past cases to conclude that since India follows the dualistic doctrine with respect to international law, it follows that an international treaty can be enforced only so long as it is not in conflict with the domestic legal framework (placing a particular reliance on *Jolly George Varghese*).

The court pointed out that section 90 of the IT Act, which empowers the government to enter into tax treaties, nowhere states that laws made by Parliament would stand eclipsed to the extent they are inconsistent with the treaty provisions. The court rightly pointed out that section 90 simply states that the provisions of the IT Act would apply to given situations to the extent they are more beneficial to the taxpayer.

Interestingly, the petitioners relied heavily on the Supreme Court's landmark ruling given in *Azadi Bachao Andolan* to make a case for supremacy of treaty provisions over domestic law (for the uninitiated, the court in that case ruled in favor of circulars issued by the government clarifying that India does not have the right to tax capital gains under the India/Mauritius tax treaty. It will not be out of place to note that India and Mauritius on May 10 announced key revisions to the tax treaty to prevent inappropriate treaty benefits, including a new limitation of benefits clause). As expected, the court rejected the petitioners' reliance on *Azadi Bachao Andolan* saying that the case did not really deal with the question as to whether or not the Parliament has the power to make a law in respect of a matter covered by a treaty.

The court also rejected the petitioners' claim that the government was bound under the *pacta sunt servanda* doctrine, ruling that international treaties are binding upon both parties and must be

performed in good faith. To quote the Judge, “if one of the parties to the treaty fails to provide necessary information, then such a party is in breach of the obligation under Article 26 of the Vienna Convention. The beneficiary of such a breach of obligation by one of the contracting parties cannot invoke the Vienna Convention to prevent the other contracting party from taking recourse to internal law, to address the issue.” (India has not ratified the Vienna Convention but courts here have repeatedly held the Convention includes principles of customary international law which could always be invoked).

The court’s verdict on the Notification

The court after perusing paragraph 3(b) of Article 28 of the treaty concluded that the lack of exchange of information by Cyprus, which led to the Notification, does not fall under the category of information, which is not obtainable under the laws or in the normal course of administration. In arriving at its findings, the court put particular emphasis on the fact that there existed a reasonable apprehension in the minds of the tax authority that the funds flowing into India from Cyprus represented unaccounted money of Indian nationals.

The court stressed that the government made numerous requests for specific information but nothing much was forthcoming from Cyprus, despite Cyprus agreeing to an exchange of information clause under Article 28 of the treaty (it is important to note that India notified Cyprus on the basis of an exchange of information clause included in the tax treaty and not pursuant to a tax information exchange agreement).

On the contention that a specific MAP provision in the treaty obviated the need for section 94A, the court vaguely concluded that a MAP framework deals only with difficulties or doubts arising as to the interpretation or application of the tax treaty and not with the failure of a treaty country to honor its commitment under the treaty (admittedly, the court could have gone into a much greater analysis here). The court proceeded rather bluntly to say that even otherwise, a MAP provision in the treaty cannot oust the Parliament’s jurisdiction to enact a law or the executive’s power to issue a notification.

Conclusion

While the court’s findings on the link between international and domestic tax framework are important in their own right, the ruling has far reaching consequences for investors as it validates treatment of transactions carried out with Cypriot residents as related-party transactions, inviting India’s transfer pricing rules. The validation of section 94A also means a higher withholding tax rate (on remittances that is) and application of additional limitations (add to that compliance burden including the burden to explain revenue flows) to deductions in respect of payments made to Cypriot financial institutions or in respect of expenditure or allowance arising from transactions carried out with Cypriot residents.

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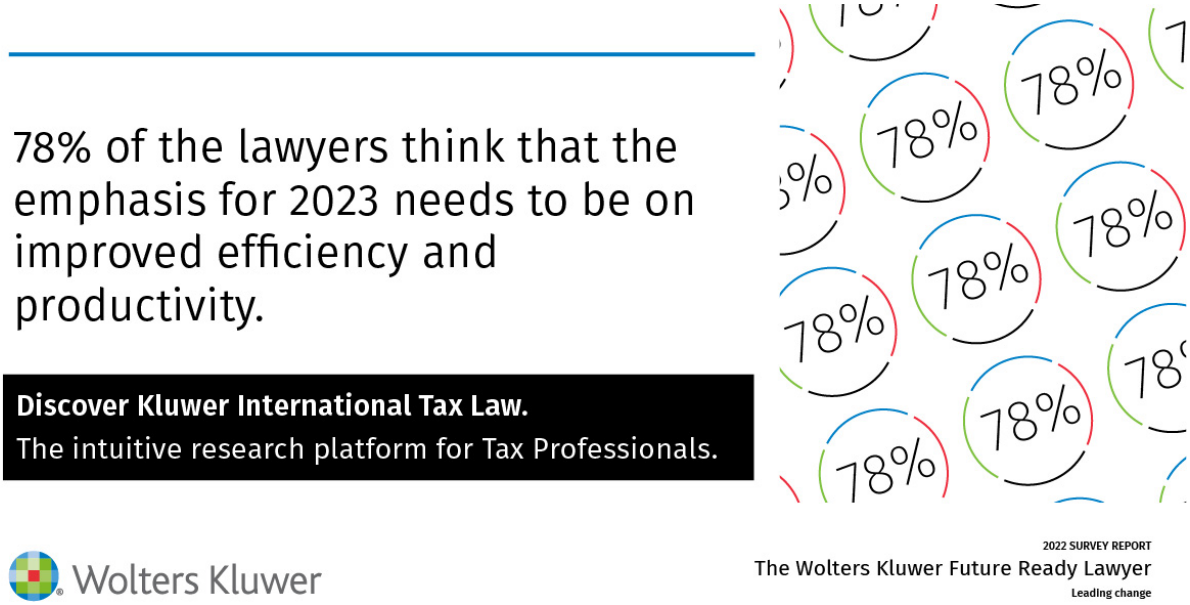

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