Anti-Tax Avoidance Measures in China and India: An Evaluation of Specific Court Decisions

Anti-tax avoidance and evasion measures are matters of great concern for both tax authorities and taxpayers. These concerns are particularly relevant in China and India, given the rapid growth of investment and the lack of experience in dealing with such issues, and as both countries have recently incorporated changes into their legislations that are analysed here.

1. Introduction

In undertaking an analysis of the anti-tax-abuse measures applied in China and in India, one starting point is to differentiate the concepts of "tax evasion", "tax avoidance" and "tax planning". These concepts cover a wide range of measures that are intended to minimize tax burdens, though the legal consequences of each are not necessarily the same. This debate is not new. In fact, an issue that frequently arises in specialized forums is the classic distinction between tax evasion and tax avoidance.

The first is often identified as a direct violation of the tax liability, characterized by a particular intensity of wilful misconduct, while the latter has been identified as conduct that does not go against the letter of the law, but, rather, seeks tax relief in atypical legal structures.

It is also necessary to consider what is commonly referred to as "tax aversion", by which is meant that taxpayers do not think of taxes as a necessary expense accruing in their interest, but, rather, as a cost that may be avoided by seeking the most advantageous tax structures to achieve this purpose.

Tax evasion can also be defined as the use of illegal means to avoid paying taxes, for example, the direct violation of a tax provision by not declaring income earned. Accordingly, the key point is the use of illegitimate means with the intent to evade the payment of tax.

The OECD report "International Tax Avoidance and Evasion: Four Related Studies" of 1987 (the "OECD Report") distinguishes tax evasion from other, less serious offences. The OECD Report lists the following explicit examples of tax evasion:

- failure to notify the tax authorities of the carrying out of an activity that is subject to taxation;
- presenting false declarations, for example, with regard to non-existent losses;
- the use of fake invoices;
- opaque structures;
- leaving a country owing tax; and
- the use of proxies in other territories with the intention of simulating income not attributable to the taxpayer.

For the tax authorities, the difficulty is not in defining tax evasion or tax fraud, but, rather, in distinguishing tax avoidance and tax planning. The literature often uses such terms as "acceptable tax avoidance" or "tax mitigation" to refer to tax planning and "unacceptable tax avoidance" or "aggressive tax avoidance" to refer to abusive tax practices.

In accordance with the principle of freedom of contract, taxpayers may arrange their affairs as they consider most advantageous to "attract the minimum tax liability". Accordingly, taxpayers are free to choose the most tax-efficient methods for themselves, as long as they provide sufficient evidence of not falling under suspicion of avoidance of tax.

As noted previously in this section, the key point is to distinguish between the concepts of "tax planning" and "tax avoidance". "Tax planning" can be defined as arranging cross-border transactions with the knowledge of international tax principles to realize a tax-efficient and lawful routing of business activities and income, and capital flows.

On the other hand, tax avoidance is where a tax structure falls within the letter of the law, but runs counter to its spirit. This may consequently be considered to be illegal, as such a structure's sole objective is to reduce or eliminate the tax burden. This is, therefore, an indirect violation of the law, i.e. a distortion of the interpretation of the law in the taxpayer's interest.
Tax avoidance transactions are implemented prior to the tax liability arising and arise from an attempt to minimize a tax burden that would otherwise be higher. In the case of tax evasion, and in contrast to tax avoidance, the taxpayer undertakes a transaction with the objective of avoiding the payment of tax where the liability is already evident.

The eradication of tax evasion and tax avoidance is a priority for both the OECD and the European Union. According to the OECD, tax planning is the only way to reduce taxes that is acceptable to governments, while tax avoidance is of concern to governments, as such practices are contrary to fiscal equity, have serious (adverse) effects on budgets and distort international competition and capital flows.

Although the OECD Report does not define the term “tax avoidance”, it provides the following three elements as being inherent in tax avoidance:

1. a complex structure that lacks economic purpose;
2. a lack of transparency; and
3. taking advantage of loopholes in the law or applying legal provisions for purposes for which they were not intended.

Most tax systems have inconsistencies. The most common methods to counter tax shelters are: (1) anti-tax abuse provisions, for example, a general anti-avoidance rule (GAAR); (2) tax treaties; and (3) anti-abuse doctrines as applied by the courts.

A GAAR is a deterrent to the use of increasingly sophisticated forms of tax avoidance by taxpayers. GAARs, as adopted by most states, seek to counter, inter alia, the following:

- the use of opaque intermediary companies with no business activities to minimize tax; this practice is countered by fiscal transparency provisions rules or controlled foreign company (CFC) rules;
- the financing of an operation using excessive debt for purely tax purposes: this practice is countered by thin capitalization rules and results in excess interest being reclassified as dividends; and
- sale or purchase services provided by related parties at a price higher or lower than they would have been agreed by independent parties by following the arm’s length principle: this practice is countered by transfer pricing rules.

In order to mitigate possible tax advantages, tax treaties usually include a number of provisions that are intended to prevent the abuse of a tax treaty or “treaty shopping”. “Treaty shopping” is the practice of structuring a multinational enterprise (MNE) to take advantage of more favourable tax treaties available in certain jurisdictions. Specifically, a business that resides in a home state that does not have a tax treaty with the source state from which it receives income can establish an operation in a second source state that does have a favourable tax treaty to minimize its tax liability in the home state. Most tax treaties contain anti-treaty shopping laws to circumvent this practice.

The anti-abuse doctrines applied by the courts are of vital importance, but are controversial. It has been argued that the courts do not try to fill in all the lacunae in tax law, but, rather, try to address the problem of avoidance directly by identifying unacceptable behaviour and limiting the resulting tax benefits. In other words, the courts deal with the consequences of the lack of clear rules, instead of regulating clearly against such practices.

The anti-abuse doctrines applied by courts differ depending on whether the law of the country concerned is based on common law or civil law. Although this article does not analyse these doctrines, countries, such as China or India, are clearly influenced by such doctrines. Consequently, these doctrines are briefly considered below:

- The basic premise of the “economic substance doctrine” is that a court may deny tax benefits resulting from a business transaction if the transaction itself lacks any economic benefit other than a tax saving.

- Under the “substance-over-form doctrine”, the facts must be assessed according to commercial substance and not the formal content. In other words, the substance of the transaction, rather than its form, determines the tax consequences. The basic premise of the substance-over-form doctrine is that the tax results of a particular transaction should be assessed based on the “substance” of what took place.

- The “step-transaction doctrine” regards a series of connected transactions as a single transaction. Under the step-transaction doctrine, even if bona fide, transactions may be disregarded and several related transactions can be treated as a single composite transaction. The doctrine is intended to prevent two transactions having the same financial result, but being taxed differently solely due to their legal form.

- The “business purpose doctrine” distinguishes between transactions with a valid or business purpose and those artificially designed to avoid tax. In other words, the courts require that transactions are driven by business purposes rather than tax considerations.

- The “sham transaction doctrine” is applied when a taxpayer claims tax benefits based on having taken

8. OECD Model Tax Convention on Income and on Capital: Commentary on Article 1 para. 9.5 (22 July 2010), Models IBFD states that “...[a] guiding principle is that the benefit of a double taxation convention should not be available where the main purpose for entering into certain transaction or arrangements is to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions”.
10. Civil law countries usually apply either the Abuse of Right (Abuse de Droit) doctrine, where the right of taxpayers to arrange their affairs to pay the minimum taxes affects third parties and there is a lack of a bona fide business purpose; or the Abuse of Law (Fraus Legisu) doctrine, where the result is contrary to the intention of the law or there is an artificial transaction with a clear intention to avoid taxation.
certain steps, but, as a matter of fact, the taxpayer has not completed the steps. The test analyses the factual proof, for example, a change in the ownership of a company’s shares when the company is controlled, as a matter of fact, by the same shareholder.

Success in countering tax avoidance not only depends on stating clear rules, but also on the courts in arriving at coordinated decisions and the ability of the tax authorities in dealing with tax avoidance to differentiate this from tax planning.

2. Anti-Tax Avoidance Measures in China and India

2.1. Introductory remarks

Tax evasion and tax avoidance have a significant effect on the economies of all countries. However, developing economies can be regarded as particularly vulnerable to such practices due to deficiencies in their institutional frameworks and the lack of sufficient experience or even enough resources to monitor the underlying complexities.

This article focuses on China and India. In this respect, with regard to these countries, despite being considered to be developing economies, there are significant issues regarding tax avoidance and tax evasion, which are the subject of the analysis in this article.

2.2. China and investment

Investment in China is based on it having the fastest growing economy in the world in recent decades, occupying, despite the recent slowdown, a strategic political and economic position due to its size and potential. In this regard, the incentives for innovative businesses in development areas (Special Economic Zones, SEZs) as established by the Chinese government have been key in attracting foreign investment.\(^{12}\)

China’s tax incentives are predominantly industry-oriented and limited geographically. In this respect, the tax system includes tax holidays for, inter alia:

- specific infrastructure projects;
- qualified new and/or high tech enterprises in certain regions;
- software production enterprises;
- manufacturing business operating for more than ten years;
- financial institutions in an SEZ operating for more than ten years;
- investment in the western regions of China; and
- undertaking an activity listed as permitted by the Guidelines on the Foreign Investment Regulations (2007).\(^{13}\)

The most common barriers to investment in China are the peculiar complexity of the Chinese market, both in terms of access and development, the enforcement of anti-dumping regulations, suspicion of foreign investment in certain areas, and the complex bureaucracy.

2.3. India and investment

Investment in India is based on the recent rapid growth in its economy, the open policy on exchange controls with regard to other developing economies, (to date) relatively moderate inflation and the excellent natural resources available for foreign investment, such as energy and gas.

Indian investment incentives are designed to channel investment to specific industries, promote economically underdeveloped regions and encourage exports. India offers a number of benefits, including tax and non-tax incentives in establishing new industrial undertakings, and incentives for specific industries, such as ports, highways, electronics and software. Investment in software Technology Parks (the Software Technology Park Scheme) and SEZs also benefits from tax holidays and exemptions. Indian tax incentives include tax holidays, depending on the industry or region, and accelerated depreciation in certain areas, such as energy saving, environmental protection and pollution control equipment.

The most common obstacles to investment in India are localized corruption, the large and complex bureaucracy, the extreme slowness and inefficiency of the judicial system, and poor investment in infrastructure.

2.4. China, India and tax abuse

For decades, China and India have displayed a number of features that have encouraged tax abuse. These can be summarized as follows:\(^{14}\)

- There is a lack of clear and transparent regulation in both China and India. In relation to this, 2008 represented a turning point for China. In that year, the state, tired of losing revenue, undertook a major reform of its domestic legislation, incorporating a GAAR and, more importantly, raising awareness and encouraging its local tax authorities to counter tax evasion and tax avoidance. Currently, China has clear regulations on transfer pricing and, despite not having a lengthy practical experience in tax auditing, it has already questioned certain cross-border operations and made the required adjustments. China has also adopted thin capitalization and CFC rules. In India, domestic regulation on anti-tax abuse can be regarded as weaker. The limited experience of the Indian tax authorities in dealing with abusive practices has allowed MNEs operating there to transfer profits by manipulating transfer prices to avoid the adverse effect of exchange control regulations and potential uncertainty with regard to the economy.


\(^{13}\) The Catalogue for the Guidance of Foreign Investment Industries (as amended in 2007), was approved by the State Council and has been in force since 1 December 2007.

In addition, India has neither thin capitalization nor CFC rules. However, the current change of direction taking place in India cannot be ignored, as a GAAR will be incorporated into the Direct Tax Code (DTC) (2010). This will establish a clear mechanism to counter tax avoidance and will emphasize the application of the substance-over-form doctrine. It is also important to note that India, in an approach towards OECD standards, signed the “Convention on Mutual Administrative Assistance in Tax Matters” (the “Convention”) on 26 January 2012. The Convention promotes international cooperation, while, at the same time, respecting the rights of taxpayers. It also provides for administrative cooperation between the parties in the assessment and collection of taxes with a view to countering tax avoidance and evasion.

In developing economies, in contrast to certain other countries, there is no culture of “voluntary contribution to public funds”, and evasion and avoidance are, therefore, not necessarily perceived as negative. It should, however, be noted that this has attitude has been changing over the past decade.

The previous inefficiencies of the Chinese and Indian tax authorities were primarily due to a lack of resources and inexperienced staff who had to deal with complex tax structures (although this issue is more related to the past that the present, as is noted in sections 3. and 4.). The lack of the effective exchange of information in respect of both countries also cannot be ignored, as this negatively affected the position of both tax authorities.

It is a widely held view that developing countries, particularly China and India, have for years implemented advantageous regimes, such as tax holidays, to attract foreign investment, which apply to certain businesses and other incentives for investing in specific areas. Such incentives clearly have potential for abuse.

Hitherto, it was accepted that companies in multinational groups undertook profit transferring activities in an extremely informal manner. Identifying all the entities involved in a group can be a complex business, sometimes with ownership links to affiliate entities in tax havens or low-tax jurisdictions.

As both China and India have become aware of such practices, and with the clear intention to counter tax avoidance and especially to avoid losing yet more revenue, both countries have amended their tax legislations so as to adapt their existing systems to those forms found in developed economies. More significantly, both countries have restructured their tax administrations, as they have become aware that excessive laxity is not a benefit, but, rather, attracts investors who do not intend to contribute to the development of the economy and, indeed, aim at the opposite.


3.1. Legislative and administrative background

The application of the GAAR and its development in China has been demonstrated in a number of cases that have been reviewed by the Chinese tax authorities. It is, however, Jiangdu (2010) (see section 3.4.) that highlighted China’s efforts to bring capital gains arising from the transfer of shares of Chinese companies within the tax net, even in the case of indirect transfers.

Despite national legislation clearly stating that capital gains arising from the transfer of shares of companies resident in China were subject to a withholding tax of 10%, for many years, it was common practice for foreign investors to avoid such taxation by incorporating holding companies in low-tax jurisdictions. This gave rise to significant tax benefits, such as the non-imposition of the withholding tax on capital gains arising from the transfer of the shares of the holding company, based on tax treaties concluded by China, for example, the Barbados-China (2000) and China-Singapore (1986) Income Tax Treaties.

The first Memorandum issued by the Chinese government to prevent abusive practices was Guo Shui Han Fu [1997] (“Circular 207”). Although Circular 207 clearly imposed the obligation to examine the true economic purpose of the purchase and/or sale of shares when Chinese entities were involved, directly or indirectly, this was rarely investigated by the tax authorities.

The Enterprise Income Tax Law (EITL) (2008) introduced a GAAR with effect from 2008. Article 47 of the EITL (2008) states that, if an enterprise engages in a business arrangement without bona fide purposes that results in reducing taxable revenue or taxable income, the tax authorities have the right to make adjustments based on reasonable methods. The tax authorities may initiate a GAAR audit if there is:

- an arrangement with an abusive application of a tax treaty;

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15. Bill 110 of 2010. On 13 July 2012, it was announced that the Prime Minister had approved the formation of an Expert Committee to consult with stakeholders and finalize the GAAR guidelines.
17. Details of Jiangdu (2010) were issued by the Jiangdu Tax Bureau on 8 June 2010.
an abuse of a claim for tax incentives in respect of investment in certain sectors;
investment in an SEZ;
abuse of the legal form chosen to undertake an operation;
the use of offshore structures, for example, tax havens; and
where an agreement lacks a bona fide commercial purpose.

The adoption of a GAAR, therefore, emphasized the desire on the part of China to eradicate abusive practices by penalizing any incorporation of holding entities in jurisdictions with a corporate income tax rate lower than that which applied in China, where the entity had no business purpose or sufficient substance, and was controlled, directly or indirectly, by Chinese entities.

As is demonstrated by the following cases, the tax authorities may identify potential cases for investigation based on the information submitted by taxpayers or by using their own channels, for example, as in Jiangdu.

On 27 October 2009, but with retroactive effect from 1 January 2008, the State Administration of Taxation (SAT) issued Guo Shui Han Circular [2009] No. 698 (“Circular 698”), which contained the guidelines regarding the relevant GAAR and established methods of tracking transactions conducted outside China, but which were, directly or indirectly, linked to China. Circular 698 specifically contained measures to strengthen tax collection and the administration of non-resident companies.

Accordingly, with regard to the transmission of the share of Chinese entities, directly or indirectly, the transferor must provide the local tax authorities, i.e. those where the company is located, with all the relevant documents and information within 30 days of the transaction. Stricter tax withholding requirements in respect of offshore companies were also implemented.

The main points indicated in the Circular 698 was the need to provide sufficient documentation concerning personnel working in an intermediary company, the way in which the company was financed, its total assets and its current and ongoing operations. Numerous tax returns and settlement requirements also became mandatory as well as registration in respect of service contracts undertaken by offshore companies. In addition, it had to be clearly stated that all meetings and decisions were to be conducted in China so as to avoid potential direct control from other territories.

Circular 698 provided a definition of “beneficial owner” for entitlement to treaty benefits. The beneficial owner would also be expected to undertake a valid economic activity. In addition, Circular 698 established an open definition of a substantial business activity, implying that this condition would be based on a case-by-case review to determine whether or not there was a lack of business purpose for each transaction.

What was surprising is the silence on possible consequences of infringement. The SAT has, however, indicated that, although compliance with the Circular may appear to be voluntary, the acceptable interpretation is that the burden of proof lies in the hands of the foreign investors. Accordingly, foreign investors must be in the possession of “all documents likely to be required” and must report to the tax authorities, if necessary without being asked.

Circular 698 has affected numerous international transactions since its adoption. Among those, this article considers two cases, one located in Chongqing (see section 3.2.) and the other in Xinjiang (see section 3.3.). (Both cases are referred to by the names of the two Chinese provinces where the transactions occurred.) In these two cases, the local tax authorities challenged conventional tax planning carried out in relation to the transfer of indirect assets located in China and imposed a withholding tax on the capital gains generated.

3.2. Chongqing

In Chongqing (2008), the local tax authorities ignored the existence of a special purpose vehicle (SPV) located in Singapore and taxed a capital gain derived from the SPV’s parent company on its sale. A precedent was thereby established regarding the application of the substance-overform doctrine in China.

The structure reviewed by the tax authorities was as follows. A company based in Singapore, which wholly controlled an SPV that was also based in Singapore, participated 31.6% in a joint venture (JV) in China. The SPV shares were sold to a Chinese company for RMB 63.3 million (approximately, USD 10 million). The Chongqing tax authorities, aware of the operation, requested the documentation regarding the transaction (see Diagram 1).

It was argued, in defence of the tax structure, that, as the shares were transferred to an entity located in Singapore by its parent company located in the same territory, the Chongqing tax authorities did not have any power to tax the capital gains, despite the fact that the purchaser was a Chinese entity and indirectly transferred the shares of a JV located in China.

The SAT, however, understood that the SPV lacked economic substance, as it only had a representative amount of capital and no business activity. Accordingly, the SPV had been incorporated with the sole purpose of holding a participation in the JV, thereby obtaining a tax advantage under the China-Singapore Income Tax Treaty (1986), which meant that Singapore could not tax such gains.

21. If a CFC is located in low-tax jurisdictions with an effective corporate income tax rate of less than 12.5% (50% of Chinese corporate income tax rate), it may be taxed in China on the basis of a deemed distribution. China has a white list of countries that are exempt from this provision, consisting of Australia, Canada, France, Germany, India, Japan, New Zealand, Norway, South Africa, the United Kingdom and the United States.

22. Art. 45 of the EITL establishes certain percentages to define a “controlled entity.” Where there is insufficient participation, a controlled entity exists if it can be demonstrated that there is substantial control of an offshore entity by a Chinese entity.

In other words, the tax authorities considered that the transaction was conducted from an entity located in Singapore with regard to a Chinese entity in respect of a JV located in China. Consequently, as a result of disregard ing the SPV, the Singapore parent had to pay income tax in China at a rate of 10% on the capital gain arising from the sale, just as if it had made the transfer directly itself.

Following Chongqing, in Yangzhou (2010)\(^{24}\) the tax authorities disregarded an SPV located in Hong Kong, which was a paper company incorporated by the US seller and a Chinese company, but, in this case, the purchaser was also a US company.

### 3.3. Xinjiang

The Xinjiang tax authorities also refused the exemption from capital gains in relation to the Barbados-China Income Tax Treaty (2000). Article 13 of that tax treaty grants exclusive taxing rights in respect of capital gains to the state in which the seller was resident, in this case, Barbados.

Xinjiang (2008)\(^{25}\) is considerably more complex than Chongqing. In this respect, Xinjiang concerned the purchase and subsequent sale of shares in a JV located in the Chinese province of Xinjiang.

The details of the case were as follows. A US group established an SPV in Barbados in May 2006, in respect of which the three managers were US residents. In July 2006, this entity paid USD 33.8 million (approximately, RMB 211 million) for 33.32% of the share capital of a JV, located in Xinjiang, to a leading oil and gas extraction company owned by Xinjiang companies. Within a month, the Xinjiang company injected the equivalent of USD 33.8 million (approximately, RMB 211 million) into the JV, so that the company increased its registered capital by this amount. In June 2007, the SPV sold back the shares in the JV to the original shareholder for USD 45.9 million (approximately, RMB 286 million), thereby deriving a capital gain of USD 12.1 million (approximately, RMB 75 million) (see Diagram 2).

In 2008, after conducting the relevant tax audit with regard to the transaction, the Xinjiang tax authorities concluded that the transaction was fictitious and had been undertaken with the sole purpose of avoiding tax. The Barbados company was not resident in China for tax purposes, as there was insufficient evidence for tax residence presented during the audit. Accordingly, the tax authorities disregarded article 13 of the Barbados-China Income Tax Treaty (2000) and considered that, instead, article 4, under which an entity is considered to be resident in the state where the entity is managed, applied and that, therefore, the SPV was not eligible to benefit from the tax treaty.

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24. Yangzhou (2010) was reported in China Taxation News (6 June 2010).
3.4. Jiangdu

Chongqing and Xinjiang gave rise to considerable debate, primarily because the two cases were the first in which the tax authorities applied the GAAR contained in Circular 698. The SAT, after noting a fall in the revenue collection, which was a consequence, inter alia, of the common practice of incorporating conduit companies in low-tax jurisdictions with the intention of reducing or avoiding taxes in China, sent instructions to all provincial tax authorities to the effect that all transactions regarding the sale of the shares of entities located in China should be audited if the transactions lacked a business purpose or were carried out by entities located in territories that exempted capital gains derived from such transactions. As a result, the local tax authorities have since been strongly motivated to investigate and to (re)characterize the nature of transactions that they consider to be abusive. The local tax authorities may, therefore, deny taxpayers the right to apply tax benefits in tax treaties concluded by China if the transactions lack economic substance and, in particular, if a conduit company is located in a low-tax jurisdiction or a tax haven. Given this background, it is easy to understand the resolution in Jiangdu.

In early 2009, during the course of undertaking normal tax administration procedures at an important telecommunications JV in Jiangdu, the local tax authorities realized that the ultimate seller could dispose of its equity interest in the JV. This was reported to the SAT.

In this case, both the seller (a well-known US fund) and the purchaser were established in the United States and the shares transferred were those of an entity located in Hong Kong (since 2007 owned by the seller), which, therefore, indirectly held 49% of the Chinese JV. (The JV was also owned by a local entity with a 51% stake.) Accordingly, the causal nexus for taxing the capital gains realized in China in this case was a priori difficult to apply.

Nevertheless, the local tax authorities in Jiangdu understood that Circular 698 applied in these circumstances. In this regard, it should be noted that Circular 698 imposes an obligation on non-residents in China to notify the tax authorities of all indirect transfer of shares in respect of Chinese entities when these are effected through an SPV located in a low-tax jurisdiction or a tax haven. In January 2010, a transfer of shares was undertaken between the two US entities, ignoring the obligations contained in Circular 698 (see Diagram 3).

The local tax authorities notified the JV that the shareholders had not fulfilled the obligation to provide information regarding the transaction conducted as stated in Circular 698. Subsequently, after considering the transaction, the JV was informed that there was sufficient evidence to assume that the potential capital gains accrued from the transaction should be subject to tax in China, as, inter alia, the holding company established in Hong Kong was a mere vehicle incorporated for the sole purpose of making the potential capital gains exempt from tax. Specifically, the SPV did not have substance in respect of employees, operating assets or liabilities and lacked any business purpose.

The tax authorities had already used the substance-over-form doctrine in the other cases analysed in sections 3.2. and 3.3. The notable point in Jiangdu was that the transferee and transferor were non-residents and the shares transferred were those of a company resident in Hong Kong.

However, in this case, the local tax authorities considered that the SPV in Hong Kong was a mere vehicle incorporated for the sole purpose of avoiding the payment of tax in China. Accordingly, under the anti-abuse rules, the opinion of the tax authorities was that capital gains should be subject to tax.

The tax authorities investigated the transaction by reviewing the equity transfer agreements and other documents. However, what is surprising, is that the tax authorities also obtained information from the purchaser’s website, where that company had published numerous details of its China investment operation, but had omitted to state that the shares transmitted were those of the SPV in Hong Kong and not the shares of the Chinese JV as a result of concern regarding the possible consequences in China and the United States.

The argument advanced by the seller was that, despite the fact that its entity indirectly participated in a JV in China, the purpose of the transaction was not the transfer of the shares of the JV, but, rather, the shares of the SPV. This did...
not appear to be sustainable, as the purchaser had stated on its website that the shares of the Chinese JV had been acquired directly.

Following a number of meetings with the local and central tax authorities, the seller, aware of the time-consuming nature of the Chinese judicial system, the facts and the minimal chance of success before the courts, agreed to a “tax ruling” and paid USD 25 million (approximately RMB 173 million) in May 2010. In so doing, the seller thereby avoided paying default interest.

In conclusion, it should be noted that China has, for many years, been the recipient of very significant investment and it has quickly become aware that a large number of foreign entities resident in China have declared excessive tax losses or sought tax incentives, resulting in a loss of revenue for China. If the amounts not subject to taxation in China due to the incorporation of intermediate structures located in territories with which China had signed a tax treaty are aggregated, the substantial loss of revenue to China is evident.

**Jiangdu** clearly shows that tax authorities are unwilling to forego further revenue. In this respect, it should be noted that never before has such a large tax payment resulting from the application of the GAAR been made in China. This has provided a further incentive for the local tax authorities to continue tax audits to deal with tax evasion and tax avoidance.

It must not, however, be overlooked that the local tax authorities had been proactive in this respect, as it were these tax authorities who, in the course of a normal tax audit suspected possible tax evasion and questioned the transaction in question, basing their investigation on the information on the purchaser’s website. Accordingly, entities with investments in China made via structures in low-tax jurisdictions should review their holdings to ascertain if the conditions relating to valid economic reasons and substance are fulfilled. This has been clearly indicated with regard to cases of the possible indirect transfer of shares where a Chinese entity is involved. It should also be noted that most of the tax treaties concluded by China include a GAAR to counter transactions that lack business purpose and that have the sole intention of taking advantage of treaty benefits.

### 4. India: Vodafone and the Taxation of Capital Gains on Indirect Transactions Involving Shares

#### 4.1. Introductory remarks

The Indian tax system has not in the past had a specific GAAR. Accordingly, over the years, the courts have established a form of doctrine to determine whether a transaction can be considered to be tax avoidance or tax evasion. Consequently, in this section, the anti-tax abuse measures arising in India as a result of **Vodafone** (2012) are considered. In dealing with tax avoidance and evasion, India cannot be compared to China, as India, being aware of the loss of revenue, has reformed the DTC (2010) to incorporate a clear GAAR, which, at the time of the writing of this article, is intended to be introduced on 1 April 2013.

#### 4.2. Vodafone

**Vodafone** has been subject of much analysis due to the importance of the verdict and its effect on foreign investment in India. The argument between the Indian tax authorities and Vodafone Group (UK) was long and tedious, with the case being suspended not only for Vodafone, but also for other international groupings in identical circumstances, i.e. Kraft-Cadbury or GE-Genpac, until the final decision was given by the Supreme Court on 20 January 2012.

The crux of the debate lay in the right to subject to tax in India capital gains arising from the transfer of a non-Indian company by a non-resident purchaser and seller. The entity transferred and the seller were both established in the Cayman Islands, and the purchaser was resident in the Netherlands.

The facts can be summarized as follows. Hutchison Telecommunications International Limited (HTIL), located in Cayman Islands wholly participated in a holding company (CGP), which was also located in this territory, and held underlying subsidiaries located in Mauritius, along with an Indian company that ultimately held 67% of the shares in Hutchison Essar Ltd. (HEL).

In February 2007, the CGP shares were transferred from HTIL to Vodafone International Holdings BV (“Vodafone”, a Netherlands subsidiary) for USD 11.1 billion. As a result, HEL became Vodafone Essar Ltd (VEL).

By purchasing the shares, Vodafone acquired certain rights and entitlements, such as, inter alia, licences to operate in the telecommunications sector in India, a control premium, the use of any rights of the Hutchison group, non-competitive agreements signed with HTIL, loan obligations and licences to open branches. A (very) simplified version of the corporate structure, involving entities interposed between the shareholders located in Hong Kong and the Indian JV (HEL), is set out in Diagram 4.

In September 2007, the tax authorities issued a notification to both Vodafone International Holding BV and VEL in respect of the failure to withhold taxes at source on payment made to Hutchison and, therefore, of a possible breach of Indian tax law. In the Income Tax Act (ITA) (1961), there is an obligation on the part of the seller...
to withhold and pay to the Revenue a percentage of the contract price on the sale of a 'capital asset' in respect of Indian entities. The consequence was that the tax authorities sought USD 2.1 billion in unpaid tax.

The tax authorities argued that, although the transfer took place between non-resident entities in respect of the shares of an entity established in the Cayman Islands, the purpose of the transaction was to transfer the control of an Indian JV and its underlying rights in the transferred shares. Vodafone had, therefore, failed to fulfil the withholding tax obligation (under domestic legislation) with regard to capital gains realized by HTIL in India.

In challenging the tax authorities, Vodafone appealed to the Bombay High Court, arguing that the withholding obligation could not apply to a non-resident who had no presence (permanent establishment) in India and in respect of assets located offshore, despite indirectly affecting a JV located in India. Vodafone argued that subjecting second-level transactions to taxation would give rise to unjustifiable legal uncertainty.

On 3 December 2008, the Bombay High Court dismissed the Vodafone appeal and stated that the tax authorities had reason to scrutinize the transaction as there was sufficient evidence for an infraction of Indian Law. The High Court stated obiter dictum that there was income deemed to have arisen in India as there was a nexus with India on which the tax jurisdiction is founded.

Diagram 4

Vodafone Group (United Kingdom) to Vodafone International Holding BV (the Netherlands)

USD 11.1 billion

Intermediate B.V.I

CGP (the Cayman Islands)

Intermediate Mauritius company

HEL/VEL (India)

HTIL (the Cayman Islands)

Shareholder (Hong Kong)

Dissatisfied with the decision of the Bombay High Court, Vodafone filed a special leave petition before the Supreme Court. On 23 January 2009, the Supreme Court dismissed the petition and remanded the case to the tax authorities and asked the tax authorities to determine whether or not there existed a right to issue a notice for subjecting a second level transaction to taxation in India.

After a detailed study of the transactions effected between HTIL and Vodafone Group, the tax authorities, on 31 May 2010, reaffirmed that there was a clear breach of Indian tax law, as the obligation to withhold tax had been ignored. This resulted in a writ of August 2010 filed by Vodafone before the High Court of Bombay. On 8 September 2010, the High Court gave its decision, which prompted Vodafone to file (yet) another petition to the Supreme Court.

The High Court, in a lengthy decision, reiterated that article 2(14) of the ITA (1961) defined "capital asset" as "property of any kind held by an assessee, whether or not connected with his business or profession". Accordingly, a transfer of shares (shares are capital assets) that results in capital gains is subject to taxation in India. As the share and the rights attached to the ownership of these are inseparable, the clear intention of the opaque structure in Vodafone was to acquire all of the rights pertaining to the assets tax free.

32. The special leave petition, also known as an “SLP” is provided for in art. 136 of the Indian Constitution.
34. See Mukundan & Ajinkya, supra n. 28, at p. 1926.
36. Vodafone (2010), at para. 70. … A controlling interest is an incident of the ownership of the shares in a Company, something which flows out of the
With regard to a “business connection”, India follows the worldwide income principle as stated in article 5(1) of the ITA (1961). Under article 5(2) of the ITA (1961), non-residents are only subject to tax by reference to the income that is received or deemed to have been received in India. In this respect, article 9(1) of the ITA states that “income is deemed to accrue or arise in India (directly or indirectly) through or from any business connection, property, asset, source of income, or transfer of capital assets situated in India.”

Based on articles 5 and 9 of the ITA (1961), the High Court held that a “business connection” was clearly demonstrated and Vodafone, aware of this, had created a complex structure with the premeditated intent of controlling the Indian JV free of any payment of capital gains tax due to the SPV in Mauritius and, in applying the India-Mauritius Income Tax Treaty (1982), the capital gains were subject to tax in Mauritius, although the domestic legislation of this territory considers such gains to be exempt. Vodafone argued that the structure was a lawful practice used frequently in cross-border acquisitions with a clear and valid economic purpose.

As noted previously in this section, the unfavourable 2010 decision of the High Court of Bombay resulted in the issuing of a writ by Vodafone to the Supreme Court. On 20 January 2012, The Supreme Court resolved the issue in favour of Vodafone.

From a consideration of the Supreme Court’s ruling, the following two factors are an especially relevant “test” in analysing a transaction:

1. the duration of the structure prior to the transaction being effected; and
2. the continuity of the JV’s activity with regard to the same business conducted after the transfer of shares has been completed.

The Supreme Court understood that it was particularly relevant to fulfill the “time test” in determining the veracity of a structure. Accordingly, in the Court’s view, artificial structures were those created or acquired at the time of the transaction, restructuring or investment.

It is interesting that the Supreme Court recognized the right of any entity or group to arrange its business, and, therefore, to choose the most advantageous tax structure, provided that this does not involve abusive practices, in accepting as evidence that the structure had been operational for many years without being questioned by the tax authorities. With regard to the “business connection”, the Supreme Court overturned the reasoning advanced by the Bombay High Court.

Although the transfer of the assets attached certain rights in a “sensitive” sector for the tax authorities (authorization is required from the Indian Foreign Investment Promotion Board), Indian legislation accepts the doctrine of the separation of a company and its shareholders. Shareholders do not have a free disposal of the rights adhering to assets. Accordingly, it appears to be unfounded that the new shareholders in the Indian JV were interested primarily in acquiring licences and other rights to operate in the Indian telecommunications market by way of a complex structure with the purpose of acquiring control of the JV and avoiding tax in India.

The Supreme Court considered that the application of article 9 of the ITA (1961) could not be used as a “look-through” provision. In this respect, it should be noted that the Indian tax system does not contain any CFC rules, so the ruling of the Supreme Court appears to be accurate in not broadly interpreting the law, otherwise it would create “hardly justifiable legal uncertainty in India.”

The key point is the provisions of the India-Mauritius (1982) and India-Singapore (1994) Income Tax Treaties. In the application of the India-Mauritius Income Tax Treaty (1982), the tax authorities had attempted only to tax the direct transfer of the shares of Indian companies. Consequently, over the years, many investors in India have relied on this provision to avoid taxation.

The India-Mauritius Income Tax Treaty was signed on 24 August 1982 (entry into force, 6 December 1983). Article 13(4) of this tax treaty states that the capital gains derived by an entity are taxable only in its residence state. Accordingly, a Mauritius-based company deriving gains from the transfer of the shares of an Indian company is not liable to tax in India. The gains are only taxable in Mauritius, which exempts such gains. The result is an opportunity for tax arbitrage, as any gains on such transactions are tax free both in India and Mauritius. Many investors have relied on this provision and there are several decisions regarding this.

The same provision, article 13(4), can be found in the India-Singapore Income Tax Treaty signed on 8 August 1994 (entry into force, 27 March 1994), but with a limitation on benefits (LOB) clause, as annual expenditure of over USD 200,000 is required in each of the two years preceding the year in which the gains were realized.

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37. Vodafone (2010), at para. 161: “... Shares in themselves may be an asset but in some cases like the present one, shares may be merely a mode or a vehicle to transfer some other asset(s). In the instant case, the subject matter of transfer as contracted between the parties is not actually the shares of a Cayman Island Company, but the assets (as stated supra) situated in India. The choice of [Vodafone] in selecting a particular mode of transfer of these rights enumerated above will not alter or determine the nature or character of the asset.”


The use of the LOB clause has already been included in most of the tax treaties concluded by India. In the case of the India-Singapore Income Tax Treaty (1994), which had been exhibiting negative effects for many years, an LBO clause was included in the Protocol (2011).

It should also be noted that, due to the numerous cases pending before the tax appellate tribunals and the slowness of the Indian judicial system, the Authority for Advance Rulings (AAR) has emerged as an important body in contributing as a fast and effective forum for foreign investors in India. Despite this, the DTC (2010) should result in significant structural changes to direct taxation to replace the ITA (1961), with, at the time of the writing of this article, effect from 1 April 2013. The DTC (2010) clearly states that, in respect of gains made from the transfer of shares between two non-resident companies with regard to an offshore SPV with a "controlling interest" in an Indian company, shares transferred indirectly will be taxable, subject to certain conditions.

It should also be noted that the DTC (2010) contains a GAAR, which will empower the tax authorities to deem an arrangement to be impermissible if a transfer is made with the objective of purely obtaining a tax benefit. Specifically, article 123(1) of the DTC (2010) states that:

Any arrangement entered into by a person may be declared as an impermissible avoidance arrangement and the consequences, under this Code, of the arrangement may be determined by:

(a) disregarding, combining or recharacterising any step in, or a part or whole of, the impermissible avoidance arrangement;
(b) treating the impermissible avoidance arrangement:
   (i) as if it had not been entered into or carried out; or
   (ii) in such other manner as in the circumstances of the case, the Commissioner deems appropriate for the prevention or diminution of the relevant tax benefit;
(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;
(d) deeming persons who are connected persons in relation to each other to be one and the same person;
(e) reallocating, amongst the parties to the arrangement—
   (i) any accrual, or receipt, of a capital or revenue nature; or
   (ii) any expenditure, deduction, relief or rebate;
(f) recharacterising:
   (i) any equity into debt or vice versa;
   (ii) any accrual, or receipt, of a capital or revenue nature; or
   (iii) any expenditure, deduction, relief or rebate ...

Accordingly, the DTC (2010) will undoubtedly affect any GAAR clause in the tax treaties concluded by India, especially, as indicated previously, the India-Mauritius (1982) and India-Singapore (1994) Income Tax Treaties. In this regard, it should also be noted that article 1 of the OECD Model (2010) states that the general anti-abuse provision in domestic law in the nature of "substance over form" or "economic substance" should not conflict with a tax treaty.

It may, therefore, be concluded that the inclusion of a GAAR in Indian legislation would welcome by the international community, as this will provide encouragement for investors who intend to make use of legitimate tax planning strategies and deter those who would wish to implement unacceptable transactions with the sole purpose of seeking a tax advantage.

5. Conclusions

In examining anti-abuse measures in China and India, it is necessary to consider the differences between the concepts of "tax evasion", "tax avoidance" and "tax planning." These terms encompass a wide range of behaviours that are intended to minimize the tax burden, but their legal consequences are not the same.

Tax evasion and tax avoidance have a significant effect on the economies of all countries. Developing economies are, however, particularly vulnerable to such practices as a result of deficiencies in their institutional frameworks, the lack of relevant experience and/or sufficient resources to monitor the complexities of these practices.

Focusing on China and India, the two countries are not directly comparable: for many years, both have had very advantageous regimes that have attracted foreign investment to their jurisdictions, such as tax holidays for certain businesses and incentives to invest in SEZs. Having become aware of this, both China (in 2008) and India (in 2012) have amended their tax legislation with the clear intention of countering tax avoidance, especially because both countries are unwilling to forgo potential sources of tax revenues.

The application and development of anti-abuse measures in China has been considered in Chongqing and Xinjiang, but it is Jiangdu that clearly highlights the efforts of China to subject capital gains arising from an indirect transfer of shares of Chinese companies to taxation (see sections 3.2. and 3.4., respectively).

Despite trying to counter tax avoidance and tax evasion, India cannot be compared to China. The Indian tax system does not (yet) have a specific GAAR in force and, therefore, the courts have, over the years, established a form of doctrine to determine whether a transaction may be considered tax avoidance or evasion. The Indian government is, however, in the process of reforming its tax legislation and will, inter alia, introduce a GAAR.

In this regard, Vodafone and its significance for cross-border merger and acquisition deals that involved the indirect transfer of shares in an Indian JV have been considered (see section 4.2.). The objective of all of a transaction that has been implemented by way of a very sophisticated structure that was intended to transfer control over an Indian capital asset without paying tax was, therefore, brought into question. In this respect, it should be noted that the proposed version of the GAAR will empower the tax authorities to deem an arrangement to be abusive if its sole objective is to...
obtain a tax benefit in a tax treaty if the arm’s length principle is ignored or the transaction lacks bona fide business purpose or substance.

Tax avoidance and tax evasion involving profits being transferred from developing countries by the use of low-tax jurisdictions or tax havens has a direct effect in the loss of tax revenue. Both China and India are aware that excessive laxity has not benefitted them and, in some cases, this has attracted a type of investor who does not intend to contribute to the development of the economy, but, rather, the opposite.

Undoubtedly, the implementation of a GAAR in both countries will be complicated and never perfect. Such measures may constitute a real risk of undermining the ability of businesses and taxpayers to carry out lawful tax planning where they are applied broadly. On the other hand, the introduction of very moderate measures could encourage taxpayer recourse to arbitrage in search for loopholes to avoid tax.

Notwithstanding this, clear legislation to counter tax avoidance should be welcomed by the international community. It should, therefore, encourage investors who intend to undertake legitimate tax planning and deter those who wish to make use of unacceptable transactions with the sole purpose of seeking possible loopholes.