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GAAR Decoded

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Contents

Foreword

The introduction of General Anti-Avoidance Rules (GAAR) is a watershed event in the evolution of India's tax policy and legislation. In today's context, any discussion on structuring of a transaction or an arrangement would be incomplete without debating its potential exposure to the provisions of GAAR.

GAAR has been enacted in some countries such as Australia, the Netherlands, Canada, New Zealand, China, Poland, the United Kingdom, the United States, France and Germany, and over the years, some of these countries have developed and implemented jurisprudence on the subject. In India, GAAR has been made effective from 1 April 2017. However, even prior to the introduction of codified GAAR in India, Indian Courts dealt with tax avoidance by drawing an inference to decisions pronounced by English Courts in cases such as that of the Duke of Westminster, wherein it was affirmed that if a document or transaction is bona fide, the tax authorities are restricted from dissecting it to arrive at some other underlying substance.

This principle has resonated in Indian Courts in the rulings of the *Azadi Bachao Andolan* and the Vodafone cases. However, the Courts have also held that where transactions were found to be 'colourable' or 'dubious', such transactions could be disregarded by applying doctrines including piercing of the corporate veil and substance over form. Therefore, the introduction of GAAR as a codified law was imperative to address widespread issues of tax avoidance as against tax mitigation. The big question is—what does the future hold for structuring of transactions in the GAAR regime?

In India, Transfer Pricing (TP) provisions, which are in the genre of a Specific Anti Avoidance Rule (SAAR), were introduced in India in 2001, while many countries had these provisions in place for a much longer period. However, since the introduction of the TP provisions, tax controversies have risen in several areas and litigation has increased exponentially. In fact, no other country has generated litigation of this magnitude. In the past, the Revenue authorities labelled certain transactions as sham or subterfuge, and disregarded them for tax purposes, even when GAAR provisions were not enacted. Consequently, there is a lurking apprehension in business people's minds about arbitrary application of the provisions of GAAR.

The Government has been perceptive of these challenges and held back its introduction of GAAR for more than two years. It has set up a standing committee to provide input on the draft law, and introduced Safe Harbour and levels of approval before GAAR is implemented by Tax Officers.

However, despite these measures, in view of the wide nature of GAAR provisions and diversity of situations in which GAAR can be applied, there still are many unresolved issues, which may result in uncertainty in people's minds, which is a deterrent to business growth and investment.

Under the GAAR regime, taxpayers will be required to demonstrate substance and commercial reasons for every transaction or arrangement that leads to an increased emphasis on documentation of the business rationale for any transaction or reorganisation.

This report aims to decode the provisions of GAAR, and enable a basic understanding of these, the conditions that will need to be satisfied to apply GAAR as well as the approval and redressal mechanisms, if GAAR is to be implemented.

What is GAAR?

It is clear that the introduction of GAAR will be a momentous event in the evolution of India's tax policy and legislation. In simple terms, GAAR codifies the principle of substance over form and brings into the law principles that several landmark cases have dealt with over the years.

GAAR empowers the Revenue authorities to deal effectively with and guard against schemes that are designed for tax avoidance. It strengthens their arms by giving them sweeping powers to disregard or re-characterise transactions and re-determine the resultant tax consequences, if such transactions are designed with the main purpose of availing tax benefit(s) or if they lack commercial substance.

Many developed countries have implemented GAAR. Their tax laws have incorporated principles similar to those effected in India to authorise their Revenue Authorities to deny tax benefits for transactions they consider impermissible avoidance arrangements.

Before introduction of GAAR in India, transactions that were designed to avoid tax were dealt with by the implementation of judicial decisions and Specific Anti-Avoidance Rules (SAAR), including Transfer Pricing regulations, by imposing the mandates of the Income-tax Act (the Act). The courts consistently affirmed the cardinal principle that if a document or transaction was genuine, they would not disregard or go beyond the existing structure of such a transaction or arrangement. However, if the courts found a transaction to be 'colourable' or 'dubious', they disregarded these by applying doctrines, including piercing of the corporate veil and substance over form.

With its codification, judicial precedents will be re-evaluated through the prism of GAAR. Therefore, it is essential to understand the fine line between acceptable tax mitigation and actual tax avoidance. The lack of clarity in this area exposes taxpayers to potential tax-related risks.

Concept of tax evasion, avoidance and mitigation

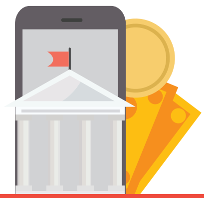
Tax evasion

Illegality, wilful suppression of facts, misrepresentation and fraud—all constitute tax evasion, which is prohibited under law.

Tax avoidance

Tax avoidance includes actions taken by a taxpayer, none of which are illegal or forbidden by the law.

However, although these are not prohibited by the law, they are considered undesirable and inequitable, since they undermine the objective of effective collection of revenue.



Tax mitigation

Tax mitigation is a 'positive' term in the context of a situation where taxpayers take advantage of a fiscal incentive provided to them by a tax legislation by complying with its conditions and taking cognisance of the economic consequences of their actions. Tax mitigation is permitted under the Act.

Run up to GAAR

16 March 2012

GAAR was introduced in the Finance Bill 2012 (with effect from 1 April 2012).*

16 March 2012

GAAR was deferred till 1 April 2014 on enactment of the Finance Bill 2012.

28 June 2012

Draft GAAR guidelines were released by the Government of India.

13 July 2012

An expert committee was constituted to review and rework GAAR guidelines.

1 September 2012

The Committee's report was published.

14 January 2013

GAAR was postponed for another two years and was to become applicable from 1 April 2016.

2015

Implementation of the Finance Bill 2015 deferred GAAR for one year. It has been applicable from 1 April 2017.**

*GAAR was introduced for the first time in the Direct Tax Code Bill, 2009, and a committee was formed by the Central Board of Direct Tax (CBDT) and gave its recommendations on formulation of guidelines and circulars to ensure that the ruling was not applied indiscriminately.

**Deferral of GAAR aimed to allow additional time for investors' sentiments to improve and also appropriately refine the law, based on the recommendations of the committee headed by Dr. Parthasarathi Shome, the former advisor to the erstwhile Union Finance Minister. The insightful input provided by this committee has enabled the Government to build in safeguards to ensure that GAAR provisions are not routinely applied and also provide for adequate redressal and appellate mechanisms for taxpayers if GAAR is invoked in their cases. India was an active participant in the Organisation for Economic Co-operation and Development's (OECD's) Base Erosion Profit Shifting (BEPS) project. It was therefore desirable that GAAR was implemented as a part of its comprehensive legislative package after finalisation of the BEPS project.

Operational framework of GAAR

Chapter X-A of the Act includes GAAR provisions, which have an overriding effect on the other provisions of the Act. GAAR will apply to transactions, notwithstanding any other provisions of the Act.

GAAR applies to any arrangement that is considered an Impermissible Avoidance Arrangement (IAA). Furthermore, under its provisions, certain transactions are deemed to lack commercial substance.

GAAR is not merely restricted to cross-border transactions, but also applies to domestic arrangements.

Once the Revenue authorities decide to treat an arrangement as an IAA, the onus to prove otherwise is on taxpayers. Consequently, they are required to substantiate the commercial reasons for such arrangements and that availing tax benefit was not the main purpose for these transactions.

Impermissible Avoidance Agreement

Under the earlier version of GAAR that was proposed to be introduced, an arrangement could be declared an IAA, if the main purpose or one of its main purposes was to obtain a tax benefit.

- The current amended version limits an IAA to only those transactions where **"the main purpose" is to obtain a tax benefit in addition to satisfaction of at least one of the four tainted elements tests.**
- The term "arrangement" has a wide ambit and also includes a step or part of this arrangement.
- Where the main purpose of a step or part of an arrangement is to obtain a tax benefit, the provisions of GAAR would apply, regardless of the main purpose of the transaction being commercial in nature.

Safe Harbour

Safe Harbour rules apply to:

A quantum of tax benefits below below a monetary limit of INR 3 crore in aggregate for all parties in a transaction in a particular year

Arrangements involving certain transactions with Foreign Institutional Investors

Arrangements entailing income accruing or arising to a person from transfer of an investment made before 1 April 2017

Conditions to be satisfied for an IAA

Main purpose to obtain tax benefit

1. Creation of rights or obligations (not ordinarily implemented) between persons dealing at arm's length
2. Results, directly or indirectly, in misuse or abuse of the provisions of the Act
3. Lacks commercial substance or is deemed to be deficient in commercial substance in whole or in part
4. Is entered or carried out in a manner not ordinarily employed for bona fide purposes

Primary condition + Tainted Element Test = IAA

Main purpose—new dimensions to be examined

Codified GAAR varies materially from judicial GAAR, which focuses on arrangements as a whole, whereas the former examines even individual steps and parts of an arrangement. For example, consolidation of profit- and loss-making businesses may be driven by commercial consideration as a whole, whereas mergers (merging loss-making into profit-making entities, or vice versa) may be guided by tax-related considerations. Codified GAAR makes it possible for the Revenue to examine the individual steps in an arrangement, i.e., the direction of a merger.

Subjectivity in ascertaining the main purpose of an arrangement:

What would be considered the 'main' purpose of an arrangement—elements or factors relevant for arriving at a conclusion?

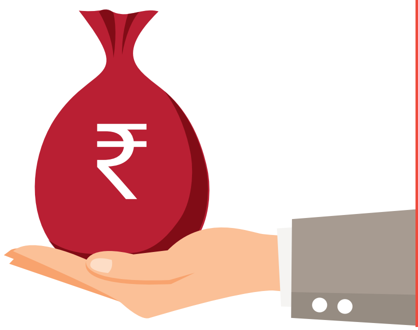
Where there is more than one main purpose for an arrangement, including the purpose of obtaining a tax benefit, the key issue to be considered is whether the Revenue can disregard the other main purposes and only focus on the tax benefit.

Arrangements that lack commercial substance

An arrangement will be deemed to be lacking commercial substance (in the following circumstances) if it does not have a significant effect (apart from tax benefits) on the business risks or net cash flows of the parties to the arrangement:

Deemed to lack commercial substance

- The substance or effect of the arrangement as a whole differs significantly from the individual steps taken
- It does not have any significant effect on the business risk or cash flow of any party other than the tax benefit to it
- Involves location of asset, transaction or residence of any party without any substantial commercial purpose
- Round-trip financing, accommodating party, elements that offset or cancel each other, transactions conducted through one or more persons to disguise the value of the deals, location, source, ownership, source or control of an arrangement



Factors relevant but not adequate for a decision on whether an arrangement lacks commercial substance:

- The period of time for which an arrangement has existed
- Payment of taxes, directly or indirectly, in an arrangement
- The existence of an exit route

Therefore, the circumstances in each case will need to be carefully evaluated to determine the existence or absence of an IAA.

Implications of invoking GAAR

- Disregarding, combining or re-characterising entire or part of an arrangement
- Re-assignment of place of residence, or site of assets or transaction
- Disregarding of corporate structure
- Re-allocation of income, expenses, relief, etc.
- Denial of treaty benefits
- Re-characterisation of equity-debt, income, expenses, relief, etc.

Please note that in the event of a particular consequence being applied in the hands of one of the participants of an IAA, a corresponding adjustment in the hands of another participant will not be allowed.

Procedure for invoking GAAR

Tax Officer

- The Tax Officer may examine arrangements for an IAA inquiry.
- He or she could refer the arrangement to the Principal Commissioner or Commissioner of Income Tax for him or her to declare it as an IAA, if he or she considers such reference necessary.

Principal Commissioner/ Commissioner of Income Tax (CIT)

- If the CIT is of the opinion that GAAR is to be invoked, he or she will issue a show cause notice to the taxpayer.
- The taxpayer is to furnish his or her objections within the period mandated in the notice (this period not exceeding 60 days).
- If satisfied that the arrangement is an IAA, the CIT will make a reference to the Approving Panel.
- If satisfied that GAAR need not be invoked, the CIT will pass an order favournig the taxpayer.

Approving Panel

- The Panel will provide the taxpayer the opportunity to be heard.
- No invocation of GAAR is required if the Approving Panel is satisfied with the explanation or submission provided by the taxpayer.
- If it is not satisfied, the Approving Panel will issue directions declaring an arrangement an IAA.
- Directions will be passed within six months from the end of the month on which the reference was received from the Commissioner.

Please note:

- The direction of the Approving Panel is binding on the Commissioner of Income Tax as well as on taxpayers. No appeal is permitted against its order.
- If the Principal Commissioner of Income Tax or the Approving Panel has held that an arrangement is permissible for one year, and facts and circumstances remain the same in subsequent years, GAAR will not be invoked for these years.
- While a GAAR inquiry can be initiated during the course of an assessment, the Tax Officer and Tax Commissioner can recommend invocation of GAAR, not only for the tax year for which proceedings are pending, but also for other tax years (earlier as well as future years).

Redressal mechanism

Remedy under the Act	Constitutional remedy
A taxpayer has the right to appeal to the Income Tax Appellate Tribunal (ITAT) against an order passed by the Revenue along with the direction of the Approving Panel. (A subsequent appeal may be filed before a High Court and the Supreme Court.)	A writ can be filed before the jurisdictional High Court against the orders of the Approving panel if this violates the principles of natural justice or if there is misapplication of the law. (However, it remains to be seen how the courts will view a writ petition filed against a reference made by the Assessing Officer to the CIT or by the CIT to the Approving Panel.)

Tax certainty under the GAAR regime

In order to achieve tax certainty in respect of a proposed transaction, taxpayers may apply for a ruling from the Authority for Advance Ruling (AAR) to determine the applicability of GAAR for transactions they propose to undertake.

Furthermore, taxpayers (resident and non-resident), regardless of the value of their transactions, may approach the AAR to determine whether such arrangements are IAAs. A ruling by the AAR would be binding on them and the tax authorities in respect of the proposed transactions. It is important to note in this context that the CBDT has recently clarified that GAAR will not be invoked if the AAR rules in favour of a taxpayer.

An application for Advance Ruling is to be made in the prescribed form and submitted with the applicable fees. On admission of the application by the AAR, a ruling needs to be delivered within six months. (This period is much longer at present.)

Recent clarifications by the Government

Queries	Clarification provided by the CBDT	Our comments
Does grandfathering apply to instruments that are compulsorily convertible from one form to another if these have been acquired before 1 April 2017?	The option of grandfathering will be available for investments made before 1 April 2017. This is in respect of instruments that are mandated to be compulsorily convertible from one form to another, at terms finalised at the time they are issued. Moreover, shares emanating from splitting or consolidation of holdings, or by issuance of a bonus in respect of shares acquired prior to 1 April 2017 (in the hands of the same investor), will also be eligible for grandfathering.	Interestingly, the Circular goes further than the recently amended India- Mauritius or India-Singapore tax treaties in relation to the grandfathering benefits provided for convertible instruments, bonus or split issues.
Does grandfathering extend to all forms of investments, including lease contracts (e.g., air craft leases) and loan arrangements?	For the purpose of grandfathering, investments will include assets that are held by an enterprise to earn an income by way of dividends, interest, rentals, as well as for capital appreciation. Since lease contracts and loan arrangements are by themselves not 'investments', grandfathering will not be available for these.	It will be imperative for corporates to review their existing inter-company loan arrangements, debt instruments, royalty or service fees and pay-out transactions from the perspective of GAAR.
What is the interplay between GAAR and SAAR?	GAAR and SAAR will co-exist and will be applicable, as required, based on the facts and circumstances of a case.	While the CBDT has clarified that GAAR and SAAR will operate simultaneously, the courts have held that specific provisions will override the general provisions. Therefore, the Courts may hold GAAR and SAAR (such as Transfer Pricing or Thin Capitalisation) to be mutually exclusive. This aspect of the law may be strongly litigated.
Can GAAR be invoked on satisfaction of the Limitation of Benefits (LOB) clause in a tax treaty?	GAAR will not be invoked if a case of avoidance is adequately addressed by a LOB in the treaty.	India's tax treaty with Mauritius, like the India- Singapore tax treaty, requires satisfaction of the LOB clause to enable capital gain benefits to be availed. A scrutiny of the adequacy of LOB conditions should not ideally be open to the Revenue authorities, once such conditions have been negotiated and settled between two countries. This aspect of the law may be highly litigated.
What is the applicability of GAAR to arrangements sanctioned by the courts?	GAAR will not apply to arrangements where a court or Tribunal has explicitly and adequately considered the tax implications while sanctioning such arrangements.	It is unlikely that the National Company Law Tribunal (NCLT) will provide an explicit and adequate view on tax matters while sanctioning these or arrangements such as mergers, de-mergers and capital reduction. Consequently, even arrangements sanctioned by the NCLT may not be 'ring-fenced' from applicability of GAAR.
Can commercial expediency be challenged under GAAR?	GAAR will not have an interplay with the right of the taxpayer to select or choose a method of implementing a transaction.	It is interesting to note that while the question raised before the CBDT was in respect of the commercial expediency of a transaction being challenged under GAAR, the CBDT has provided a clarification on the method of implementation of a transaction, rather than on the reasons for it being undertaken. Judicial precedents have held that the commercial expediency of a transaction cannot be challenged by the Revenue.

Recent clarifications by the Government

While the CBDT has issued guidance from the perspective of the GAAR regime, many questions remain unaddressed, e.g., the following:

- Can the legal status of an entity, i.e., a firm or body corporate, be questioned under GAAR provisions?
- Can a procedure under the Company Law (e.g., buy-back of shares or capital reduction under a court scheme) be re-characterised for the purpose of Income Tax?
- Can valuation of an asset be challenged under GAAR provisions?

Interplay between GAAR and the Multilateral Instrument under BEPS

The Multilateral Instrument (MLI) was introduced as a part of the BEPS Action Plan by the OECD. It will exist alongside existing tax treaties, to bring these in line with the measures set out in the BEPS Action reports in order to address the menace of erosion of the tax base. India signed the MLI in Paris on 7 June 2017.

MLI requires all signatories to meet certain treaty-related minimum standards to counter abuse of treaties. One of these minimum standards is the Principal Purpose Test (PPT), wherein tax treaty benefits can be denied if one of the principal purposes of an arrangement or transaction is to directly or indirectly obtain a tax benefit.

The PPT is broader in its ambit than GAAR. Under the PPT, benefits emanating from treaties can be negated if the main or even one of the principal purposes is to obtain a benefit. However, GAAR requires fulfilment of the Main Purpose Test as well as one of the Tainted Element Tests.

Consequently, if a structure satisfies the requirements of the PPT, it is likely that it will pass the Smell Test required for GAAR as regards application of the tax treaty benefit. However, in cases where the PPT is avoided on the ground that the benefits are in accordance with the objective and purpose of the treaty (a carve-out for application of the PPT), such a structure will have to independently pass the Smell Test mandated by GAAR.

Furthermore, unlike the Approving Panel in the case of GAAR (to determine whether or not a transaction is an IAA), there is no separate panel or authority to decide whether the PPT has passed the test required by the MLI. In such cases, it is likely that an Income Tax Officer will refuse to provide treaty-related benefits on the ground that the requirements of the PPT under the treaty were not met. This may lead to increased litigation.

Therefore, the co-existence and related applicability of the MLI and GAAR are currently uncertain, which results in anxiety among taxpayers.

Call to action

With the implementation of GAAR provisions in the Act, effective 1 April 2017, some of the following routine transactions undertaken by taxpayers will need to be reviewed:

- Inbound structures where the holding company is in a low-tax jurisdiction or holds Intellectual Property (IP) in a low-tax jurisdiction
- Restructuring of transactions such as mergers, de-mergers, acquisitions, slump sales, selective buy-backs, gifts of shares and conversion of Limited Liability Partnerships (LLPs)
- Trust structures and succession planning
- Cash repatriation structures including inter-group transactions involving royalty, service fees, etc.
- Transfer of land using partnership structures
- Employee benefit plans and Thin Capitalisation planning avenues

GAAR–key takeaways

Like some developed countries, India has now codified GAAR provisions to safeguard its tax base against impermissible taxpayer behaviour. However, uncertainty persists in relation to the operational scope of these provisions, their interaction with SAAR and their application in the context of tax treaties. Moreover, with GAAR still being at its nascent stage, there may be a number of challenges and issues that may arise on account of different interpretations of the provisions.

Aggressive application of Transfer Pricing provisions by the revenue authorities has resulted in increased litigation. In this scenario, the possibility of application of GAAR provisions to augment revenue collection cannot be ruled out, and any indiscriminate application of the provisions is likely to result in increased litigation and adversely affect investors' sentiments.

In the backdrop of the Government's policy to ease their doing business in India, investors look forward to tax certainty and facilitated resolution of disputes. This could be a challenge with the introduction of GAAR. Based on the experience of other countries in implementing GAAR, it is clear that it is the most complex and controversial tax legislation for all stakeholders. Its operation requires entities to pay close attention to the commercial purpose, substance and documentation of transactions to make a representation in a GAAR proceeding.

Under GAAR, the onus lies on the taxpayers to establish that transactions are not undertaken with the main objective of tax avoidance but are backed by commercial and economic substance. Therefore, defence documentation that spells out the commercial reasons for a transaction is crucial in this scenario. Taxpayers may however choose to obtain tax certainty through private rulings.

GAAR is set to play a significant role in future enforcement of compliance. Multinational companies seeking to operate an effective global tax governance regime should appreciate and understand current developments in this area and be ready to address application of GAAR.

To sum up

Drawing from past experience of aggressive application of SAAR by the Revenue authorities, the implementation of GAAR is expected to lead to significantly increased litigation, resulting in tax uncertainty. Such litigation may be in the form of proceedings filed before the Approving Panel or Tribunal in the form of a writ petition before the jurisdictional High Court in the event of violation of natural justice (if there was an inadequate opportunity of being heard) or misapplication of law.

How we can help you

We can advise you on the applicability of GAAR on existing agreements or arrangements, and guide you on its applicability for proposed transactions and preparation of defence documentation (based on a business or commercial rationale) in your existing or proposed arrangements.

In addition, we can represent you before the Revenue authorities, Approving Panel, AAR or Tribunals.

Notes

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