A Research Paper on

General Anti-Avoidance Rule (GAAR)

&

Impacts and Implications

As a Term Paper for 1st Quarter for
Post Graduate Program in Financial Markets

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“SUBVERT THE PARADIGM”

Thank you for all your support!!!
INTRODUCTION

General Anti-Avoidance Rule (GAAR) introduced by the Finance Act, 2012 is applied to deny tax treaty benefits to non-residents taxpayers who would otherwise be entitled to them through improper use of treaty provisions.

Under Indian GAAR, an arrangement whose main purpose or one of the main purposes is to obtain a tax benefit and which satisfies certain prescribed conditions such as lack of commercial substance, abuse of treaty provisions, etc would qualify as an impermissible avoidance arrangement on which GAAR could be applicable.

The tax effect of such impermissible avoidance arrangements is to be determined by the Indian Revenue Authority (‘IRA’) in any manner it sees appropriate, which would include disregarding or combining or re-characterising any step / parties in the arrangement, ignoring the arrangement, re-allocation of income and expenses, re-characterising equity as debt and vice versa, re-locating the place of residence of any party or suits of an asset, etc.

Tax avoided is considered as tax evaded. GAAR can be made applicable in dealing with potential misuse of treaties and can override the provisions of a tax treaty in situations involving treaty shopping. Treaty shopping is subject to GAAR.

Doctrine of ‘substance over form’ codified to deter tax avoidance.

No carve out for genuine tax planning:

- Trigger for GAAR - main purpose or one of the main purpose is to obtain ‘tax benefit’.

Authority of Advance Rulings (‘AAR’) may be approached for determining applicability of GAAR.

Onus to prove that transaction meant to obtain a tax benefit on the Indian Revenue Authorities (‘IRA’).

GAAR panel to approve the application of GAAR.

If GAAR invoked, Revenue empowered inter-alia to:

- ‘disregard’ or ‘combine’ any step in the arrangement.
- look through the arrangement by disregarding the corporate structure.
- ‘re-allocate’ income/ expense, ‘re-characterize’ equity into debt or debt into equity.
- treat the place of residence of any party or part of an asset or transaction other than place or location mentioned in the arrangement.

Draft Guidelines issued by Chairman, Central Board of Direct Taxes (‘CBDT’) to give recommendations and suggest safeguards for proper implementation of GAAR.

The Draft Guidelines give a sneak preview into the mindset of the IRA.

The legality of the Draft Guidelines can be questioned as they propose to overrule the provisions of the domestic tax statute and the international tax treaties.

Draft Guidelines contain explanation of GAAR provisions and illustrations for applicability of GAAR.
Impact on Foreign Institutional Investors (‘FII’)

It was felt that these provisions would give unbridled powers to tax officers, allowing them to question any tax saving deal. Foreign institutional investors in particular were worried that their investments routed through Mauritius could be denied tax benefits enjoyed by them under the Indo-Mauritius tax treaty.

Net FIIs have been illustrating an inflow since December, 2011. Net FII inflows peaked to $7 bn in February, 2012. However, foreign institutional investments have declined post the announcement of GAAR on 16th March, 2012. March saw a net inflow of mere $0.4 bn while April registered an outflow of $8 bn. This clearly indicates that the adoption of GAAR by India was not found to be favorable by foreign investors.

Two options given under the proposed safe harbor:
- FII to pay tax under the domestic tax law (i.e. not to avail treaty benefits) or
- Avail tax treaty benefits but be open to application of GAAR; however GAAR not to apply to non-resident investors of the FII

Unilateral payment of tax not exactly a safe harbor!

Constitutionality of safe harbor requiring outright payment of tax in lieu of non- application of GAAR could be questioned.

The provisions stated that there would be no special treatment for FIIs. Also, there was no clarity on level of substance required to be established by FIIs / PE Funds. The question still remains unanswered as to what would be the level, would it be the same as in case of other holding/operating companies?
Implications of GAAR

Gaar empowers tax authorities to invalidate any arrangement if it is entered into by the assessee with the objective of obtaining a tax benefit. It is subjective in nature. Tax officials would have wide-ranging powers to declare any arrangement as ‘an impermissible avoidance arrangement’.

Certainty and stability form the basic foundation of any fiscal system. Gaar provisions, in their present form, would introduce uncertainty in terms of tax implications of various business and non-business arrangements. Business decisions are made on a real-time basis. If the revenue department were to sit on judgment in hindsight, it would introduce considerable uncertainty.

One of the main worries with Gaar, in its present form, is that the onus is on the assessee to prove that tax benefit is not the main purpose of an impugned arrangement. An anti-abuse provision that shifts the burden of proof on the assessee goes against the fundamental principle of ‘innocent unless proven guilty’.

Another concern for foreign investors is the applicability of tax treaties. India, which is looking at significant inflows of capital, cannot sacrifice growth at the altar of tax revenues. Under no circumstances should Gaar override the tax treaties.

The guidelines on Gaar should leave no room for ambiguity in its application. This can be achieved only if we have a large number of examples specifying where Gaar can or cannot be invoked. A review mechanism at the finance minister’s level to ensure that Gaar is invoked as an exception rather than a rule and only in deserving cases would help. Ideally, Gaar should become specific anti-avoidance rule.
Analysis

The General Anti Avoidance Rules (GAAR) proposed by the Finance Act, 2012, along with the retrospective amendments on taxation of indirect transfers have been a subject of intense debate with largely negative reactions, particularly from the investment community abroad. With this as the backdrop, a committee had been formed for formulating guidelines for the implementation of GAAR and to provide clarity on the provisions so as to safeguard taxpayers against their indeterminate use.

The committee's much-anticipated recommendations were issued last week in the form of draft guidelines for public consultation. The guidelines have sought to cover aspects pertaining to the interpretation of the GAAR provisions and the type of transactions that are likely to be impacted by it.

On the positive side, the guidelines prescribe certain timeline to provide certainty to the proceedings and recommend fixing a monetary threshold for application of GAAR. No recommendation has been made on the actual monetary limits and it is hoped that the same is not unrealistically low as to bring a majority of the transactions within GAAR’s purview.

Another positive development is the recognition of the difference between tax evasion, tax avoidance and tax mitigation. The guidelines have rightly stated that tax mitigation, such as claiming a fiscal benefit provided under the tax laws, will not be covered within the ambit of GAAR provisions.

Similarly, the guidelines have allayed another significant concern of the taxpayers by recommending that GAAR would not be applied where the provisions of the tax laws have Specific Anti Avoidance Rules (SAAR), such as the transfer pricing provisions or provisions relating to tax holiday for SEZ units and where the taxpayer satisfies the prescribed conditions.

The clarification that GAAR would not be invoked against the non-resident investors of FIIs appears to be aimed at only exempting participatory notes
(P-notes) from the applicability of GAAR. Other than this exception, the FIIs may not have much to cheer about as the non-applicability of GAAR provisions in the case of FIIs has been restricted to cases only where they choose to be taxed as per the provisions of the income tax laws by foregoing the benefits under the double-taxation treaties.

The committee has also sought to bring in additional clarity on the various provisions of GAAR through the use of multiple illustrations. The illustrations do provide some clarity but the conclusions in some of the illustrations seem to be in conflict with the provisions in the guidelines and in some cases with the conclusions in other illustrations. Given that the facts in each case would be different, it would be extremely difficult and impractical to assess the impact of GAAR on the basis of the principles provided in the various illustrations. Hence, while the intent is no doubt good, the illustrations provided cannot be a substitute for more substantive guidance on the interpretation of key terms.

Having said this, some of the illustrations do address key concerns to an extent. For example, the guidelines include a clarification which briefly illustrates the factors that go into determining substance and states that the location of board meetings, manpower, infrastructure etc would be considered for this purpose. Similarly, the clarification explaining that the carry forward and set off of losses of a company in an amalgamation would not fall within the purview of GAAR is a big positive.

Overall, while the guidelines are a step in the right direction, a lot more clarity needs to be brought in, especially on the meaning and interpretation of various terms such as ‘misuse or abuse’ and ‘commercial substance’ to provide a reasonable level of precision and certainty in understanding the impact of GAAR on day to day business transactions.
Conclusions

While the Indian Government has not provided any (much) clarity on GAAR yet, one aspect which nevertheless is crucial would be documentation. It is at the back of the documentation that the real intent behind a transaction would be examined, and it would be the documentation that would assist in making assertions for defence during a tax audit. In addition to this, it would become pertinent to strengthen substance in the intermediate jurisdiction, measured amongst others, in terms of expenditure incurred by the holding company in the intermediate jurisdiction, employment of local Directors with appropriate skills and experience, etc.

GAAR is therefore undoubtedly set to overhaul the conventional ways of doing business not only in India but globally. With countries asserting their taxing rights more strongly than before, extra efforts to rationalise your own tax outgo seems to be the need of the hour. A change, requiring existing investors to appropriately improvise their current structures before the implementation of GAAR and the new investors to approach with caution seems inevitable to avoid tax litigation in India.