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Is Round-Tripping Illegal in India?

Swaranjali Yadav^a

^aAmity Law School, Noida, India

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Globalization, in the year 1991, opened the door to rapid growth and development in India. Foreign Direct Investment played a big role in growing India's economy. However, with the positives, many negatives also entered the Indian Territory. One such problem was the ease of evading taxes. The following article seeks to understand one of such methods of evading tax in India in the guise of Foreign Direct Investment, known as round-tripping. It seeks to understand the legality of the process and its structures by exploring what round-tripping is, what regulations are in place related to round-tripping, some recent developments that have taken place (RBI's actions), and what improvements can be done to handle the problem better.

Keywords: *tax evasion, round-tripping, international taxation law.*

INTRODUCTION

Dr. B. R. Ambedkar had once said, "History shows that where ethics and economics come in conflict, victory is always with economics. Vested interests have never been known to have willingly divested themselves unless there was sufficient force to compel them". Currently, the Indian economy is infested with the problem of Tax evasion. It is an economic offense that is categorized as a crime in India. According to a report published by the State of Tax Justice in 2020, due to international corporate and domestic tax abuse, India loses more than \$10 million

annually.¹ Round tripping is one of such many tax evasion methods which is done by domestic companies in collusion with a foreign entity to evade tax and manipulate investors. However, round-tripping is not always done to evade tax. This warrants the need to look deeper into what round-tripping is and how it is regulated in India.

ROUND TRIPPING EXPLAINED

Round-tripping is a phenomenon where capital flows out of the country to a tax haven country and then back to the original place, posing as foreign investment. This process usually does not have any commercial use and is used to evade taxes, manipulate investors into thinking that the company is doing a lot of business, and convert black money into white money. The businesses usually establish an entity outside the jurisdiction of India for this purpose, which is known as 'Round-Tripping Structures' or 'ODI- FDI Structures'.² Let us take an example. 'X' is in the business of making furniture and he lives in India. He sells some of his furniture to an entity in Mauritius named 'Y' and buys it back after a year for the same price (India has a DTAA with Mauritius). This is called round-tripping since there was no commercial purpose for this transaction and it was done only to obtain tax benefits since Mauritius does not tax capital gains. Now, in the same example, if 'X' sells his furniture to an entity in Mauritius named 'Y', and then later buys some furniture from 'Y' which is made of some special quality wood, then it will not be considered as round-tripping. Here, the transaction has a commercial purpose, that of obtaining furniture made of special quality wood. It was not done solely to evade tax. The most commonly used method of round-tripping in India is by way of gift. A third party would usually incorporate an entity in a tax haven country and then gift it to the company in India.³ The foreign entity would then raise enough money to buy the company in India. This structure is known as a SPAC or Special

¹ 'Tax Evasion: India Losing Over \$10.3 Billion Every Year' (*Business Today*, 21 November 2020) <<https://www.businesstoday.in/latest/economy-politics/story/india-losing-103-bn-every-year-due-to-tax-abuse-by-mnecs-evasion-279314-2020-11-21>> accessed 05 March 2022

² 'RBI Regulations on Offshore Investments' (*The Hindu Business Line*, 31 October 2021) <<https://www.thehindubusinessline.com/business-laws/rbi-regulations-on-offshore-investments/article64355771.ece>> accessed 06 March 2022

³ Payaswini Upadhyay, 'RBI to Tighten Rules on ODI, Ease Up On Round- Tripping' (*Bloomberg Quint*, 4 September 2021) <<https://www.bloombergquint.com/law-and-policy/rbi-tightens-rules-on-overseas-direct-investment-but-goes-soft-on-round-tripping>> accessed 07 March 2022

Purpose Acquisition Company. To facilitate such transactions, the existence of tax havens is very essential, but why and how are they created? FDI is important for every country as it leads to the multifaceted development of the economy. It is especially favored by developing countries because it generates employment, leads to sharing of technological and other knowledge which benefits the organization in the long run, contributes to the GDP of the country, and has many other positive effects that aid in the growth of the company and ultimately the country. This can lead to a race among nations for creating the most suitable climate for investment in their countries by offering them tax benefits, ease of incorporation, sufficient intellectual property protection, etc. When taken to extremes, these eventually turn into tax havens for such companies. The companies divide their operations and conduct some of these in different jurisdictions, usually tax havens. For this, they incorporate SPAC. Round-tripping does not help in the development of the economy in any way. It is only done for taking advantage of tax benefits and to manipulate investors into thinking that the company is doing a lot of business. There is no sharing of technical know-how or generation of jobs.

However, companies in some developing economies may use it to utilize opportunities that may be offered in other countries and are not provided by theirs. It may be because of the laws that are still backward and do not foster a healthy environment for the development of a company in that country. The countries may opt for round-tripping also when their home countries have excessive control over such companies hindering their development. Therefore, round-tripping is not always done with mala fide intentions. In light of this, let us understand if India has declared round-tripping to be illegal, and if not, then how it regulates it.

REGULATIONS TO CURB ROUND-TRIPPING IN INDIA

Round-tripping has not been expressly declared to be illegal, however, there are certain regulations in place which seek to handle all tax avoidance matters (including round-tripping). “Chapter XA” of the “Income Tax Act, 1961” entails provisions relating to the “General Anti-Avoidance Rule” (Section 95- 102) which came into force in 2017.⁴ Section 96 and 97 are the most relevant sections related to round-tripping. Section 96 states that when the transaction

⁴ Income Tax Act, 1961, s 95-102

“lacks commercial substance” and “the main object of which is to obtain tax benefit” then such transaction shall be known as an “Impermissible avoidance arrangement”.⁵Section 97 states that a transaction shall be considered to “lack commercial substance” if it involves “round-trip financing”.⁶ The section further defines “round-trip financing” as a “series of transactions” in which “funds are transferred among the parties to the arrangement” and “such transactions do not have any substantial commercial purpose other than obtaining tax benefit”.⁷Accordingly, if found guilty under these sections, the assessee may be penalized according to the relevant sections of the “Income Tax Act, 1961” (Section 270A and 270B)⁸.

RECENT DEVELOPMENTS

The process of round-tripping is incomplete without a tax haven country. In India’s case, it was Mauritius. India and Mauritius signed a Double Tax Avoidance Agreement (DTAA) in 1983 in which a Mauritian could sell his shares in an Indian company and he will only be taxed in Mauritius for the transaction.⁹DTAAs are signed between countries to protect companies from being taxed twice and to allow ease of business for such companies. However, in Mauritius’ case, capital gains were not taxed.¹⁰ This allowed the companies to avoid taxes altogether and allowed round-tripping to foster. After a long time of companies taking advantage of the Agreement, India decided to amend the Agreement in 2016 by taxing any capital entering India from an entity registered in Mauritius. Around the same time, GAAR was also introduced in the Income Tax Act of 1961. Subsequently, India and, specifically RBI, decided that it was time to provide more clarity on the regulation of round-tripping. RBI, in 2019, elucidated its position on round-tripping according to which Indians were allowed to conduct these kinds of transactions with foreign entities only after getting the nod from the

⁵ Income Tax Act, 1961, s 96

⁶ Income Tax Act, 1961, s 97

⁷ *Ibid*

⁸ Income Tax Act, 1961, s 207A and 207B

⁹ DilekAykut, ApurvaSanghi, & Gina Kosmidou, ‘What To Do When Foreign Direct Investment Is Not Direct or Foreign: FDI Round Tripping’ (*Open Knowledge Repository*, April 2017)

<<https://openknowledge.worldbank.org/handle/10986/26498>> accessed 07 March 2022

¹⁰*Ibid*

RBI.¹¹ Although this provided some semblance of clarity on RBI's take on round-tripping, it was not enough to regulate it. Therefore, recently they came up with a draft foreign Exchange Management (Non-debt Instruments-Overseas Investment) Rules, 2021.¹² The rules unlike the present ODI regulations deal with the problem of round-tripping however it does not define it. These rules take a more lenient view as compared to the views of the RBI as expressed in the FAQs. The rules allow such ODI- FDI structures to exist and operate if their main purpose of existence is anything other than escaping tax. As discussed earlier, most of the round-tripping transactions in India take place via the route of gifts which is also allowed under the present FEMA Rules. However, these rules seek to curb that, by allowing only the relatives (as defined under the Companies Act, 2013) residing outside India to make such gifts.¹³ The rules seek to exercise more control over the flow of money in and out of India. They state that if the voting share of an Indian entity in a foreign entity is more than 10% then it is ODI and if it is less than 10% then it will be OPI (Overseas Portfolio Investment).¹⁴ The rules also propose that the RBI will closely monitor the investments in foreign entities (which will be categorized as ODI) that are not listed. It can be implied that RBI will keep a check on the capital leaving the country in the form of investments in foreign entities, especially those that qualify as ODI. The rules have not yet come into effect, however, it is important to analyze the effectiveness of these rules and look into other possible solutions to the problem of round-tripping.

CRITICAL ANALYSIS

India has dealt with the problem of round-tripping for a long time. It has tried to regulate it but in vain. Here, banning the process altogether does not seem to be the solution as it would drive companies further away from doing business in India, as was seen in the case with Mauritius. Amending the DTAA with Mauritius did not change much since India has similar Agreements with other countries as well, such as Singapore and Cyprus. So, the companies just relocated their operation to a different country. However, DTAA can be used positively to curb such practices. For example, the whole foundation of round-tripping is based on the

¹¹ RBI Regulations on Offshore Investments (n 2)

¹² *Ibid*

¹³ Payaswini Upadhyay (n 3)

¹⁴ *Ibid*

secrecy of the assessee which may be protected by the foreign state. The agreements can be amended to disclose the identity of such persons or entities as and when required by the other party as was done in India's DTAA with Switzerland. India can also utilize other existing regulatory norms effectively to detect the real nature of such transactions, for example, the KYC requirements of FPIs (Foreign Portfolio Investors) asked for by SEBI. The draft rules are a good step forward in regulating round-tripping. The rules do not take a strict stand against round-tripping and prohibit it only if it is done to evade tax. However, the Act does not clarify which transactions will qualify as those done to evade taxes and who shall have the authority to determine the same.¹⁵ The Base Erosion and Profit Shifting (BEPS) initiated by the OECD can also bring a positive change regarding this issue if implemented by all the countries effectively. BEPS refers to the relocation of capital by companies to tax haven countries, to evade taxes in their home country, which in turn causes a loss of taxes to the home country. Action No. 6 of the Project advises countries to amend the Agreements such as DTAA to prevent Treat- Shopping.¹⁶ This has already been implemented by India in the case of Mauritius and Switzerland. However, India needs to apply this across all such Agreements with other countries. India is currently at 63rd position on the Ease of Doing Business ranking.¹⁷ Although India has improved by 23 positions, it can still work to focus on improving its position in the global ranking and foster a healthy environment for the growth of companies so that they don't have to look for other places to shift.

CONCLUSION

It can be drawn from the above discussions that round-tripping is not illegal in India, however, India does seek to regulate it. As we have already seen, banning the round-tripping

¹⁵ 'Making Overseas Investments Simpler' (*Financial Express*, 30 August 2021)

<<https://www.financialexpress.com/opinion/making-overseas-investments-simpler/2319970/>> accessed 07 March 2022

¹⁶G. Sampath, 'The Hidden Wealth Of Nations' (*The Hindu*, 4 December 2021)

<<https://www.thehindu.com/opinion/lead/Black-money-the-hidden-wealth-of-nations/article62116050.ece>> accessed 08 March 2022

¹⁷ 'India Improves Rank By 23 Positions in Ease Of Doing Business' (*Press Information Bureau*, 31 October 2018)

<<https://pib.gov.in/newsite/PrintRelease.aspx?relid=184513#:~:text=India%20Improves%20Rank%20by%2023%20Positions%20in%20Ease%20of%20Doing%20Business&text=The%20World%20Bank%20released%20its,assessed%20by%20the%20World%20Bank>> accessed 07 March 2022

structures may prove to be counterproductive, so it was a wise decision to regulate them instead. On the regulation front, India needs to do a better job. For Instance, RBI should bring the draft rules into effect and monitor its implementation closely to make improvements and reduce round-tripping done to evade taxes. India should also seek global cooperation through the BEPS project to curb this menace. It is also important to recognize India's Ease of Doing Business ranking and focus on improving it to attract more businesses to operate in India. Therefore, even though India has made significant gains in recent years in terms of regulation of round-tripping structures, it needs to be more proactive in this regard.