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GAAR Horizon: Strategy for tapping the Untapped

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As the traditional Indian tax regime has been unable to fully swathe its loop holes, assesses in the form of individuals as well as corporate organisations have successfully capitalized by finding new means to evade tax. GAAR is the shotgun approach of the tax legislators attempting to cover a wide range of tax avoidance practices.
General anti-avoidance rules (GAAR) provides that where an enterprise enters into arrangement without a reasonable commercial purpose and with a sole or dominant purpose of obtaining a tax benefit, the tax authorities can disregard the existing arrangement and make an adjustment using appropriate methods.These rules empower the Commissioner to hold any business arrangement as an "impermissible avoidance arrangement" if certain conditions are met.
In case of the Vodafone-Hutchison merchandise this tactic came into spotlight. The urgency for structuring legislature to control the tax evasion tactic was conceived and therefore in the year 2009 along with Direct Tax Code our government promenaded towards General Anti Avoidance Rule (GAAR).
This paper concentrates on when GAAR will be invoked; will Participatory Note (P-notes) be subject to GAAR, FII's attract GAAR, GAAR provisions override India's tax treaties and lastly clarify provisions to protect taxpayers from harassment.
With the emergence of GAAR, our Indian tax system will be at the threshold of a paradigm shift, GAAR tactics will attempt to bring about structural changes in the Indian tax system.
Key Words: GAAR, Tax evasion, Income Tax, Participatory notes, Investment, FII's

Background

Vodafone-Hutchison merchandise was the alarming call for the government to propose GAAR policy. Apex Court during the Vodafone issue discussed 3 landmark cases to ascertain the situation:

- In English case IRC v Duke of Westminster [1] it was held that it is the taxpayer's legal right to attract least amount of tax and it will construe a situation of tax avoidance. Thus, declaring that tax avoidance is different from tax evasion.
- In McDowell & Co. V. CTO [2] theHonourable court held that tax avoidance is bad. The case blurred between the provisions of tax avoidance and tax evasion.
- In Union of India v. AzadiBachaoAndodal [3], the honorable court while disagreeing the judgment of McDowell case held that tax avoidance is valid and legally right provided that the scheme is within the parameters of law.

Supreme Court overruling the judgment of Bombay High Court held that principles lead down in AzadiBachaoAndolan were correct and court while judging such situation should give priority to legal form of the transaction and that in application of judicial anti-avoidance rule, the revenue may invoke the "substance over form" principle or "piercing the corporate veil" principle only after it is able to establish on the basis of the facts and surrounding the transaction that the impugned transaction is a sham or tax avoidant. The observations of Supreme Court in the context of Anti-Avoidance are also in line with Canada Supreme Court ruling on GAAR.

Need for GAAR

There is a difference between Tax Evasion, Tax Mitigation and Tax Avoidance. Tax Mitigation is permitted by Law; it means to apply provisions of law to minimize effect of Taxation within four corners of law and hence permitted. Tax Evasion is completely outside the ambit of Tax Law and hence not permitted. Tax avoidance is restructuring financial position of an individual or entity in such a way as to lower its Income tax liability. GAAR is targeted at curbing the practice of 'Tax Avoidance'. In other words GAAR prohibits structures or deals only aimed at avoiding tax.

Introduction

The methods adopted to reduce the tax liability can be broadly put into four categories: "Tax Evasion", "Tax Avoidance", "Tax Mitigation" and "Tax Planning". The difference between these four methods sometimes becomes blurred owing to the perception of the tax authorities and / or tax payer.

Point of Difference	**Tax Planning**	**Tax Avoidance**	**Tax Mitigation**	**Tax Evasion**
Meaning	Logical analysis of a financial situation or plan from a tax perspective, to align financial goals with tax efficiency planning.	Legal means so as to avoid or reduce tax liability, which would be otherwise incurred, by taking advantage of some provision or lack of provision in the law.	It is a situation where the taxpayer takes advantage of a fiscal incentive afforded to him by the tax legislation by actually submitting to the conditions and economic consequences that the particular tax legislation entails.	Illegal arrangements where liability to tax is hidden or ignored.
Outcome	1. Reducing taxable income 2.Deferring payment of taxes to the extent possible	Legal exploitation of tax laws to one‘s own advantage.	It may be considered as getting the best possible deal available within the law.	Tax payer pays less than he is legally obligated or pays by hiding income or information from tax authority.
Status	Legal	Legal	Legal	Illegal and fraudulent means
Examples	Taxpayer can plan investment in a manner so that overall return is optimum.	Individuals who contribute to employer-sponsored retirement plans with pre-tax funds.	Setting up of a business undertaking by a tax payer in a specified area such as Special Economic Zone (SEZ).	Substantially understating your taxes (by stating a tax amount on your return which is less than the amount owed for the income you reported).

The above four terms certainly cover four different set of situations, there is a very thin line between these four terms.

Proposed GAAR is based on the doctrine of "substance over form" which means that the tax authorities ignore the legal form of an arrangement and they look into its actual substance to prevent artificial structures form being used for tax avoidance purposes. The draft GAAR guidelines have explained with the help of examples how certain transactions would be construed as cases of tax avoidance and would attract GAAR provisions. Some of these indicative transactions are -

i. If the taxpayer avoids distribution of profits to evade dividend distribution tax; and repatriates such profits by way of buyback of shares from a shareholder in a favourable jurisdiction to benefit from non taxation of capital gains under the treaty, the arrangement will be considered as impermissible and GAAR would be invoked. This example is similar to the AAR ruling in the case of OTIS Elevators
ii. An arrangement involving finalizing loan from one country and assigning it to another country to avoid withholding provisions is a tax avoidance arrangement to be subjected to GAAR provisions.
iii. An arrangement involving splitting of a transaction into several parts to ensure that the threshold limit for taxability is not exceeded is a tax avoidance arrangement to be subjected to GAAR provisions.
iv. If a foreign company interposes another company for investing into India to take advantage of treaty benefit, GAAR would be applicable since direct transfer of shares by the foreign company would have attracted capital gains in India read with the relevant treaty of foreign company's residence.

GAAR and SAAR

Anti Avoidance Rules are broadly divided into two categories namely "General" and "Specific". Thus, legislation dealing with "General" rules are termed as GAAR, whereas legislation dealing with "Specific avoidance are termed as "SAAR"

SAAR have many points to its favour, since its specific there is no scope of confusion, it doesn't provide taxation authorities any discretion and from the point of view of tax payer it provides certainty regarding the nature of his arrangement. Provisions of SAAR are there in Chapter X of the Income Tax Act 1961 and some of the provisions pertaining to SAAR are in various other chapters of Income Tax Act.

Under the Code, **GAAR** will be invoked if the following **conditions** are satisfied:

The taxpayer should have entered into an arrangement with the main to obtain a tax benefit and the arrangement;

- has been entered into, or carried out, in a manner not normally employed for bonafide business purposes.
- has created rights and obligations which would not normally be created between persons dealing at arm’s length.
- results, directly or indirectly, in the misuse or abuse of the provisions of this Code or;
- lacks commercial substance, in whole or in part

Recommendations of the Shome Committee

Committee headed by tax expert ParthasarathiShome, was set up by the government to undertake more widespread stakeholder consultations to finalize the guidelines for GAAR and the road map for its implementation. The committee is expected to bring transparency and a high degree of technical expertise to the consultation process.

Recently this committee has submitted two reports on GAAR and retrospective amendments relating to indirect transfers.

Major recommendations are as follows;

1) A threshold of Rs 3 crores of tax benefit has been fixed for setting in GAAR. It also suggested that GAAR should not be invoked in intra-group transactions.
2) Foreign investment made before August 30, 2010 excluded from clutches of GAAR.
3) GAAR would not apply on non-resident foreign institutional investors and those who don’t take tax benefit under a treaty. Investors availing of benefits under **Section 90 or 90A of the I-T Act** (which provides relief from double taxation under a treaty) would be **covered** under GAAR. But those investing in stock markets through instruments like participatory notes would be out of the ambit.
4) Some income shall not get taxed twice under the GAAR regime; advance ruling can be sought on applicability of GAAR to an arrangement.
5) In a breather to foreign investors, especially those coming via Mauritius, the government deferred the controversial General Anti-Avoidance Rules (GAAR) by two years, making the norms effective from the 2016-17 assessment year. Those coming under Indo-Singapore tax treaty and having tax residency certificates from Mauritius would escape GAAR.
6) It also recommended that where the circular number 789 of 2000 with respect to Mauritius is applicable, the GAAR provisions should not be applied to examine the genuineness of the residency of an entity set up in that country.
7) Noting that there are number of pending tax disputes over indirect transfer, the panels said this is also a matter that needs to be addressed.
8) On retrospective amendments committee said that the provisions "should be applied prospectively".

HighlightsGAAR

A. *P-notes*

The application of General Anti-Avoidance Rule (GAAR) will be valid only if P-notes fail to meet one in four tests. The tests include Lack of Commercial Purpose, Bonafide Purpose Test, Misuse & Abuse and Abnormality

B. *FIIs*

GAAR provisions will not apply to non-resident investors who have invested in the FIIs provided such investment has an underlying asset in the form of investment in listed securities. And GAAR will not apply when a FII chooses to be governed by domestic law against the applicable treaty.

C. *Override India's tax treaties*

If any arrangement is found to be impermissible under GAAR, it will be denied treaty benefits.This essentially means treaty benefits will be available to residents of the country and not those who use to route to save tax.

D. *Transaction coming through Mauritius will be taxed?*

GAAR will be invoked only if a company is found setting up plant in a country that has a DTAA with India for the purpose of tax avoidance.

GAAR can over-ride bilateral tax treaties, but genuine residents can claim treaty benefits. Government's decision on GAAR is silent on if Mauritius investors with a tax residency certificate will be treated as a Mauritius resident. So investors routing their investments through Mauritius to avail tax benefit will face Damocles' sword in new GAAR regime.

E. *Grandfathering*

To protect the existing arrangements they will be grandfathered. Grandfather clause is a situation whereby an old rule continues to apply to old existing situations, while the new rule will applies to all the future situations. Thereby ensuring the current transactions are not disturbed by introduction of GAAR. This also provides an important safeguard to the present investors and parties who have their interest in the money market.

Criticism of GAAR

Many provisions of GAAR have been criticized by various people. However, the basic criticism of GAAR provisions is that it is considered to be too sweeping in nature and there was a fear (considering poor record of IT authorities in India) that Assessing Officers will apply these provisions in a routine manner (or misuse) and harass the general honest tax payer too. Also,GAAR provides that the Commissioner Income Tax will have the power to look into a business arrangement or a transaction and declare it to be 'impermissible avoidance arrangement' and thereby denying tax benefits to the parties. GAAR borrows this provision from the South African model of GAAR where the post of Commissioner is very high but in India we have more superior positions than that of Commissioner and also to be noted here is that we have more than 700 Commissioners.
GAAR alsoprovides for denial of exemption for capital market transactions and it was not taken well by the investors and hence, it proved to be a let-down for the FII community. It had a negative impact on the investments in India as investors sold off their investments which lead to the crash of stock markets. Tough some comfort is provided through safe harbor rules applicable to the FIIs, provided payment of domestic taxes is made, further it is desirable to have a simple provisions of GAAR which can be applied for all portfolio investments including the FIIs and promissory note holders.

Provisions to protect taxpayers from harassment

1. Assessing officer will be required to issue a show cause notice stating reasons for invoking GAAR.
2. Taxpayer will have an opportunity to put its case before the officer.
3. The three member panel that will finally approve GAAR will have only one income tax official.
4. There will be a mechanism of obtaining advance ruling whether an arrangement is permissible or not.
5. Time limits will be prescribed for various authorities under GAAR.
6. GAAR will apply only when tax benefit exceeds Rs 3 crore.
7. Same income will not be taxed twice by invoking GAAR.
8. Where SAAR and GAAR both apply, only one will be invoked where only a part of an arrangement impermissible GAAR will apply to only that part.

Mauritius defence Plan

Mauritius, the 2,000-sq-km island nation in the Indian Ocean with a population of less than 1.5 million, is one of the top tourist destinations worldwide. The foreign direct investment (FDI) that is made from there into India is quite substantial. As per the latest statistics, about 40% of India's annual FDI of about $23 billion comes from Mauritius; next on the list is Singapore, from where around 10% comes. An astronomical sum, $75 billion, has flown into India from Mauritius as FDI between April 2000 and July 2013. Similarly, for investments by foreign institutional investors (FIIs) in India, the share of Mauritius is again significantly high. The key reason for this is the well-known capital gains tax exemption accorded to foreign investors under the India-Mauritius Tax Treaty.

For many years now, the Indian revenue authorities have been closely monitoring the flurry of investments from Mauritius from a tax avoidance and treaty shopping perspective. The crux of Revenue's argument is that the investments are routed by foreign investors through conduit vehicles formed in Mauritius merely to claim tax treaty benefits. With the Indian General Anti-Avoidance Rules (GAAR) slated to come into force in April 2015, the issue of demonstrating substance in Mauritius entities is bound to become more prominent.

Interestingly, the Financial Services Commission (FSC) in Mauritius has now proposed certain amendments in the Mauritius law to prescribe additional economic substance requirements by Category 1 Global Business Companies (GBC1 Companies). In case theserequirements are not complied with, it is provided that a Tax Residency Certificate (TRC) will not be issued to such entities. This becomes relevant from an Indian standpoint since the Indian income-tax law now provides that a foreign company is mandatorily required to obtain a TRC from the government of its home country in order to avail the benefits of a tax treaty.

The additional requirements laid down by FSC for the substance criteria, i.e. being regarded as 'managed and controlled' in Mauritius, are:

- A minimum of two directors are required to be resident in Mauritius, and be of sufficient caliber to exercise independent judgment. The directors are now required to be 'appropriately qualified'.
- If the GBC1 Company is authorized/licensed as a collective investment scheme, closed-end fund or external pension scheme, it would have to be administered from Mauritius.
- In addition to the above, the GBC1 Company is also required to satisfy at least one of the following specified requirements:
  - Have office premises in Mauritius.
  - Employ, on a full-time basis, at least one person who is resident of Mauritius.
  - Hold assets of at least $100,000 in Mauritius.
  - Have its shares listed on a securities exchange licensed by the FSC.
  - Constitution of GBC1 Company should contain a clause whereby all disputes arising out of the constitution shall be resolved by way of arbitration in Mauritius.
  - Incur a yearly expenditure in Mauritius, which can be reasonably expected from any similar company controlled and managed from Mauritius. The onus to satisfy the FSC that its level of expenditure in Mauritius is reasonable would be on the GBC1 Company. Factors to be considered for deciding whether the level of expenditure is reasonable include the type of activity of the corporation, its average turnover, the country(ies) in which it conducts business, the value of its net assets and the industry average.

Interestingly, the amendments provide for a leeway in a situation where if a group has more than one entity registered as GBC1 Company in Mauritius, all group companies would be deemed to be compliant if any one group company is compliant.

The FSC has stated that these additional requirements are to be complied on and from January 1, 2015, which incidentally is just prior to the trigger date of the Indian GAAR. Though not formally stated, it appears that the amendments have been proposed to negate a possible GAAR enquiry from Indian authorities on the Mauritian entities.

Future for GAAR

The draft may be viewed as a first step towards implementing a more balanced and reasonable GAAR. However, a lot more work still needs to be done so that GAAR is implemented in a manner that provides certainty to investors. It is important for the policy-makers to clarify that GAAR aims to target artificial and abusive tax avoidance schemes that, because they are often complex and/or novel, could not have been contemplated directly when formulating the tax legislation. In such cases GAAR may be applied to counteract, on a just and reasonable basis, the tax advantage that would otherwise be obtained. The GAAR should have a narrow application and should not affect the centre ground of tax planning.

It has often been felt by the business community that a more broad-based consultation process is required before implementing GAAR in India.

Although the GAAR has yet to be implemented, it will have a far-reaching impact and would affect every taxpayer including investors, multinationals and Indian business houses. Hence, taxpayers readiness towards GAAR would depend on various factorssuch as its implications, particularly for all structuring and transactions being undertaken, as well as in respect of existing arrangements, structures and business models.

Conclusion

The guidelines on interplay of Specific Avoidance Rules and GAAR will aid sensible application. Recognizing factors such as an arrangement's duration, tax payments, exit route for holistic assessment of an arrangement under GAAR will provide weight to 'substance' and 'motive'. In a major relief, the Government clarified that foreign institutional investors (FIIs) not claiming tax treaty reliefs and their non-resident investors contributing through participatory notes via FII route would not come under the purview of GAAR. Now, it is for FIIs to carry out a cost-benefit analysis of claiming a tax treaty relief vis-à-vis staying clear of GAAR and consequent litigation.

Setting an Rs 3-crore monetary threshold will entice small-timers, but it is too low a benchmark for investors with a high risk-appetite and huge investments. Good or bad, now tax administrators and taxpayers would know their tolerance limits.

Robust and careful documentation and an eye on commercials will prove the cornerstones for all investment structures of the future & this will be a milestone in sustainable practice of Indian tax regime.

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