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India: Taxing Time for Foreign Investors

By Kunal Kumar Kundu

Ignorance, they say, is bliss. But not for a country when the government ignores the ground realities while devising plans and policies. The recent union budget of India is a veritable test case of the above. Earlier I have talked about how the budget over-estimated the revenue numbers and under estimated the expenditure numbers by ignoring the various risks (both endogenous and exogenous) lurking around. I would now talk about couple of ill-timed (read ill-advised) policy announcements that can further exacerbate he problems.

Lack of policy stability has been a big bane for India. The recent multiple episodes of corruption (cutting across party lines), political one-upmanship leading to policy logjams, clear evidence of the government losing control by the day etc highlights the fact that the investment climate in the country has worsened. Since 2007, both savings and investment has been on a decline. Despite relatively good GDP growth numbers, foreign investors have not shown the appetite of rushing to India. The resource starved government's stubbornly dedicated effort to make Vodafone pay taxes to the tune of USD2.3 billion as capital gains tax on a transaction in 2007 that involved the purchase of a controlling 67% stake in Indian telecom company Hutch Essar from a company controlled by Hong Kong's Hutchison Whampoa is a case in point. This became the talking point for the international investors, till India's Supreme Court over-ruled the government's contention and ruled in favour of Vodafone. As if this was not bad enough, the Supreme Court played its part to further vitiate the investment climate by cancelling all the 2G licenses awarded earlier, in the process of trying to punish the guilty who were involved in the scam of awarding the 2G licenses. This gave the signal that investment in India can be risky as policies can change over time and can materially affect the existing investment. And, then came the budget.

Here I am referring to two specific announcements – one relatively harmless (though could have waited and definitely better defined) and the other simply insane.

First, the softer one. Introduction of GAAR or General Anti-avoidance Rules in the budget. Not that this came out of the blue. There has been some discussion around this even during the previous budget and this was supposed to be part of the DTC or the Direct Tax Code that is to be introduced in the future. The essence of this code is that if a transaction is designed with the sole purpose of avoiding tax, then that transaction would be taxed by superseding other existing laws. Surely this is not something new. There are many other countries that have GAAR provisions. In India's case, this seems to have been triggered because majority of capital flows into India (be it in the form of direct investment or portfolio investment) is routed through Mauritius with whom India has a DTAA (Double Tax Avoidance Agreement) Treaty. Indian tax laws allow for tax benefit to an entity if it can provide proof of residence (of Mauritius) for tax purpose. History of India's FDI flows show that majority of India's direct investment has come through the Mauritius route. Similar is the case with FII (Foreign Institutional Investor) flows. The problem with the definition so far is that, it is defined in a way that leaves enough room for faulty interpretations. The GAAR provision can be triggered if the tax authorities can prove that the tax paid in India is lower than what could have been the case in general situation. To make the matter even worse, the onus of proof lies on the tax assessees and not on the income tax department, which is generally the case elsewhere. This has the potential to complicate the working environment. More importantly, when GAAR is triggered, it will over-ride any other existing law. This means that, even if a transaction is clean under the Indo-Mauritius DTAA, the DTAA provisions will be over-ruled if GAAR is triggered. There is, therefore, a clear difference between the provisions GAAR and that of the DTAA and this is not healthy. Forex inflows have already started reacting to this new provision. When India desperately needs

NEW YORK - 95 Morton Street, 6th Floor, New York, NY 10014 | TEL: 212 645 0010 | FAX: 212 645 0023 | americas@roubini.com | asia@roubini.com
LONDON – 120 Holborn, 5th Floor, London EC1N 2TD | TEL: +44 (0) 207 092 8850 | FAX: +44 (0) 207 242 4783 | europe@roubini.com
NEW DELHI - Suite 210 Chintels House, A-11 Kailash Colony, New Delhi, 110048 | TEL: +91-11-49022000 Ext. 3001 | india@roubini.com

forex inflows, such moves are ill-advised. While the dust will eventually settle (GAAR, as a concept is not wrong), it will bring in lot many uncertainty into the existing investment climate in the short to medium term.

However, what is really dangerous is the budget provision to amend tax laws retrospectively (going back to as much as 50 years). The aim is clearly (though the government denies, as it quite often does to justify missteps) to over-ride the Supreme Court's judgement on the Vodafone case and force it to cough up tax that has so far failed to stand up to the scrutiny of the existing Indian legal system. This has the potential to open up a Pandora's box and lot many litigations will be under way as the desperate government seeks to garner revenues in whatever which way, cornered as they are by high levels of dual deficit. This clearly is a law which is very bad is spirit as it not only opens up several past transactions to scrutiny, it also reinforces the message that policies in India are unstable. One can understand prospective amendments of tax laws (as these can still be built into one's business plan while taking investment decisions) but doing so retrospectively is nothing short of being draconian. That the foreign investment community is worried can be gauged from the fact that several global business giants (hailing from countries which are among the biggest investors in India) have made an appeal to the Indian Prime Minister to have a rethink on the retrospective clause. Even the British Prime Minister has voiced his concern in no uncertain terms. This clearly is a retrograde step that further vitiates India's investment climate.

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