Taxing Controlled Foreign Corporations In India – Flashlights Or Distress Signals?

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Abstract

This paper targets the introduction of Controlled Foreign Corporations Regulations [CFC] in the Direct Taxes Code, 2010. The CFC regime seeks to make taxable in India, the deferred passive income of a corporation incorporated outside India, usually in tax havens like Luxembourg and Cayman Islands but, owned or controlled by a resident of India. The undertone of the new regime is thus, anti-tax avoidance measures that are expected to result in the widening of the Indian tax base. The CFC framework is well established in jurisdictions like the United States, United Kingdom and Germany, which are capital-exporting countries. The import of the CFC idea to a largely capital-importing jurisdiction such as India appears to be a premature and hurried attempt. The proposed regulations, coupled with the redefined concept of residence of a company incorporated outside India might adversely impact both offshore investments and foreign direct investments into India. The possibility of double taxation cannot be ruled out either. The debate surrounding the CFC regulations has two tiers. Tier one questions the allocative efficiency of the CFC regime for India and considers its feasible alternatives. Tier two assumes that the CFC regime is workable for India in the long run, and thus critically analyses the provisions of the DTC in this regard while suggesting amendments.

Introduction

The halls of Indian tax policy these days are charged with the question of unearthing information on black money stashed in tax havens, requiring the overhauling of several wings of tax laws, such as service tax and generally, increasing the resource base for taxation revenue, particularly through a crackdown on tax avoidance measures. One of these policy initiatives is the proposed tax on Controlled Foreign Corporations[1] set to come into effect in the new Direct Taxes Code[2] from April 1, 2013.

It is a time-honoured principle of corporate law that a corporation is to be considered a legal entity, distinct from its shareholders.[3] Thus, while the corporation is subject to taxation law, at the shareholders level, taxation rules do not apply until the income is distributed as dividends to the shareholders.[4] This scheme of the 'incorporated

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1 Hereinafter CFC.

2 Hereinafter DTC.

3 Salomon v. A. Salomon & Co. Ltd., (1897) AC 22.

4 Organization for Economic Cooperation and Development: Working Party on Tax Policy Analysis and Tax Statistics, 'Tax Burdens: Alternative Measures' (2000).

pocketbook'[5] has become one of the most prevalent forms of tax avoidance and is often referred to as 'deferral.'[6] Deferral of income by storing it away in the foreign corporation controlled by the Indian resident thus results in delayed taxation where the income can be taxed only when the Indian shareholder receives it as dividends.

The CFC Regulations, also called Anti-Deferral Rules, first made an appearance in United States tax laws. In as early as 1913, tax deferral was allowed on most types of foreign subsidiary income.[7] In 1961, in a message to the Congress, the then President John F. Kennedy stated thus:

> *The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland…I therefore recommend that legislation be adopted which would, after a two-step transitional period, tax each year American corporations on their current share of the undistributed profits realized in that year by subsidiary corporations…*[8]

In 1962, the US enacted Sub Part F in the Revenue Act, 1962 which serves as an anti-deferral code. In what has been labelled 'race to the bottom' in corporate taxation,[9] capital-hungry economies, in order to attract investment, set their tax rates to dangerously low levels. This, in turn, invites reactions from other nations that lower their taxes further and a chain reaction is triggered with countries engaging in harmful tax competition. They end up eroding their own tax base and adversely influencing tax policies of other jurisdictions.[10] The Organization for Economic Cooperation and Development[11] noted the necessity to incorporate CFC rules to counter not only legitimate transfer of passive income but also harmful tax competition.[12] In a CFC regime, low tax rates will be redundant or at least less effective as an incentive to defer corporate incomes to a jurisdiction with a more beneficial tax structure. The CFC framework thus, could potentially counteract the disastrous impacts of policies of tax haven countries.

Section 115-O of the Indian Income Tax Act, 1961 taxes only on the distributed profits of domestic companies. Presently, there are no provisions in force to check deferral

5 H.R. Rep. No. 704, 73d Cong., 2d Sess. 1 (1934) (1934 House Report). *See* in OFFICE OF TAX POLICY DEPARTMENT OF TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH US CONTROLLED FOREIGN CORPORATIONS – A POLICY STUDY (2000), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf.

6 ROBERT E. MELDMAN & MICHAEL S. SCHADEWALD, A PRACTICAL GUIDE TO U.S. TAXATION OF INTERNATIONALTRANSACTIONS 601 (1996).

7 Glen M. Secor, *Runaway Plants, Runaway Tax Policy: The Continuing DebateOver the Taxation of Controlled Foreign Corporations*, 16 SUFFOLK TRANSNAT'L L. REV. 200 (1992-1993).

8 John Fitzgerald Kennedy, President, United States of America, 'Special Message to the Congress on Taxation' (April 20, 1961), *available at* http://millercenter.org/scripps/archive/speeches/detail/5669.

9 Organization for Economic Cooperation and Development, 'Harmful Tax Competition- An Emerging GlobalIssue'(1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf.

10 *Id.*

11 Hereinafter OECD.

12 *Id.*

of income and the consequent tax avoidance as described above. The purpose that the new CFC regime seeks to achieve lies in attracting into India the deferred passive income of a corporation incorporated outside India, usually in tax havens like Mauritius, Luxembourg and The Cayman Islands, but owned or controlled by an Indian resident.

Presently the foreign income of a controlled foreign corporation does not become subject to taxation unless it is repatriated to the concerned jurisdiction in the form of dividends paid to the resident.[13] In a CFC regime however, the subject of taxation is that income of a corporation (incorporated abroad but controlled by an Indian resident), which is not distributed as dividend to the shareholders but is deferred to the next year. The undertone of the new regime is thus to check tax avoidance which is expected toplug the leakage of tax and thereby result in the widening of the Indian tax base.

Pertinently, a CFC is not necessarily a storehouse for black money or illicit financial flows stashed abroad in tax haven countries.[14] While the morality or otherwise of tax avoidance itself is beyond the scope of this paper,[15] it has been succinctly observed by the Supreme Court of India:

> *My Lords, of recent years much ingenuity has been expended…to devise methods of disposition of income by which those who were prepared to adopt them might enjoy the benefits of residents in this country…without sharing in the appropriate burden of British taxation. Judicial dicta may be cited which point out that…those who adopt them are entitled to do so. There is, of course, no doubt that they are within their legal rights…one result of such methods…is of course to increase pro tanto the load of tax on the shoulders of the great body of good citizens who do not desire or do not know how, to adopt these manoeuvres.*[16]

Thus, tax avoidance through deferral measures is not *per se* illegal, since there are no laws yet in place prohibiting such deferral. Yet, a CFC regime is warranted because

13 Ashutosh Chaturvedi & Dheeraj Chaurasia, *Controlled Foreign Firms: Is This The Last Resort*, The Business Standard (February 20, 2012), *available at* http://www.business-standard.com/budget2012runup/news/controlled foreign-firms-is-this-last-resort/465174/.

14 India has recently entered into a Tax Information Exchange Agreement [TIEA] with the British Virgin Islands according to which India can seek information about the alleged black money parked in British Virgin Islands by Indians. *See India signs Tax treaty with British Virgin Islands*, The Hindu (February 10, 2011), *available at* http://www.thehindu.com/business/article1327627.ece. The first TIEA was signed with Bermuda and another with the Isle of Man. More such agreements are in the offing.

15 *See* Leonard Hoffman, *Tax Avoidance*, 2 British Tax Rev. 197-206 (2005) where Lord Hoffman highlights thebasic difference between tax evasion and tax avoidance by noting that tax avoidance cannot be said to be contrary to the intentions of the legislature which intention is visible in the text of a statute. "…sometimes there are holes….and the courts find they cannot plug them by appealing to the economic event,which……it appears that Parliament wished to tax. It is one thing to give a statute a purposive construction.Itisanother to rectify the terms of a highly prescriptive legislation in order to include provisionswhichmight have been included but are not actually there." *See also* G.S.A. Wheatcroft, *The Attitude of the Legislature and the Courts to Tax Avoidance*, 18(3) The Mod. L. Rev. 209 (May 1955).

16 Lord Simon in Latilla v Inland Revenue Commissioners, 1943 AC 377, as cited by O. Chinappa Reddy, J. in his concurring opinion in McDowell and Co. Ltd. v Commercial Tax Officer, 1985 (3) SCC 230, ¶35.

tax avoidance is undesirable from the point of view of national interest and should be discouraged by the legislature.[17]

The CFC framework is well established in jurisdictions like the United States, United Kingdom and Germany that are capital-exporting countries. The wisdom in importing the concept of CFC Regulations into a largely capital-importing jurisdiction such as India is under intense debate and is being alleged as a premature and hurried attempt.[18] Concerns are running high that the proposed regulations, coupled with the redefined concept of 'residence' of a company incorporated outside India, might adversely impact both offshore investments and foreign direct investments into India. The possibility of double taxation cannot be ruled out either. Certain institutions such as the Bombay Chartered Accountants Society have advocated a double tax credit system in place of the CFC rules to achieve the desired end of repatriation of profits earned abroad.[19]

The debate surrounding the CFC regulations has two tiers. Tier one questions the allocative efficiency of the CFC regime for India and considers feasible alternatives. Tier two assumes that the CFC regime is workable for India in the long run, and therefore critically analyses the provisions of the DTC in this regard and suggests amendments. This paper is an attempt to comprehensively realize the tasks outlined in Tier two with the first tier occasionally figuring in at relevant junctures.

I. Models To Check Deferral Of Active Income

The following are some methods that have been in active use alongside the CFC rules in several jurisdictions. These systems govern taxation of active business income as opposed to passive income of the CFCs. Active income is that income of a foreign corporation which is derived from its primary business activities, whereas passive income includes income derived from all other sources like dividends, rents, royalties, etc. Whether the CFC framework should cover in its ambit the active income is a different debate beyond the scope of this paper.

A. Exemption System

Under this system, if the income of the foreign corporation is repatriated to the parent company's country, the dividend is exempt from tax.[20] Thus, only the foreign

17 G.S.A.Wheatcroft, *supra* note 15.

18 Shyamal Mukherjee, *Regulations on Controlled Foreign Corporations: Are We Ready?*, Business Standard (June 21, 2010), *available at* http://www.business-standard.com/india/news/regulationscontrolled-foreign-corporationswereadу/23/02/398921/. Shyamal Mukherjee is Executive Director & Joint Leader of Tax Practice, PricewaterhouseCoopers. *See* 'Statement on Controlled Foreign Corporation (CFC) Rules', Prepared by the Task Force on CFC legislation, International Chamber of Commerce, *available at* http://www.iccwbo.org/policy taxation/id537/index.html.

19 Declan Gavin, *Worldwide tax view - Controlled foreign corporation regimes*, Bombay Chartered Accountants Society (December 2007), *available at* http://www.bcasonline.org/articles/artin.asp?742.

20 Samuel C. Thompson, Jr., *Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption and Imputation*, 53 How.L.J. 337, 341 (2010).

jurisdiction taxes the dividend of the CFC. Countries like France, Germany, Australia and Netherlands follow an exemption system in one form or another. The laws of these countries generally diverge in so far as the type of foreign source income that is exempt from the parent country's tax laws.[21] This system places the CFCs on the same platform as other foreign corporations in the concerned foreign jurisdiction. The CFCs are thus, ensured competitiveness and capital import neutrality[22] where the incomes of all corporations located within a particular locality or nation are taxed at a uniform rate irrespective of the country of residence of the owners of such corporations. However, in an exemption framework, the parent corporation has a greater incentive – than it would have in an anti-deferral regime – to divert more and more income to the CFC located in the low-tax jurisdiction, then repatriate it to the home country and avoid considerable amounts in tax. Thus, the exemption system also provides perverse incentives for transfer pricing abuse.

B. Imputation System

In this system, the CFC is treated as a foreign branch of the parent corporation and is subject to domestic taxation in the parent corporation's country of residence.[23] The tax treatment is much the same as in the case of a partnership and the income is imputed to the owners of the corporation who are then taxed.[24] To prevent situations of double taxation of the CFC, both in its country of incorporation and in the parent corporation's country of residence, the imputation system generally has provisions for foreign tax credits. The imputation system promotes capital export neutrality[25] wherein the corporation is taxed for the same amount irrespective of where the investment is made or the income is earned. It also preserves the tax base of the parent corporation's country of residence.[26] However, it raises administrative costs and decreases the competitiveness of the CFCs. On October 9, 2009, New Zealand switched to exemption from imputation citing the need to put New Zealand businesses on an equal footing at the international level.[27]

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21 Government Accountability Office, Report to the Commission on Finance: U.S. Senate Study Countries that Exempt Foreign-Source Income Face Compliance Risks and Burdens Similar t Those in the United States, GAO-09-934 6 (Sep. 2009) as cited in Samuel C. Thompson, Jr., *Assessing the Following Systems for Taxing Foreign-Source Active Business Income: Deferral, Exemption and Imputation*, 53 Howard L. J. 337 (2010).

22 Peggy B. Musgrave, *Capital Import Neutrality*, *in* Encyclopaedia of Taxation and Policy 50 (Joseph J. Cordes et al ed., 2005).

23 Samuel C. Thompson, Jr., *supra* note 20 at 341.

24 Samuel C. Thompson, Jr., *supra* note 20.

25 Peggy B. Musgrave, *Capital Export Neutrality*, *in* Encyclopaedia of Taxation and Policy 45 (Joseph J. Cordes et al ed., 2005).

26 Samuel C. Thompson, Jr., *supra* note 20.

27 Mary Swire, *New Zealand Forges Ahead with International Tax Reform*, Tax News (October 23, 2007), *available at* http://www.tax- news.com/news/New_Zealand_Forges_Ahead _ With _International _Tax _Reform _____28766.html.

II. Worldwide Legal Regime On CFCs

A. United States Of America

The United States pioneered the enactment of the CFC rules. Since 1962, the law has evolved from treating CFCs as a partnership for the purposes of both active and passive income to taxing deemed dividends. The law relating to CFCs is contained in Subpart F (Sections 951 – 965) of the Internal Revenue Code. The taxable income, also called Subpart F income, is defined and categorized into various heads like insurance income, foreign base company income, foreign company holding income, etc. and for each of these categories, a *de minimis* threshold is prescribed which can be excluded from Subpart F income.[28] Section 954(c) defines foreign personal holding income that includes dividends, rents, royalties, annuities and certain property transactions. A shareholder owning 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation, is liable to tax under Subpart F. Section 960 has special rules for foreign tax credit. Section 965 of the Internal Revenue Code enacted as part of the American Jobs Creation Act, 2004 offers a reduced tax rate on distributed dividends, from 35% to 5.25%, to companies, in a bid to encourage repatriation. The Stop Tax Haven Abuse Act – introduced by Senator Carl Levin in the Senate in 2007[29] – recommends that foreign corporations, managed and controlled in the United States, be treated as domestic corporations, thus, arguing for an imputation system for passive income of the CFCs and almost going back to the first leg of the CFC regime back in 1962. The US regime has often been criticized for being overly complex.[30]

B. United Kingdom

Sections 747–756 and Schedule 25 of the Income and Corporation Taxes Act, 1988 contain the British law on CFC. Provisions akin to the motive test have been included, which mandate an enquiry into why the CFC was set up, whether it was only for the purpose of avoiding UK tax, etc. A wide definition of 'control' has been provided according to which UK residents holding more than 50% interest in the company or a UK resident holding 40% or more and a non-resident holding 40%-55% interest in the foreign corporation are subject to CFC rules. CFCs whose UK chargeable profits would be below £50,000 per annum have been excluded from the CFC regime. Acquisitions

28 The *de minimis* threshold is provided in Section 953 for Insurance income and in Section 954 for Foreign Base Company income.

29 The earlier draft of the bill was read twice and referred to the Committee on Finance. In July 2011, a new draft was introduced in the U.S. Congress by Representatives Lloyd Doggett, Sander Levin and Rosa DeLauro. *See Reps. Doggett, Levin, DeLauro Introduce Bill To Stop Abuse of Tax Havens*, *available at* http://doggett.house.govindex.php?option=com_content&view=article&id=352:summary-of-rep-doggetts-stop-tax-haven-abuse-act&catid=49:latest-news&Itemid=149.

30 *See generally*, David Myers, *Section 482 and Subpart F: An Internal Revenue Code Dilemma*, 11 Am. U. J. Int'l L. & Pol'y 1073 (1996), *See also* Daniel P. Shepherdson, *The Simplification of Subpart F*, 17 Case W. Res. J. Int'l L. 459 (1985).

of certain subsidiaries from third parties that have not been previously controlled in UK have also been exempt for up to two years.

The following proposals for reform are considered under the Finance Bill, 2012:[31]

1. introduce an exemption for certain intra-group trading transactions where there is little connection with the UK and therefore, unlikely that UK profits have been artificially diverted;
2. introduce an exemption for CFCs with a main business of intellectual property (IP) exploitation, where the IP and the CFC have minimal connection with the UK;
3. introduce a statutory exemption which runs for three years for foreign subsidiaries that, as a consequence of a reorganisation or change to UK ownership, come within the scope of the CFC regime for the first time;
4. amend the conditions of the current *de minimis* exemption; to increase the limit for large groups from £50,000 to £200,000 profits per annum.

The UK is in a continuous process of reforming its CFC law. According to the latest update by the Revenue and Customs department,[32] a three-pronged test is proposed to identify profits that are outside the CFC regime: the UK activities test[33], the capability and commercial effectiveness test[34] and the tax purpose test[35].

C. Brazil

The CFC regime in Brazil is highly interesting albeit drastic. There is no exemption provided for the active business carried on by the CFC. Irrespective of the percentage of ownership, the shareholder must include in its taxable income a proportionate share of the undistributed dividends from a CFC that has not been taxed in Brazil.[36] Thus, the word 'controlled' appears to be a misnomer with respect to the Brazilian law on CFCs.[37] Regardless of the existence of a tax treaty, all foreign taxes paid by the CFC are creditable in Brazil.[38]

D. The Organization For Economic Cooperation And Development

The OECD has prepared a Model Tax Convention on Income and on Capital[39] which lays out a framework to settle common issues across jurisdictions regarding

31 *Part IIIA: Controlled Foreign Company (CFC) interim improvements*, *available at* http://www.hm-treasury.gov.uk/d corporate_tax_reform_part3a_cfc_interim_improvements.pdf.

32 *See* HM Revenue & Customs, 'Controlled Foreign Companies (CFC) reform: a Gateway update', February 2012.

33 This condition is met unless the control and management of a foreign subsidiary is carried on to a significantextent in the UK.

34 This test is satisfied if the foreign subsidiary has the capability to carry on its business without the UK activities mentioned earlier.

35 This condition is met if the main purpose of the arrangement is not achieving a UK tax reduction. This condition is similar to the motive test.

36 Amanda D. Johnson, Brazil Tax, Law and Business Briefing 31 (2005).

37 *Id.*

38 *Id.*

39 The Model Convention was first released in 1992 and has been periodically updated since then.

international double taxation. The provisions relevant to this paper are the following:

Article 7(1) provides that a Contracting State can tax the profits of an enterprise of another Contracting State only when such an enterprise carries on business in the taxing Contracting State through a permanent establishment situated in such a State. The relevant portion of Article 10(5) provides that a Contracting State may not tax the undistributed profits of a company resident in another Contracting State even if such profits wholly or partly arise in the taxing Contracting State.

The OECD Commentary on the Model Tax Convention notes that arguably, the CFC regime violates the above provisions of the Convention in that the CFC rules authorize a State to tax the undistributed profits of an enterprise situated in another Contracting State and which is not a permanent establishment of any enterprise of the taxing Contracting State. The Commentary summarily rejects these arguments and notes that the CFC rules and the double taxation avoidance treaties operate in different spheres and therefore do not conflict with one another.[40] Ireland, Belgium, Switzerland, Netherlands and Luxembourg have noted their disagreement with the OECD's view.

III. India: The CFC Regime In The Direct Taxes Code

The DTC is the Indian answer to the complexity and high administrative costs associated with the collection of direct taxes, particularly income tax. The DTC aims at streamlining the tax-collection procedure and lessening, if not wiping out altogether, the inefficiencies and loss of revenue which an intricate tax structure will not bring.

In January 2003, a Working Group headed by the then Director General of Income Tax for International Taxation, Mr. Vijay Mathur, released a Report on Non-Resident Taxation [Vijay Mathur Report].[41] The Report noted that owing to the increase in outbound investments, the enactment of CFC rules was imperative to prevent Indian companies from parking profits in low or no-tax jurisdictions and thereby, deferring Indian tax.[42] In an appendix, the Report also provided a comparative overview of the working of CFC regulations in USA, UK and Finland.[43]

In June 2010, in the Revised Discussion Paper on the DTC issued by the Central Board of Direct Taxes under the Ministry of Finance, it was recommended that in line with internationally accepted practices, CFC rules should be introduced providing that the passive income of the foreign corporation, which has not been distributed to the shareholders, will be deemed to have been distributed and the deferral of tax can therefore be contained.

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40 The OECD, Model Tax Convention on Income and Capital, July 2010, Commentary on Article 1, ¶ 22.1.

41 Ministry of Finance Government of India, Report of the Working Group on Non-Resident Taxation, *available at* www.finmin.nic.in/reports/NonResTax.pdf. Hereinafter 'the Vijay Mathur Report'.

42 *Id.*

43 *Id.*

The following are the relevant provisions of the DTC which provide for a CFC framework in India:

> Clause 58(2)(u) provides that the gross residuary income shall include "any amount of attributable income of a controlled foreign company to a resident in accordance with the Twentieth Schedule."
>
> Clause 59(1)(c) provides that any amount received during the financial year as dividend from a CFC, to the extent such amount has been included in the total income of the assessee in any preceding financial year in accordance with the provisions of the Clause 58(2)(u), is to be considered to arrive at the deductions for the purposes of computation of income from residuary sources.

The Twentieth Schedule provides for the method of computation of income attributable to a controlled foreign company.

According to Clause 113(2)(k) in Part E, Chapter X of the DTC, any preference or equity shares held by a resident in a controlled foreign company, as referred to in the Twentieth Schedule, are to be considered 'specified assets' for the computation of 'net wealth' under Clause 112 for the purposes of wealth tax.

Generally, under Indian law, between the domestic tax law and a double tax avoidance agreement[44] or treaty, that which is more beneficial to the assessee is considered applicable.[45] However, in the Revised Discussion Paper on the DTC, it was proposed that the CFC provisions should have precedence over the application of the DTAAs. This recommendation has been incorporated in Clause 291(9)(c) according to which, whether or not the CFC regulations are beneficial to the assessee, they shall apply to him. This provision erodes the effectiveness of the DTAA when it comes to controlled foreign companies. Domestic taxation law will thus, continue to apply to these corporations despite the existence of a DTAA.[46]

A. Controlled Foreign Corporation

According to Paragraph 5(a) of the Twentieth Schedule, a 'Controlled Foreign Company' means a foreign company that satisfies five conditions:

i) *Resident of low tax territory*: It is a resident of a territory outside India that has a lower rate of taxation. 'Territory with lower rate of taxation' is further defined

44 Hereinafter DTAA.

45 The Income Tax Act, § 90 (1961).

46 The OECD in its Model Tax Convention on Income and Capital noted that once rules like CFC have been incorporated in the domestic law, a State is unlikely to be a part to bilateral tax conventions like DTAAs and is also unlikely to interpret the existing conventions in a manner contrary to the CFC rules. *See* the OECD, Model Tax Convention on Income and Capital, July 2010, Commentary on Article 1, ¶ 7.1, , the OECD. The Indian legislature, by giving a superseding effect to the CFC rules over the DTAAs, confirms the OECD view.

under Paragraph 5(d) of the Twentieth Schedule to mean a territory or country outside India according to the laws of which the amount of tax payable on the profits of a company is less than one half of the corresponding tax payable in India if that company were a domestic company. Thus, territories with lower rate of taxation may or may not be tax havens.[47]

ii) *Control*: One or more persons, resident in India, individually or collectively exercise control over the company. Paragraph 5(b) provides that one or more Indian residents are said to exercise control of the CFC if they either individually or collectively, possess or are entitled to acquire, directly or indirectly, shares carrying 50% or more of the voting power or capital of the CFC; or they are entitled to secure that 50% or more of the income or assets of the CFC be directly or indirectly applied for their benefit; or they exercise dominant influence on the CFC due to a special contractual relationship; or they have sufficient influence to exercise decisive influence in a shareholder meeting of the CFC.

iii) *Public listing*: The shares of the CFC are not traded on any stock exchange recognised by the law of its country of residence for the purposes of tax.

iv) *Active trade or business*: The CFC is not engaged in any active trade or business. According to Paragraph 5(a) of the Twentieth Schedule, only a company that is not engaged in active trade or business is to be considered a controlled foreign company. Paragraph 5(e) of the Twentieth Schedule lays down the kinds of income that are considered to be income from 'active trade or business' carried on by a company. Illustratively, this list includes active participation in the industrial, commercial and financial undertakings in the economic life of the low tax territory in which the foreign company is a resident for tax purposes. It also includes income, as long as such income is less than 50% of the income of the said company during the relevant accounting period; from dividends, interest, house property, capital gains, royalty, annuity, sale or licensing of intangible rights in literary, artistic or industrial property, etc.

v) *De Minimis for income*: The specified income of the CFC, to be determined in accordance with Paragraph 4 of the Twentieth Schedule exceeds 25 lakh rupees. This is the income threshold or the *de minimis* limit for a CFC to fall within the ambit of the framework prescribed under the Twentieth Schedule.

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47 Contrary to the popular perception, tax havens are not just low-tax jurisdictions. Most corporations prefer operating from tax havens because the laws there offer secrecy that allows them independence in business operations, and allegedly, in commission of tax fraud. Indeed, tax havens are labeled "offshore secrecy jurisdictions" under the Stop Tax Haven Abuse Act introduced in the United States. *See supra* note 20. *See also* Robert M. Morgenthau, *These Islands Aren't Just a Shelter From Taxes*, New York Times (May 5, 2012), *available at* http://www.nytimes.com/2012/05/06/opinion/sunday/these-islands-arent-just-a-shelter-from-taxes.html?_r=1. *See also* Nicholas Shaxson, *The Tax Haven in the Heart of Britain*, New Statesman, February 24, 2011, http://www.newstatesman.com/economy 2011/02/london-corporation-city.

IV. The Troubled Waters Of An Unpromising Territory- Controversial Features Of The DTC Regime On CFC

According to the International Chamber of Commerce, protection of the national tax base through a CFC regime leads to economic inefficiency in the long run and transfer pricing rules are a better way of preserving the tax base.[48]

A. Grace Period To Newly Acquired Structures

It is likely that a company that has been newly set up or newly acquired may not generate sufficient active income in the initial few years despite being actively involved in trade or business. It is highly possible that such a company earns income through passive means like dividends, interest, etc.[49] In this scenario, the DTC offers no succour and the said company would be covered under the CFC regime. By taxing under the CFC rules, a company whose underlying purpose might not even be tax deferral, and which might have an excess of passive income over active income simply because it is grappling with the survival of its new structure, the DTC leads to a perverse implementation of the law which is required to be checked. It is therefore, necessary that an exemption be provided to newly acquired structures for at least two or three years, as also recommended in the UK Finance Bill, 2012, during which time the company can start functioning on a full scale. It will then be easier for the revenue department to investigate if the concerned company generates more of active or passive income.

At this point, the 'motive test' is of immense relevance. As stated by the European Court of Justice in the *Cadbury Schweppes case*, CFC rules should cover only those "cases where there is both (i) an intention to obtain a tax advantage and, objectively, (ii) the absence of an establishment carrying on genuine economic activities."[50] It is essential to incorporate the motive test in the DTC to tax only those CFCs that have tax deferral as their ultimate motive. The DTC presently contains the potential to stifle the growth of newly established or acquired companies that might be genuinely interested in carrying on active trade.

B. A Hurried Groundless Attempt?

As Frederick Bastiat once wrote: "the purpose of the law is to prevent injustice from reigning".[51] The anti-CFC quarters argue that historically, CFC rules have been used

48 The International Chamber of Commerce, *ICC Statement on Controlled Foreign Corporation (CFC) Rules*, *available at* http://www.iccwbo.org/policy/taxation/id537/index.html.

49 HP Agarwal, *CFC Rules under Direct Taxes Code Need Relook*, Business Standard (Dec 27, 2010), *available at* http:/www.business-standard.com/india/news/cfc-rules-under-direct-taxes-code-need-relook/419640/.

50 Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, Judgment of the European Court of Justice in Case C-196/04, September 12, 2006 [Cadbury Schweppes case], ¶¶ 64-67. The case is explained later in the heading 'Role of the Judiciary'.

51 Frédéric Bastiat, The Law 19, (2007).

mostly by countries that primarily export capital like United States, Australia, etc. India being a net importer of capital, our inbound investment far exceeds outbound investment. Thus, India does not require enactment of this harsh law to check tax avoidance.[52] However, with the introduction of CFC rules in developing countries like Brazil, this argument does not hold water. What is more important to investigate is whether facts, data and statistical analysis mandate and justify a stringent CFC regime like the one we are concerned with.[53] To begin with, CFC rules would be urgently needed if it was found that outbound investments by Indian companies has increased significantly over a considerable span of time and that there is increased danger of Indian holding companies parking their profits in foreign subsidiaries, thereby resulting in huge losses in tax revenue to the Indian exchequer. This hypothesis warrants factual examination but unfortunately, this exercise has not been carried out in India. Until recently, there was no specific data available suggesting that investments in controlled corporations abroad by Indian residents had increased considerably. The data published by the Ministry of Finance on investment outflows was rather sketchy and a country-wide breakdown of the actual value of outflows was not available in the public domain.[54] It was only since the financial year 2008-2009 that the Reserve Bank of India started releasing such data in its monthly bulletin. A period of three years is too short an assessment period to necessitate a CFC regime in India.

Further, the only evidence asserting that foreign outflows from India were *expected* to surpass foreign inflows for a single financial year, i.e 2007-2008 lies in the lone study[55] conducted by the Associated Chambers of Commerce and Industry of India.[56] On the other hand, the UNCTAD notes that there has actually been a drop in outbound flows of equity investments from India.[57] Clearly, this insufficient and contradictory evidence cannot justifiably support the need for a whole new law marking a significant shift in the tax policy. The proposed CFC regime in India is thus, *a priori*. It is suggested that the Indian government should put the CFC law on hold until enough data accumulates and

52 HP Agarwal, *supra* note 49.

53 A cost-benefit analysis is indispensable in this regard. *See* Nishith Desai Associates, Direct Taxes Code GlobalThink Tank, *International Dimensions of the Direct Taxes Code Bill, 2010: Comments and Recommendations* (2011), *available at* http://www.nishithdesai.com/Budget2012 DTC%20Global%20Think%20Tank%20Report%20%28Summary%29.pdf.

54 Sasidaran Gopalan & Ramkishen S. Rajan, *India's FDI Flows: Trying to Make Sense of the Numbers*, 5 *Alerts on Emerging Policy Challenges*, United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) (Jan. 2010), *available at* http: www.unescap.org/tid/artnet/pub/alert5.pdf.

55 Jyoti Bhutani, *FDI outflow of USD 15 billion seen in 2007; Manufacturing to lead the drive- A Report on FDI Outflow and role of manufacturing sector in the Mergers & Acquisitions front*, ASSOCHAM Eco Pulse Analysis, *available at* www.assocham.org/arb/aep/FDI-ouwards.doc.

56 Hereinafter ASSOCHAM.

57 United Nations Conference on Trade and Development (UNCTAD), 'World Investment Report 2011: NonEquity Modes of International Production and Development', United Nations, *available at* http://www.unctad-docs.org/files/UNCTAD-WIR2011-Full-en.pdf.

sufficient experience figures in. In its present form, the CFC law will only serve to throttle the corporate markets in India that has fortunately, been picking up slowly.

C. Impact On The M&A Market In India

It is believed that the "Introduction of CFC regulations would safeguard the interest of the revenue and prevent companies from accumulating profits in low-tax jurisdictions."[58] Corporate leaders have however, raised concerns that the CFC regulations are likely to operate to the detriment of the offshore activities of Indian corporations. Structures such as foreign subsidiaries serve as important means of finance for their Indian parents. With controls on raising capital in India, an ill-developed debt market, excessive reliance on equity financing and full capital account convertibility yet to see the light of the day, income parked in the foreign subsidiaries assumes an even larger role. It is observed that this income primarily finances the transnational merger and acquisition activities of Indian corporations, that are progressively riding up the figures.[59] The argument then follows that if this major source of finance is brutally taxed by the CFC rules, a significant decline in the offshore M&A activities by Indian companies is the natural outcome. Such an eventuality would not only contain the global competitiveness of the Indian corporate sector but their domestic operations are also likely to take a hit.[60] It has been observed in the United States that "Foreign investment that is triggered by foreign economic growth is associated with growing domestic capital accumulation, employment compensation and R & D…"[61]. Though such a survey has been hard to come by in India, it does not preclude the odds that growing foreign activity of Indian companies may result in increased domestic operations too, and the harsh CFC regime in its existent form might grind the grain with the chaff.

D. Reduce Corporate Tax Rate

As law and economics would predict, laws work better when the target group has an incentive to follow the law to its letter. A famous example of the reverse situation is the story of Aditya Birla of the Birla Group who shifted his expansion plans to Thailand and Indonesia owing to the red taped bureaucracy in India.[62] At an abstract level, the

58 Vijay Mathur Report; *supra* note 5.

59 *Deloitte sees Increase in M & A activity in India*, The Economic Times, September 20, 2010, *available at* http://articles.economictimes.indiatimes.com/2010-09-20/news/27600579_1_m-a-activity-cairn-energy-energy-sector; *See India Leads in Merger and Acquisition Deals*, NDTV Profit, August 23, 2010, *available at* http://profit.ndtv.com news/show/india-leads-in-merger-and-acquisition-deals-91165.

60 *See Will CFC Hurt India Inc's M & A Ambitions?* CNBC-TV18, *available at* http://thefirm.moneycontrol.com news_details.php?autono=466428. *See also Raining on India's Parade – What India Can Learn From Brazil About Controlling Capital Flows*, The Economist, October 29, 2009, *available at* http://www.economist.com/node/14753808?story_id=14753808.

61 *See* Mihir A. Desai, et al., *Domestic Effects of the Foreign Activities of U.S. Multinationals*, 1 American Economic Journal: Economic Policy 181 (2009).

62 *See* Gurcharan Das, India Unbound – From Independence to the Global Information Age 179-186. (2002).

CFC regime presents an extremely uncomfortable situation for Indian companies, who not only have to pay tax in the country of residence of the CFC (the low-tax jurisdiction), since the CFC regime takes precedence over any DTAA, but also face exorbitant corporate tax rates in India bordering on 30%, exclusive of surcharge.[63] In order to end deferral and incentivize repatriation of CFC profits, it is essential that the corporate tax rates in India be reduced for such deemed dividends. The Budget 2011-2012 took a positive step in this direction by halving the tax for deemed dividends from 30% to 15%. However, this incentive came packaged with a disincentive that distorts the desirable repatriation scenario. Presently, an Indian company which has incurred debt to invest in the foreign subsidiary can claim expenditure on interest as deduction against the taxable dividend income from such foreign subsidiary. However, the Budget 2011 removed this benefit for no comprehensible reason. There have been no changes regarding the same in the 2012 Budget and there remains a likelihood of increase in administrative costs besides a thwarting of the objectives behind a reduction in tax rate in the first place.[64]

E. Lack Of Foreign Tax Credit Provisions

It is undisputable that the power of taxation is a sovereign power of every state[65], and consequently, nations cannot dictate terms to one another in the framing of tax policy. A DTAA is a double taxation avoidance agreement or treaty between India and another country. Thus, a DTAA is bilateral in nature.

As mentioned earlier, the CFC regime in the DTC will override all DTAAs entered into between India and any other nation. The foreign corporations will be unable to avail of a safety net against double taxation. By superseding the DTAAs, the CFC rules allow the Indian government to unilaterally terminate a DTAA. These rules also allow a potential for double taxation to operate and thwart, if not paralyse, the functioning of the CFCs. In effect, the CFC rules foster the possibility of disturbing the international comity that the DTTAs sought to achieve.[66]

Assuming but not conceding that the CFC rules are the need of the hour in India, it is suggested that a system of foreign tax credits be put in place to cushion CFCs against the likelihood of double taxation. This is a how a tax credit would work: suppose company X is controlled from India and is a resident of country Y, a low tax jurisdiction. Its tax liability on its income in country Y is $100,000. Its tax liability on its 'deemed dividends' according to the CFC regime is $250,000, assuming Indian corporate tax rate

63 The corporate tax rate in Budget 2012 remains at 30% for domestic companies and 40% for foreign companies. The surcharge on income tax for companies with total income exceeding INR 10 million also remains at 5% for domestic companies and 2% for foreign companies.

64 The International Tax Team of Nishith Desai Associates, *India Budget Insights 2011-12*, *available at* http://www.indialawjournal.com/volume4/issue_1/india_budget.html.

65 Amrit Banaspati Co. Ltd. v State of Punjab, (1992) 2 SCC 411.

66 The magnitude of the problem is substantial as India has entered into DTAAs with 82 countries.

is higher than the rate in country Y. In the absence of a foreign tax credit provision, company X will have to shell out $100,000 in tax liability to country Y and $250,000 in tax liability to India. Its total tax liability for any financial year thus stands at $350,000. However, if tax paid by company X was allowed to be credited in India, in case of a full credit, company X pays only $150,000 ($250,000 - $100,000 [already paid to country Y]) as tax to India. The total tax liability of X would thus stand at $250,000, a full $100,000 less than if such tax was not allowed to be credited.

Such credits have been used in several jurisdictions to tackle the problem of double taxation.[67] Moreover, India can tweak the tax credit regime to suit its policy. This means that a choice is available from an array of systems of foreign tax credits that presently exist.

Foreign tax credits have often been criticized as forming an extremely complex set of rules, hard to administer and implement.[68] However, denying foreign tax credits "seems unduly to elevate simplicity over fairness."[69] The CFC rules, as proposed in the DTC, amount to what has been called confiscatory taxation[70], over-taxation and double taxation, and hence must be redeemed by the introduction of a foreign tax credit system.

Further, tax credit should also be allowed when the dividends, which have already been taxed under the CFC regime, are later actually paid to the resident Indian company.[71]

V. Effect Of The New Test For Residential Status Of A Company

Clause 4(3) of the DTC now provides that a company shall be considered to be an Indian resident if the place of its *effective management*, at any time in the financial year, is located in India.[72] Under Section 6 of the Income Tax Act, 1961, which is presently in force, a company is to be considered a resident in India if in the previous year, the *control and management* of its affairs is *wholly* situated in India. While an evaluation of the true import of the above clause is subject to judicial pronouncement,[73] it would not be unreasonable to assume that at least in some cases, *effective management* would be the same as *control and management* and in such cases; a CFC will be treated as an Indian company under the DTC. Needless to say, in that event, the CFC rules will lose their effect.

67 Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Non-Conforming Taxes*, 4 Fla. Tax Rev. 2, 84 (1999).

68 Charles I. Kingson, *The Foreign Tax Credit and its Critics*, 9 Am. J. Tax Pol'y 1 (1991).

69 John P. Staines, Jr., *Whether, When and How to Tax the Profits of Controlled Foreign Corporations*, in the *Symposium on International Tax Policy in the New Millennium, Panel III: U.S. Multinational and International Competitiveness*, 26 Brook.J. Int'l L. 1595 (2001).

70 Conversation with Manmohan Singh in V.N. Balasubramanyam, Conversations With Indian Economists 85 (2001).

71 See the OECD, Model Tax Convention on Income and Capital, Commentary on Article 10, ¶ 39.

72 The twofold test for determining the place of effective management is:
i. The place where decisions are madebythe executive directors or board of directors of the company. or
ii.The place where the board of directors routinely approve the commercial and strategic decisions which are made by the executive directors or office of the company. The Standing Committee on Finance has

VI. Applicability Of The GAAR

At this point, it is also expedient to note the interactions between the CFC regime and the General Anti-Avoidance Rule[74] which has been widely and most recently debated for its draconian measures. The GAAR codifies the rule of 'substance over form' which, for the determination of tax liability, accords significance to real intention of the parties to a transaction, effect of the transaction and the purpose of the arrangement rather than the sophisticated legal structure set up by the parties. Thus, 'impermissible avoidance arrangement'(s) which lack any commercial character and are entered into mainly for the purpose of obtaining tax benefits are hit by the GAAR. The GAAR thus incorporate provisions similar to the motive test as elaborated in the *Cadbury Schweppes* case. After the latest amendment in the Finance Bill 2012[75], the GAAR enjoys a limited override of the DTAAs except in cases of indirect transfers.[76] The burden of proof has been shifted back to the Revenue Department.[77] As a part of its most controversial and draconian feature, when a structure has been determined to be an 'impermissible avoidance arrangement', the GAAR grants wide discretionary powers to the tax authorities to re-characterize debt as equity and capital as revenue, relocate the place of residence of a party, the location of a transaction, and the situs of an asset to a place other than that provided in the arrangement, in addition to reallocating expenses and incomes between parties to a transaction.[78] The GAAR provisions are in addition to and in conjunction with other anti-avoidance measures that determine tax liability. Thus, it cannot be ruled out that both the CFC rules and the GAAR will become applicable to a CFC after the DTC is in force. That would be a double blow to the expansion plans of Indian companies and Indian businesses in general as they would be subject not only to an incomplete CFC regime but also to the vagaries of the tax authorities under the GAAR.

VIII. Role Of The Judiciary

As an expected consequence of the half-hearted attempt of the legislature in introducing the CFC regime, several provisions in the rules are vague and find no clarity

highlighted the problems assosicated with the 'place of effective management' test for determining the residence of a body corporate. One of the problems is that the above test does not take into account the decisions made by Independent Directors of a company. See Recommendations of the Standing Committee on Finance on the Direct Taxes Code Bill, 2010 (March 17, 2012) Nishith Desai Associates *available at* http://www.nishithdesai.com/Budget2012/Standing%20Committee%20Recommendations_Hotline.htm.

73 The concept of 'control and management' has been the subject of controversy in the Indian judiciary. *See* CIT v. Bank of China (in Liquidation), [1985] 23 Taxman 46 (Cal.), Narottam & Pereira Ltd. v CIT, [1953] 23 ITR 454 (Bom.).

74 Hereinafter GAAR.

75 The amendment was made on May 7, 2012. The implementation of the GAAR has been deferred to April 2013.

76 Nishith Desai Associates, *Antidote for Panic: FM Announces Delay of GAAR* (May 14, 2012), *available at* http://www.nishithdesai.com/New_Hotline/Tax/TAX%20HOTLINE_May1412.htm#b%23b.

77 *See Memorandum to the Finance Bill 2012: Provisions Relating to Direct Taxes, available at* http://indiabudget.nic.in/memo.asp.

78 *See Memorandum to the Finance Bill 2012: Provisions Relating to Direct Taxes*, http://indiabudget.nic.in/memo.asp.

within the DTC. For instance, expressions such as 'collective' exercise of influence, exercise influence so as to assert 'decisive influence', 'indirect' entitlement to shares, 'direct' and 'indirect' holding, and 'routinely' in the place of the effective management test have no explanations leaving the taxpayer uncertain about his tax liabilities. Adam Smith would not be the least bit happy about this obvious violation of the Canon of Certainty.[79] Further, the CFC regime only excludes a corporation carrying on active trade or business from the definition of a 'controlled foreign corporation' but does not recognize the international practice of excluding passive incomes derived from the active conduct of a trade or business such as transactions in insurance, banking, finance or incomes derived from certain securities transactions. The above coupled with the lack of foreign tax credits indicates that the CFC rules in the DTC come with insufficient exemptions, contrary to the established practice in jurisdictions such as the UK, Japan and even South Africa.[80]

A.The Motive Test

Another bone of contention with respect to the CFC rules is the motive test. In the UK, the matter of *Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [Cadbury Scweppes case] is an important ruling by the Grand Chamber of the European Court of Justice [ECJ]. The Cadbury Schweppes group established two subsidiaries in Dublin, Ireland in order to avail of the low tax rate regime [10% corporate tax rate as opposed to more than double that rate in the UK] in relation to profits from internal financing activities. When UK authorities demanded corporate tax, Cadbury Schweppes appealed to the ECJ. The Court ruled that "…the CFC rules could be justified where they were designed to restrict wholly artificial arrangements intended to escape the national tax normally payable".[81] Whether a CFC is a 'wholly artificial arrangement' is a determination based on objective factors. If a CFC was established or incorporated with the sole purpose of arbitraging tax laws among the Member States in the European Union, carries out no other economically productive activities and has no commercial presence otherwise, the CFC must be judged to be a 'wholly artificial arrangement'. However, CFC rules are not attracted where a CFC, active in its commercial sphere and carrying on genuine economic activities, seeks to take advantage of favourable tax regimes. Freedom of establishment[82] cannot be said to have been abused in such cases. Further, the Court ruled that CFC rules are also not attracted where a CFC satisfies the motive test according to which the parent resident UK company must show that reduction in tax by diversion of profits to the CFC or exploiting opportunities of

79 *See* Charles F. Bastable, *Canons of Taxation*, *in* PUBLIC FINANCE (1892), THE ONLINE LIBRARY OF LIBERTY, *available at* http://oll.libertyfund.or?option=com_staticxt&staticfile=show.php%3Ftitle=275&chapter=35256&lay out =html&It emid=27.

80 Nishith Desai Associates, DTC Global Think Tank, *supra* note 53.

81 Cadbury Schweppes case, *supra* note 50.

reduction in tax liability by resorting to low tax rate regimes was not the main reason for the incorporation of the CFC [thus bringing 'wholly artificial arrangements' within the purview of the CFC rules]. Later, the ECJ delivered a reasoned order[83] in *CFC GLO (C-201/05)* placing the burden of proof on the resident UK company to establish that it has not entered into a wholly artificial arrangement to avoid tax and that its activities in the foreign jurisdiction reflect economic reality or in other words, it carries on 'genuine economic activity' in the other Member State.[84] The Court of Appeal issued a similar ruling in *Vodafone 2 v HMRC*[85] noting that the new exception of 'genuine economic activity' could be read into the UK CFC rules. The concept of 'genuine economic activity', however, remains without sufficient elaboration.

The situation in the USA seems even more uncertain. The present CFC regime is vaguely worded and is subject to wide interpretations by the tax authorities. The US courts have been alternating between objective and subjective factors or a combination of both to determine if a transaction lacked economic substance and was a sham, and thus have failed to provide an encompassing legal standard.[86] More recently, in *Merck & Co. Inc. v United States,*[87] the Third Circuit Court merely applied the substance over form doctrine and did not consider it necessary to examine the economic substance of the transaction.

In the CFC regime incorporated under the DTC, the 'active trade or business' requirement comes closest to the motive test used by the courts in the UK and the US. The import of the phrase 'active trade or business' is only illustratively explained, and hence, the Indian courts will have to assume the responsibility of interpreting this (and many others outlined above) phrase on a transaction-by-transaction basis and suitably follow or reject the motive test as outlined by the practices of the courts in other jurisdictions. In the face of an incomplete legislation, an active role will have to be assumed by the Indian judiciary.

IX. Conclusion

This paper has attempted to understand and comment upon the probable impacts of the new CFC Rules under the Indian DTC, awaiting enforcement. Without a sufficiently

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82 Treaty Establishing the European Community [TEC], Article 43, 48.

83 Reasoned orders are issued in place of a judgment when the Court has already ruled on an identical question.

84 *See* Tom O'Shea, *ECJ Clarifies Issues Raised in Connection with U.K. Dividend Tax, CFC Rules*, May 20, 2008, *available at* http://www.ccls.qmul.ac.uk/docs/staff/oshea/52231.pdf.

85 [2009] STC 1480 (CA).

86 *See* David Myers, *supra* note 30 citing Packard v Commissioner 85 T.C. 397 (1985) [subjective factors in determining the taxpayer's motive]; Rose v Commissioner, 88 T.C. 386 (1987) [combination of both subjective and objective factors used].

87 No. 10–2775. 2011.

detailed study and data analysis, it is almost impossible to conclude whether or not India can do without a CFC regime. Yet, an alternative to the CFC regime might be a framework where it can be made mandatory for Indian shareholders (and controllers) of a CFC, to include in their taxable income, the income that has attributed to them by virtue of their shareholding in such foreign corporation, but has not been distributed as dividends. A similar framework exists in the US Passive Foreign Investment Company Rules. It is also worthy of note here that such a regime would in effect, bear the same outcome as the imputation system for active income discussed earlier. The law would thus, play a role not at the frontier but from the barracks and would shift the cost of the undistributed dividends on to the shareholders rather than the CFC. This shift is likely to push the shareholders towards the receiving end of the law and would thus, provide them with an incentive to take necessary internal actions to minimize or eliminate this new cost by inducing the CFC to repatriate its profits to India.

It is essential to realize the distinction between an economy that has upgraded to making outbound investments on a large scale and an economy that is only slowly but progressively increasing outbound investments. It is urged that the Indian legislators must study the market pattern for a few years to get a good grip over the facts. They will then be in a better position to determine whether CFC rules are required in India in the first place.[88] This strategy is better than unleashing a badly written law and then making regular amendments to it, through infinite circulars and notifications as the Central Board of Direct Taxes[89] is wont to do, as more facts reveal themselves. Without fact-based evidence, the CFC rules are at best, a premature attempt to tackle a problem of whose existence one isn't even sure of.

On the other hand, irrespective of whether the CFC rules are intended to be introduced as a measure of abundant caution or whether India is in a hurry to match up its tax policy to international practice, the task must not be left incomplete at the very first stage. Foreign tax credits have been unexplainably left out of the CFC regime and must be included at the earliest. The international scenario supports this suggestion too. The content and structure of the tax credit apparatus is best left to the Indian policy makers and is beyond the scope of this paper. However, the absence of such tax credits altogether from the framework of the law is an uncomfortable, even an unjust situation for the taxpayers and flies in the face of one of the sacred canons of taxation, i.e. convenience.[90] Additionally, provisions that can cushion the Indian companies against the hard strike of the CFC law, merit consideration. Such provisions can include brief exemptions for certain intra-group activities,[91] for instance, an acceptable distribution range of profits where the foreign corporation would be exempt from CFC rules if it distributes 80% of profits in 2 years; and *sui generis* mechanisms.

88 Declan Gavin, *supra* note 19.

89 CBDT is the Indian Government body that monitors and regulates the collection of direct taxes in India.

At this point, the words of the famous economist John Maynard Keynes in the context of the National Industrial Recovery Act[92] seem rather well placed:

"The Act is on the Statute Book; a considerable amount has been done towards implementing it; but *it might be better for the present to allow experience to accumulate before trying to force through all its details*. That is my first reflection—that (N.I.R.A., which is essentially Reform and probably impedes Recovery), *has been put across too hastily*, in the false guise of being part of the technique of (Recovery) [added emphasis]."[93]

90 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, (1776).

91 As is to be incorporated in the UK CFC law discussed earlier.

92 Act of June 16, 1933 (Ch. 90, 48 Stat. 195, formerly codified at 15 U.S.C. sec. 703). This legislation established a national public works program and authorized the US President to regulate industry, permit cartels and monopolies. The legislation sought to stimulate economic recovery in the aftermath of the Great Depression.

93 John Maynard Keynes, *An Open Letter to President Roosevelt*, *available at* http://newdeal.feri.org/misc/keynes2.htm