



## Tax Controversies and Litigation in India

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### ABSTRACT

*The past few years have seen an unprecedented increase in tax litigation in India involving high-profile names and huge numbers. This coupled with pending backlog of cases has resulted in long delays in administration of justice. Such a scenario points to the inadequacy of the legal apparatus existing in the country which calls for major overhaul of the entire justice delivery system. This paper looks at the various types of tax litigation and its impact on tax payers and investors. It also suggests measures that can be undertaken to reduce the extent of controversies and litigation and speed up the process of resolution.*

**Keywords:** *Tax litigation, Tax administration, Taxpayers.*

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### 1.0 Introduction

Over the past few years, the high-profile names and huge numbers involved in tax litigation in India have drawn much attention and discussion, not only in India but also in the global arena. So, what is going on at the various tax litigation forums? Unprecedented increase in litigation coupled with pending backlog of cases has resulted in long delays in administration of justice. This is a clear evidence of the inadequacy of the legal apparatus existing in the country which calls for major overhaul of the entire justice delivery system.

Based on a discussion paper released in March 2013 by the Federation of Indian Chambers of Commerce and Industry (FICCI), there were approximately 2.6 lakh disputes involving Rs. 4.37 lakh crore as of December 2011. Of these, about 2.23 lakh disputes (Rs 3.74 lakh crore) are pending before CIT(A) and ITAT. About 30,000 disputes are before the High Courts, and 6,000 await Supreme Court's verdict - together involving Rs. 62,000 crore.

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The tax environment in India is often viewed as complex with multiplicity of taxes, burgeoning litigation and lack of certainty. As an example, India ranks third in the world in terms of pending transfer pricing litigations, according to a survey conducted by Ernst and Young. However, the more important question is that how real or relevant are some of these disputes? The present paper attempts to analyse the types of tax litigations and their impact on investors and taxpayers.

## **2.0 Types of Tax Litigation**

The types of tax litigation in India can be broadly classified into different categories. They are discussed as under:

### **2.1 Litigation arising from revenue controverting settled issues**

First, the tax disputes raised by the assessing officers revolve around issues on which the legislature is very clear and principles of interpretation are also well settled by the various courts. Still the assessing officer raises the same issues without any significant merits, probably to merely meet their tax collection targets. Examples are disallowance of bad debts written off, initiation of penalty proceedings with respect to each and every adjustment to income, income from sale of shrink-wrapped software, cherry picking of comparable companies in transfer pricing assessments etc. Such tax disputes are initiated by the Assessing Officer in practically all cases. We have also witnessed in the recent past that when tax officers keep harping on a point repeatedly against a particular position taken by the taxpayers, then in certain cases the position of the tax officials finds its way to the legislation through amendments. This boosts the confidence of the tax officers and they get more stimulated to make adjustments. The obvious outcome of this approach is repetitive and queued up litigation which absorbs years of efforts at all levels and the case is decided in favour of the taxpayers at either the first or second appellate level, without much ado.

### **2.2 Litigation from inadequate guidance in law**

Secondly, inadequate guidance and accountability coupled with a fear of revenue audit objections, at the lower levels in tax administration lead to increased number of tax disputes. There is lack of clarity or guidance on the interpretation of the tax provisions to meet various situations and issues and thus make them susceptible to multiple interpretations, such as determination of permanent establishment, transfer pricing approach towards attribution of profit, HQ cost allocation, financial leasing, derivatives etc. To further compound the situation, often judicial forums have expressed different

opinions with regard to the interpretation and scope of some provisions of the Income Tax Act.

### **3.0 Tax Officers as Policy Makers**

In such an environment, the tax officials i.e. executive or administrative machinery of the Constitution starts stepping into the shoes of the law makers i.e. the legislature, and instead of restricting their duties as administrators of law and monitor its compliance as stated in the book, the tax officials start taking policy decisions on how tax law should be read or interpreted and at times, go beyond the written law to impose tax. Strict adherence to the words of law, uniformity and consistency should be seen as the corner stones of any legal framework. Deviation from these principles can throw the system out of gear and trigger controversies. As witnessed in the past, every individual tax official has used his own logic of interpretation. No doubt that many of our own tax officials are bright and smart and have demonstrated out of the box thinking in taxing a particular transaction, but at the same time inexperience at their level has contributed more to this ever increasing volumes of litigation ushering in instability which further begets more instability. Thus more than doing well to the economy, they have busted foreign investors' confidence into the Indian tax laws. Uncertainty continues to loom large on the investors and has impacted not only the direct business decisions as taxpayers are not able to budget for the right tax costs but also the secondary transactions in the M&A space.

### **4.0 Retrospective Amendments**

Lack of thoughtful planning at the legislative stage has resulted in protracted and multiple litigations over issues, which under the long drawn litigation chain in India, receive finality from the Supreme Court. From our experience in recent past, one does not know that the certainty received from a Supreme Court verdict can be said to be steady for how long. If the ruling is favorable to the taxpayer, the government has made 'clarificatory' retrospective amendments to over-turn these rulings. Shome Committee notes with respect to some of these amendments that neither the amendments were clarificatory nor based upon principles of equity in taxation. Retrospective amendments should be used exceptionally and should be avoided to use it as a means to expand tax base. Article 141 of the Constitution says that Supreme Court judgments are law of the land, and it can be seen that some of these judgments are now being set aside by making retrospective amendments to law. Government across the world have used retrospective

amendments to amend tax laws from a prior date to clarify the intent of the tax provisions, but have used them very selectively and largely restricted to cases where taxpayers are using tax avoidance schemes, and not to overcome court rulings pronounced in favour of the taxpayer or expand the tax base.

### **5.0 Impact of Litigation**

With respect to cross border payments, the going is tough both for the foreign recipient and even the Indian payer at the lower levels of tax administration. Faced with the prospect of being treated in default, the Indian payer seeks to withhold tax at source, even when it is technically not subject to tax under the tax treaty. To compound the problem, it is also likely that the home country of the foreign recipient may not allow a foreign tax credit on the ground that the tax was wrongfully withheld in India. Many more such conflicts and uncertainties can be cited which severely impact the decision making by the investors.

Even if after the long drawn litigation, taxpayers are ultimately successful in defending the challenges made by tax authorities, the prospect of facing lengthy negotiations or litigation will be unattractive for taxpayers if it were to be measured in terms of the fair value of money. Generally, an assessee has to pay the tax demand in full or in part depending upon the level at which the litigation is pending. So what is the real worth of the disputed tax paid today? Let's say the amount of disputed tax paid today is Rs. 100; cost of capital is 12% p.a.; simple interest on refund is 6%p.a. Based on these assumptions, the real value of Rs. 100 paid today and received back after 15 years (approx. time for litigation to reach finality in Supreme Court) would be about Rs.10. After considering the depreciation of rupee and the cost and time spent in litigation, the real worth of the refund would be almost zero or in fact negative for a foreign investor. The anguish and frustration of the foreign investors look justified and calls for some serious steps to be taken by the Indian government to repose the faith and certainty back. While the government tries to woo investors by announcing various investment policies and benefits, enough attention is not being paid to the present system's coercive tax measures. Most businessmen prefer to avoid protracted and non-defensible litigation. This incidentally is the stated objective of the government as well.

### **6.0 Resolution to the Quagmire – Roles for Everyone**

Thus, the cases which fall into the aforesaid categories need to be handled with more maturity by all the stakeholders i.e. legislature, tax department, tribunals, courts,

alternate dispute resolution bodies and of course, the taxpayers. By following some of the measures suggested below, the controversies and litigation will get reduced to a significant extent or will speed up the process of resolution.

- Firstly, legislature has the onerous responsibility of drafting the law with more clarity. Corporate India is increasingly concerned about the fact that the uncertainty and lack of clarity in law seriously impacts the big business decisions and also the fact that it takes a significant amount of time to reach a conclusion on litigation where they have large amounts of money getting blocked in tax demands. Government's effort in inviting recommendations from various stakeholders on Direct Tax Code (DTC), General Anti Avoidance Rules (GAAR), Indirect transfers, corporate law etc. were seen as a positive and welcome step – though perhaps, government's inability to accept most of the recommendations was not as desired. To brainstorm and debate over all possible scenarios and outcomes before enacting the law would help in drafting the law with desired contours. Once the law is enacted, it is equally important to provide appropriate guidance on its interpretation to assist the tax department in administering the law within its letter and spirit and also facilitate the taxpayers in determining the tax cost associated with each of the business decisions. Another positive step taken by the government towards reforms required in tax administration, in line with global best practices, is setting up of the Tax Administration Reform Commission (TARC). Some of the objectives of this commission are to review and structure the resources and processes in tax department, evaluate the existing mechanism of dispute resolution, recommend measures for taxpayer education programs etc. The Commission comprises of senior tax officials and industry representatives and therefore we hope to see some affirmative recommendations to change the face of tax administration.
- Due to the pressure exerted by tax enforcement and collection targets, assessing officer engages in intense tax audits. Over the years of performance of their duties, the primary function of the tax officials, which is to administer the compliance of tax laws as legislated, has been lost somewhere. It has been superseded by tax collection targets becoming the primary objective and causes egregious tax audits by tax officials. Tax mobilization should be just seen as a secondary step if taxpayers have violated the provisions of law and thereby incremental tax needs to be collected. The tax system should be designed in a way that there are enough checks and balances in the system itself for it to detect such egregious tax audits so that they can be dealt with appropriately. It requires a fundamental change in the mindset of the assessing officers and they need to be made more accountable for their actions. The assessing officer should give a clear finding in every order to show why the matter ought to be

litigated, despite a preceding favorable order from a tax tribunal or court. Where an issue has been considered and decided consistently in a number of earlier assessment years of the taxpayer in a particular manner or on a particular subject in case of certain other taxpayers, the same view should continue to prevail unless there is some material change in the facts and circumstances of the case i.e. principle of *res judicata* to be followed.

- Tax tribunals have played a vital role as part the Indian tax judiciary and will continue to do so. Structurally, tribunals are the only independent forum to examine the questions of facts and historically have attempted to ensure complete functional independence of the institution with legal and technical expertise. Tribunals should further help curtail the mounting cases of litigation by doing a more rigorous and detailed evaluation of the cases and thereby acting as a filter for issues being sent to the High Courts. Thus, some of the barriers such as lack of independence of the judges at times, lack of exposure of the judges to variety of issues, number of members/benches, lack of resources etc., need to be effectively addressed to ensure speed, quality and consistency in delivery of justice. Inconsistency impairs the quality of legislation and also undermines the confidence of investors/taxpayers.
- Formation of the Dispute Resolution Panels (DRP) was initially perceived as a game changer towards providing a mechanism for resolving international tax related disputes on a fast track basis but lost its sheen soon as the directions from DRP happened to be largely pro-revenue. If we look back, the genesis of setting up the DRP was to have a forum where the tax department and tax payer come together, facts and merits are debated and a resolution is proposed which looks fair and acceptable to both parties. There were certain underlying principles in comprehending the DRP model such as good faith by parties, a genuine inclination from both parties to resolve the matter and an unbiased approach from DRP. Experience has shown that both assessing officer and taxpayer have shown their inflexibility to alter their original positions, subsequent amendments in law to bring DRP at par with appellate commissioner including powers to raise new issues or enhance the original assessment, are all counter to the rationale of setting up this body. This body requires overhauling to bring the shine back so that it lives up to its primary objective and facilitates the tax system in resolving disputes with more equity and fairness.
- The Authority for Advance Rulings (AAR) was set up to facilitate non-residents in planning for their income tax affairs well in advance. AAR process has been widely used by the taxpayers and its contribution in limiting the litigation cannot be denied. Over the last two decades AAR has pronounced various rulings. However looking at

the increasing volumes of pending applications (as AAR has not been able to meet the statutory time period of 6 months to pronounce the ruling), the institution needs to be made more effective by increasing the number of benches to overcome the delay. The standing committee on DTC has in fact recommended the expansion of the scope of AAR to include domestic taxpayers. However, AAR needs to ensure more consistency in its rulings. There have been few instances where a ruling on a transaction based on one set of principles has not been applied to another transaction with same set of principles. As noted in above paras consistency in justice is one of the most important pillars in tax framework.

- While it is uniformly acknowledged by everyone that tax evasion cannot be supported under any situation, world over, the acceptance for legitimate tax avoidance under the framework of law is also rapidly changing. Therefore taxpayers now need to ensure that their tax planning do not trip the facts. The notion of substance over form is here to stay and should therefore be respected. Any inconsistency between planning and underlying business model will come under sharp focus not only in India but even within the advanced nations who are members of the OECD etc. Taxpayers need to proactively and continually monitor the scope and manner of conduct of their activities to ensure that their tax positions fully reconcile with the facts. Actual operations and documentation remain key in ensuring that any position taken by the taxpayer is well structured and fully substantiated. Thus, with the sprouting new businesses and business models and continually evolving jurisprudence on various tax matters, a careful consideration of multiple aspects is necessitated by the taxpayer before taking any tax position to avoid litigation.

## **7.0 Evolving business models and their impact**

Increasing globalisation, ever evolving and emerging business models, world of e-commerce, dynamics in the existing business operations etc. create situations or transactions which are fairly untested and can therefore potentially create tax conflict due to lack of clarity in applying the existing law. Such situations were probably never anticipated or envisaged at the time of drafting the law. Only such cases may call for a debate on the provisions in law or may even require amendment, as appropriate. Thus, it is only this residual category of cases which are fairly nascent in terms of applicability of tax laws and may require discussion at the appropriate levels. However, to resolve such instances, instead of resorting to regular long drawn litigation chain, there needs to be growing acceptance to the reality that a lot of such taxation disputes such as new types of

transactions pertaining to transfer pricing, marketing intangibles, determination of PE under unique facts and attribution of profits under tax treaties, etc. can be settled conveniently and expeditiously through alternative dispute resolution mechanisms such as DRP, APA, AAR, MAP, Settlement Commission, etc. However, to make these platforms a success and meet the desired objective, the rules of the game need to be clear and these bodies need to operate with complete independence and a fair approach. Since these are very sophisticated tools to resolve conflicts, it would require appropriate staffing and training of the members.

India should look out as to how some of these issues are managed globally by other countries and should start making itself heard at appropriate global forums as quickly as possible on some of the current topics such as BEPS initiative, country-by-country reporting etc. and take guidance. Until a cogent answer emerges from these bodies, India may consider resolving some of these issues in given expeditious manner through the aforesaid forums. Having said the above, there is no denying the fact that the tax rules around these topics need to be legislated ... sooner the better. We cannot perpetually look up to these forums for settlement of cases. It's a desperate need of the hour to make thoughtful, detailed and prescriptive tax laws and curb the litigation practices.

### **7.1 Emerging global landscape**

Fundamental aspects of dealing with audits and controversies though evolving in recent times, need further developing on certain aspects such as how tax authorities obtain information (under Exchange of Information), how they choose who will be audited, their choice of audit techniques, and how controversies should be expeditiously and equitably resolved. Historical frameworks should be modified by more modern approaches to handle the tax controversies. The government is awakening to this fact and has made several legislative changes to combat the increasing volume of litigation such as Advance Pricing Mechanism (APA), safe harbour rules etc. but still lot needs to be done. As evident in OECD's Base Erosion and Profit Shifting (BEPS) Action Plan, due cognizance should be given to the business environment in which MNCs operate and the fact that MNCs manage many unique tax systems around the world, each country employs varying approaches and tax rates resulting in different financial impacts among competitors depending upon where they are established to do business and where they operate.

The global tax community is already experiencing signs of this movement. The tax audit and controversy environment in the next several years will be marked with enhanced changes to audit and dispute approaches. Certain countries are starting to



recognise the need to pursue administration changes to drive efficiencies. They are either currently using or are shifting to a more efficient risk-based assessment method to help tax authorities identify which taxpayers and issues to audit (as compared to historical methods). This change can be further witnessed from the new discussion draft on country-by-country reporting under transfer pricing guidelines released by OECD on January 30, 2014. The draft carries a template to provide information covering various aspects of the MNC's structure, transactions and tax positions. From our experience, Indian tax authorities during the audit procedure already ask for very detailed and lengthy information covering most of these proposed requirements, and still we see that transfer pricing adjustments are not necessarily based on any risk assessment. Thus, it will have to be seen that in the Indian context, whether calling for such information upfront would be of any help in reducing the litigation or not.

India had traditionally been following the UN model of taxation. In one of the FICCI press conferences, the finance minister had said that India wants to accept OECD model of taxation. It is therefore all the more important for the government to comprehend the signals sent by OECD and make further efforts to align to the OECD model of taxation.

## **8.0 Closing remarks**

India desperately needs resources and overall policy shift, which means measures are required to promote generation of wealth as compared to current practices of redistribution of wealth. Change in policies is required to spin the wheel of wealth creation in a way that the nation itself develops the ability to keep on generating more wealth and in turn revenue, on a more sustainable basis. At present, tax authorities pursue aggressive tax scrutiny on a select set of corporate taxpayers that may be inimical to the agenda of setting up a conducive investment climate in the country.