

## The Rising Popularity of Advance Rulings in India

by Harshal Shah and Bijal Ajinkya

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# PRACTITIONERS' CORNER

## The Rising Popularity of Advance Rulings in India

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**I**ndia has earned the dubious distinction of being the country adding the most teeth to its tax regime in the previous year, according to a *Forbes* study.<sup>1</sup> This has been compounded by the aggressive approach adopted by the revenue authorities in the recent past, leading to uncertainty for foreign investors when it comes to tax implications on their transactions in India. The Authority for Advance Rulings (AAR) has emerged as a significant player contributing to international tax jurisprudence, not just in India, but also internationally.

With more than 70,000 cases pending before the Income Tax Appellate Tribunal,<sup>2</sup> the AAR is emerging as a fast and efficient forum for obtaining clarity on the tax implications for foreigners in India.

### Background

The advance ruling system has been in existence in approximately 60 countries for the past four decades.<sup>3</sup> The AAR in India is a relatively late entrant: Although the concept of obtaining an advance ruling was con-

ceptualized by the Wanchoo Committee in the mid-1970s, it was only in the early 1990s that it was implemented. In 1993 the finance minister promised to establish a forum to give advance rulings for transactions involving nonresidents. A new chapter was inserted into the Income Tax Act, 1961, creating the AAR in order to provide certainty, avoid needless litigation, and promote better taxpayer relations with nonresidents in India.

The most striking feature of the Indian system is that the proceeding is adversarial (in most countries, proceedings are negotiated), which makes the decision binding on the applicant and the revenue authorities.

### Uniqueness of the AAR

In most countries the advance rulings are delivered by the revenue authorities and not by a judicial or quasi-judicial body. Therefore these rulings are largely considered to be nonbinding. However, in India the AAR has been set up as a high-level quasi-judicial authority, which has been granted statutory recognition.<sup>4</sup>

The AAR is presided over by the chair and two members. The chair is a retired judge of the Supreme Court of India, which is the highest court in India. One of the members is from the Internal Revenue Service and the other is an officer of the Indian Legal Service.<sup>5</sup> Also, the tax laws in India give binding value to the AAR ruling, both on the person applying for the

<sup>1</sup>Jack Anderson, "2009 Misery & Reform Index," *Forbes*, Apr. 13, 2009, available at <http://www.forbes.com/global/2009/0413/034-tax-misery-reform-index.html>. See also <http://www.hinduonnet.com/businessline/blnus/14061050.htm>.

<sup>2</sup>"70,000 I-T Cases Still Pending as Additional Benches Yet to Start Functioning," *The Financial Express*, Dec. 25, 2008, available at <http://www.financialexpress.com/news/70-000-it-cases-still-pending-as-additional-benches-yet-to-start-functioning/402620/>.

<sup>3</sup>Authority for Advance Rulings, *Handbook on Advance Rulings*, May 2008 edition.

<sup>4</sup>Chapter XIXB of the ITA.

<sup>5</sup>Section 245 O of the ITA.

ruling and the Revenue Department.<sup>6</sup> These are the features that make the AAR system in India akin to the advance ruling system practiced in Denmark<sup>7</sup> and Sweden.<sup>8</sup>

Another distinctive feature of the AAR regime in India is that it does not have any discretionary power regarding the admission of an application made before it. As long as the application is made by a nonresident for determining its tax liability and does not fall within the category of prohibited questions (discussed later herein) for which an advance ruling cannot be sought, the AAR is bound to pass a ruling on the question. This is unlike the practice in other countries, where providing a ruling is completely contingent on the discretion of the Revenue Department or the authority from which a ruling is sought.

## Once a ruling is passed by the AAR, the applicant is bound by that ruling and cannot renounce the right to rely on it.

In many countries there is no process to appeal against advance rulings issued. In India as well, under the ITA there is no process to appeal against the order passed by the AAR. However, one may resort to the remedy provided by the Constitution of India by filing a special leave petition to appeal against the AAR's ruling before the Supreme Court of India<sup>9</sup> or by a writ petition before the High Court.<sup>10</sup>

Another distinctive feature of the AAR system in India is that once a ruling is passed by the AAR, the applicant is bound by that ruling and cannot renounce

<sup>6</sup>Section 245 S of the ITA.

<sup>7</sup>In Denmark, the advance rulings are issued by the SKAT. They are binding on the applicant and the tax authorities for five years provided the facts described in the application remain constant. See *International Master Tax Guide*, 5th Edition 2008-2009, CCH India, p. 469.

<sup>8</sup>In Sweden, private rulings are issued by the Council for Advance Tax Rulings, a tax law commission that is an independent body of the National Tax Board, the revenue collection agency. As in India, the process followed by the council is adversarial in nature; the National Tax Board and the applicant are made counterparties to the application. See Carlo Romano, *Advance Tax Ruling and Principles of Law Towards a European Tax Rulings System?* Doctoral Series, Vol. 4, IBFD, Netherlands, pp. 406-407.

<sup>9</sup>Article 136 of the Constitution of India.

<sup>10</sup>Article 226 of the Constitution of India.

the right to rely on it. This is contrary to the position in the U.S.,<sup>11</sup> France,<sup>12</sup> Germany,<sup>13</sup> and Sweden.<sup>14</sup>

## AAR in India

### Who May Seek an Advance Ruling?

The advance ruling process is designed to provide certainty to nonresidents undertaking or proposing to undertake transactions in India. While initially an advance ruling could only be sought by a nonresident of India, the scope has now been expanded to resident Indians regarding transactions with nonresidents. Under Indian law, a nonresident is an individual who has not fulfilled either of the following two conditions:<sup>15</sup>

- in the financial year immediately preceding the year in which the application has been made, the individual resided in India for a period of 182 days or more; or
- in the span of four years immediately preceding the year in which the application has been made, the individual resided in India for 365 days or more and has not resided in India for 60 days or more in the preceding year.

In the case of a company, it will be considered a nonresident of India if it has been incorporated outside India and has been controlled and managed entirely from outside India for the financial year preceding the year in which a ruling has been sought.<sup>16</sup>

### Matters That Cannot Be Considered

The AAR is precluded from considering three categories of questions:<sup>17</sup>

- questions already pending before other authorities under the ITA;
- questions pertaining to market value of any property; and
- questions pertaining to transactions designed for the avoidance of tax.

<sup>11</sup>In the U.S., the taxpayer has a right to renounce a letter ruling, which is a statement by the IRS National Office to the applicant after the application of law to his specific facts.

<sup>12</sup>In France, the taxpayer generally has the right to renounce an advance ruling, but in some exceptional circumstances the ruling may also be binding on the taxpayer. See Romano, *supra* note 8, pp. 409-413.

<sup>13</sup>In Germany, rulings are either binding or nonbinding. In nonbinding rulings, the tax authorities express their intention not to bind the applicant. See Romano, *supra* note 8, pp. 395-397.

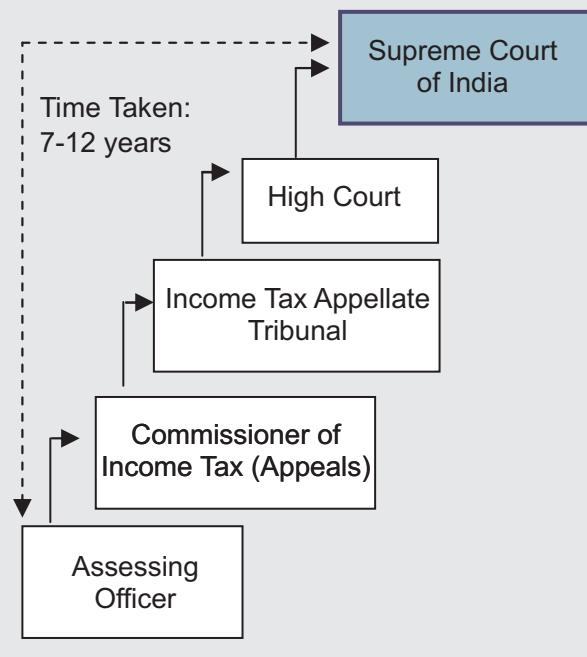
<sup>14</sup>In Sweden, a favorable ruling is binding on the revenue officers and the court if the taxpayer so requests, while an adverse ruling does not bind the court that pronounced it. See Romano, *supra* note 8, pp. 409-413.

<sup>15</sup>Section 2(30) read with section 6 of the ITA.

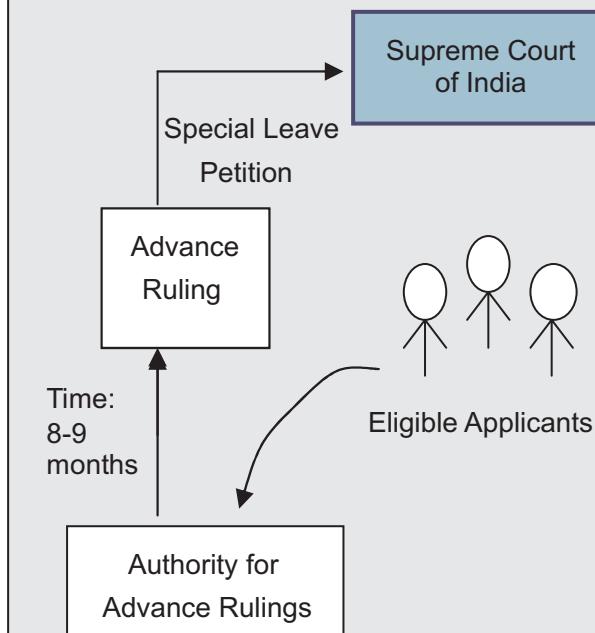
<sup>16</sup>Section 6 read with section 2(26) of the ITA.

<sup>17</sup>Section 245 R of the ITA.

**Figure 1. Hierarchy of Courts in a Standard Litigation Procedure**



**Figure 2. Hierarchy of Courts in an Advance Ruling**



A similar question pending before any other authority in the applicant's matter prevents the AAR from admitting the application made before it. However, the mere filing of a tax return and the pendency of assessment proceedings will not bar the applicant from making an application before the AAR.<sup>18</sup> The pendency envisaged in the ITA is specific to the question for which an AAR ruling has been sought. The question must be in dispute before the tax department. A mere notice issued by the Revenue Department pertaining to the return filed without referring to the question for which the ruling is sought will not prevent the AAR from adjudicating the questions.

The second question that falls outside the jurisdiction of the AAR relates to the determination of fair market value of any property, immovable or movable. Lastly, the AAR cannot allow any application if it relates to a transaction that in the authority's *prima facie* opinion is designed for the avoidance of income tax.<sup>19</sup>

<sup>18</sup> *Jagtar Singh Purewal v. CIT*, (1995) 213 ITR 512 (AAR).

<sup>19</sup> See *Advance Ruling No. P-9 of 1995*, (1996) 220 ITR 377 (AAR), in which the AAR, regarding investments through Mauritius, held that the transaction was *prima facie* to avoid tax, and hence it did not give a ruling. See also *In re Canaro Resources Ltd.*

(Footnote continued in next column.)

### Transfer Pricing and the AAR

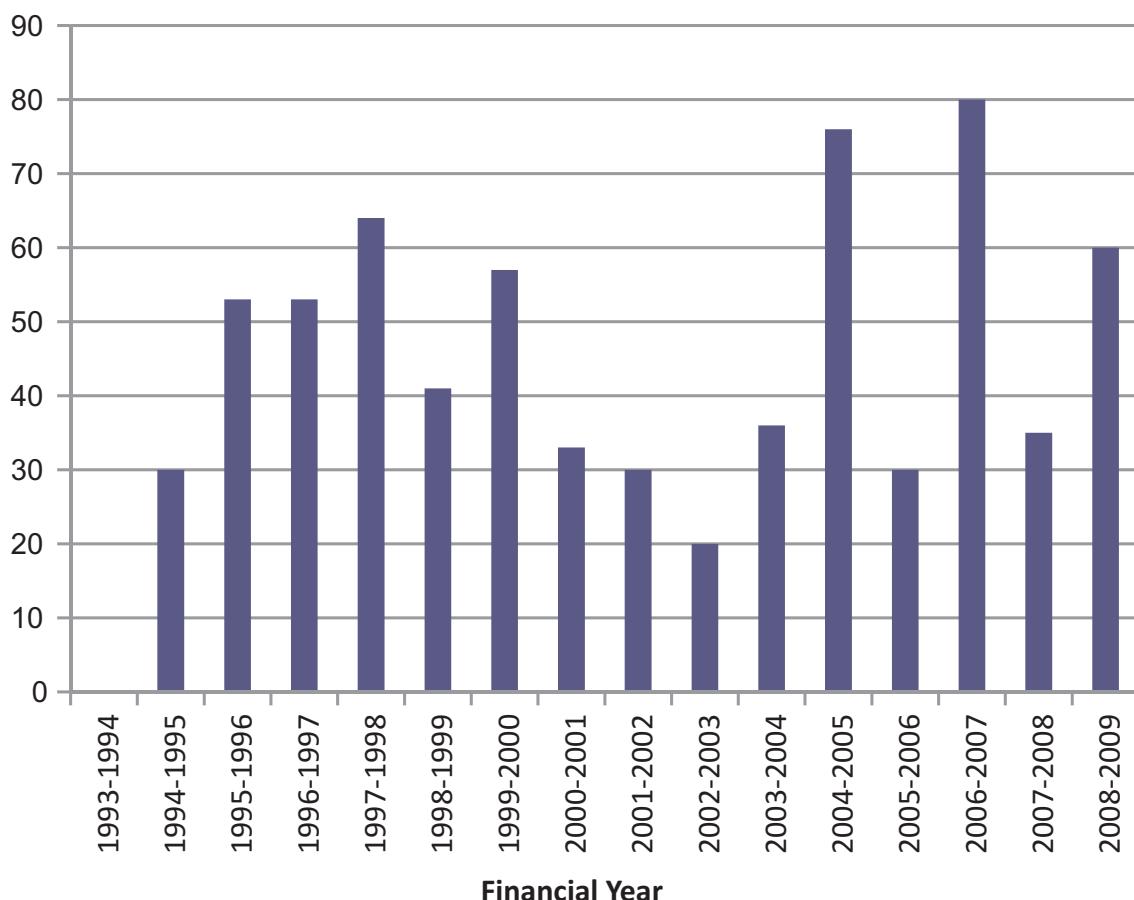
The AAR has yet to rule on issues of transfer pricing,<sup>20</sup> but it may rule on such questions in the future. So far the AAR has considered that a ruling on transfer pricing would involve a determination of the fair market value of a property, which is prohibited by the ITA. However, these restrictions apply only to questions pertaining to tangible and intangible property, and cannot be expanded to determine the arm's-length price pertaining to services. In the landmark *Morgan Stanley*<sup>21</sup> case (in which an appeal was filed from the AAR ruling), the Supreme Court ruled on the issue of determination of arm's-length price of a particular service. From this it can be inferred that the AAR has the requisite jurisdiction to rule on transfer pricing pertaining to services.

Also, the AAR was created in 1993, while the provisions pertaining to transfer pricing were introduced

<sup>20</sup> *2009-TIOL-ARA-IT*, in which the AAR held that since the transaction was motivated by a business purpose, it should not amount to tax avoidance and on that basis it gave a ruling on the transaction.

<sup>21</sup> *In re Instrumentarium Corporation*, (2005) 272 ITR 499 (AAR); *In re Morgan Stanley and Co.*, (2005) 272 ITR 416 (AAR).

<sup>22</sup> *DIT v. Morgan Stanley*, (2007) 109 BOMLR 1348.

**Figure 3. Annual Rate of Disposal of Applications by the AAR**

Data source: Authority for Advance Rulings, New Delhi.

much later, in 2001. Therefore the intent of the legislature was never to restrict the jurisdiction of the AAR to prevent it from ruling on issues such as transfer pricing.

### Effect of an AAR Ruling

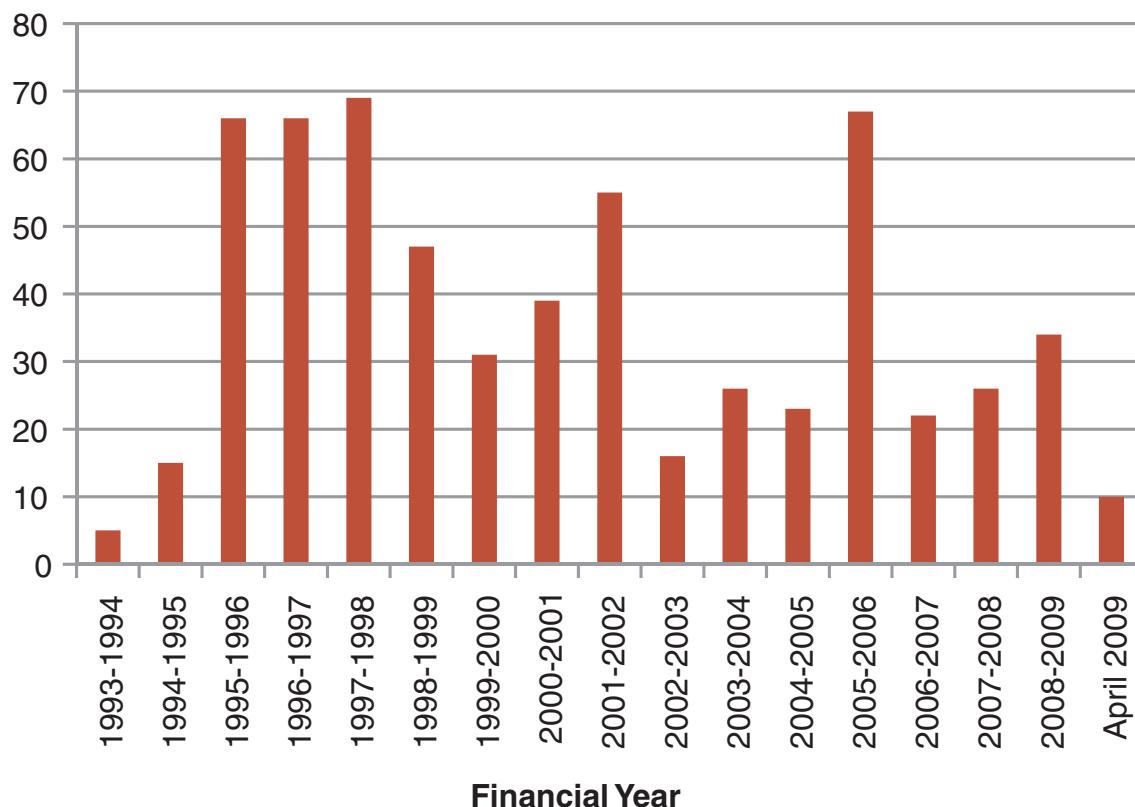
Unlike in other jurisdictions where the applicant or the revenue service has the option to accept the ruling, an AAR ruling is binding — not only on the applicant but also on the Revenue Department.<sup>22</sup> Further, since such a ruling pertains to a question relating to the transaction and is not specific to a particular assessment year, any ruling passed by the AAR will be binding so long as there is no change in law or facts on the

basis of which the ruling was pronounced. This is unlike the practice in some other jurisdictions in which the binding nature of a ruling is restricted to a specific period.<sup>23</sup>

An AAR ruling in India does not have any precedential value like a ruling of the High Court or Supreme Court of India. It is not a judgment in rem but rather a judgment in personam; that is, the ruling applies on a case-by-case basis, not universally. However, the rulings of the AAR do have some persuasive value for persons other than the applicant. The AAR generally follows the ruling in other cases on materially similar facts, and mostly certainly in other cases that it has ruled on that raise the same question of law.

<sup>22</sup>Section 245 S of the ITA.

<sup>23</sup>Supra note 7.

**Figure 4. Number of AAR Applications Received Each Year**

Data source: Authority for Advance Rulings, New Delhi.

### Appeal of AAR Rulings

There is no provision in the ITA for appealing against the order of the AAR. However, the Supreme Court has been granted the discretionary jurisdiction to hear appeals from subordinate courts by way of a special leave petition under article 136 of the Constitution of India. Recently there have been many cases in which the Supreme Court has admitted a special leave petition against orders of the AAR and ruled in favor of the applicant. In these cases, the Supreme Court has considered the matter expeditiously and delivered a ruling within about one year, in the interest of justice. In the alternative, the applicant or the Revenue Department may also file a writ petition in either the High Court or the Supreme Court alleging that the applicant's fundamental rights (as contained in Part III of the Constitution of India) are being violated, for example, by noncompliance with the rules of natural justice or by pronouncement of an arbitrary or unreasoned decision.

### Rise in Popularity of the AAR

Over the last few years, AAR rulings have come a long way in removing uncertainty and imbalance in the tax administration. The AAR has helped instill confidence in foreign investors who, after obtaining a ruling, get a true picture of their tax liability in India, and can then plan their business affairs before entering India. The AAR mechanism has also proved beneficial as it avoids long and expensive litigation.

Figure 1 represents the hierarchy of courts in a standard litigation procedure, while Figure 2 show the situation when an advance ruling is filed.

As shown in Figure 1, the average time taken for the final determination of a tax liability of a nonresident in a standard litigation process may take anywhere from 7 to 12 years. This is largely because of the adversarial approach adopted by the authorities at initial stages of the litigation process, cumbersome procedures that result in delay, and the hierarchy of the

administrative and judicial authorities that must be adhered to. Further, it is only when the matter reaches the judicial authorities, the Income Tax Appellate Tribunal, the High Court, and the Supreme Court, that one can expect justice.

Conversely, the time taken for the final determination of the tax liability of a nonresident by applying for an advance ruling as contemplated in the ITA is six months, but in practice, as shown in Figure 2, it is approximately eight to nine months. Therefore the process of approaching the AAR to determine the tax liability substantially eliminates the long litigation process. Only in cases when an aggrieved party chooses to exercise its constitutional right to file a special leave petition before the Supreme Court or file a writ petition to the High Court do the issues take time to resolve. The expeditious manner in which the AAR disposes of an application is the primary reason for the rise of its popularity. Figure 3 clearly illustrates a high annual disposal rate of the applications observed by the AAR.

Also, the approach adopted by the AAR is highly judicious and unbiased. In the 582 judgments delivered by the AAR through the financial year-end of March 31, 2009, there have been only 12 cases that have gone on for further litigation. On the other hand, appeals

filed through the regular litigation process before the Supreme Court and the High Court have witnessed a steady growth over the past five years. This clearly shows the acceptance of an AAR ruling not only by the Revenue Department but the applicant as well, which is one of the main reasons that the popularity of the AAR has increased.

The AAR has also significantly contributed to international tax jurisprudence in India, as it has for the first time discussed issues that are ambiguous or controversial under Indian law. In deciding such issues, the AAR is responsive to international developments, and relies on the writings of eminent jurists, international judicial precedents, and recent developments in other countries while considering the questions of law placed before it. Figure 4 shows the rise in popularity of the AAR in India.

## Conclusion

The advance ruling mechanism has turned out to be an effective method of obtaining clarity on the possible tax implications for an eligible applicant in India and also provides a quick solution for a foreign investor to obtain certainty on the tax implications of a particular transaction. ◆