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News Alert
3 September, 2012

Expert Committee Report on General Anti Avoidance Rules

Background

General Anti Avoidance Rules (GAAR) were incorporated in the Income-tax Act, 1961 (the Act) to provide a basic framework/structure for its application and consequences. GAAR is a broad set of provisions which grant powers to authorities to invalidate any arrangement for tax purposes, if the main purpose or one of the main purposes of entering into the transaction by the taxpayer is to obtain a tax benefit. Besides the "tax benefit" test, the arrangement also has to test positive any one of the following four specified additional tests:

- It creates rights or obligations which would not ordinarily be created between persons dealing at arm's length.
- It results in the misuse or abuse of the provisions of the Act.
- It lacks commercial substance or is deemed to lack commercial substance in whole or in part.
- It is entered into or carried out by means or in a manner, which would not normally be employed for bona fide purposes.

Furthermore, it was prescribed in the Act that GAAR provisions would be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed.

For the purpose of formulating these guidelines, a Committee was constituted under the chairmanship of Director General of the Income-tax (International Taxation) (DGIT (IT)) which published draft guidelines on 28 June 2012.

Subsequently, the Prime Minister of India constituted an Expert Committee on GAAR under the chairmanship of Dr. Parthasarathi Shome to undertake stakeholder consultations and finalise the GAAR guidelines to bring more clarity on it. The Expert Committee analysed the GAAR provisions, discussed the inputs of various stakeholders and has presented its draft report recommending:

- Amendments in the Act
- Amendments in Income-tax Rules, 1962 and
- Clarifications/illustrations through a Circular.

It is important to note that the Expert Committee headed by Dr. Parthasarathi Shome has endorsed the views of the Committee headed by DGIT (IT) that the GAAR provisions are not applicable to tax mitigation or to tax evasion (result of illegality, suppression, misrepresentation, fraud) situations. Rather, the GAAR provisions may be applicable to the legal structures/transactions exclusively designed to avoid tax.

Recommendations

Deferral of GAAR by three years

The implementation of GAAR should be deferred by three years on administrative grounds. However, pre-announcement of the applicability of GAAR from financial year 2016-17 should be made in advance. The Committee has suggested that time is required for intensive training of the tax officers in the finer aspects of international transaction, and for putting in place appropriate procedures and policies including establishment of the approving panel.

Monetary threshold

A monetary threshold of INR 30 million of tax benefit (*excluding interest*) to a taxpayer in a year should be used for the applicability of GAAR provisions. The tax liability may be actual or potential (i.e. in case of increase in loss).

In case of tax deferral, the tax benefit is only the difference between the current value of tax vis-à-vis the present value thereof (i.e. when the tax is paid). The benefit would be computed *based on the interest rate* charged for shortfall in payment of advance tax.

Moreover, the tax benefit should be considered separately for each arrangement unless the arrangements are interlinked or connected with each other.

Negative list for not invoking GAAR

The tax mitigation arrangement should be distinguished from tax avoidance arrangement before invoking GAAR. Furthermore, GAAR should not be applicable to every tax avoidance arrangement unless it is abusive, contrived and artificial. The Committee has also recommended an illustrative list of tax mitigation arrangements or a negative list for not invoking GAAR which is as under:

- Selection of one of the options offered in law
  - payment of dividend or buy back of shares by a company
  - setting up of a branch or subsidiary
  - setting up of a unit in special economic zone (SEZ) or any other place
  - funding through debt or equity
  - purchase or lease of a capital asset
- Timing of a transaction (for example sale of property in loss while having profit in other transactions)

- High Court approved merger and demerger schemes

- Intra-group transactions (i.e. transactions between associated persons or enterprises) which may result in tax benefit to one person without affecting the overall tax revenue either by actual loss of revenue or deferral.

GAAR to be invoked if the main purpose (and not one of the main purposes) is to obtain a tax benefit

Currently, GAAR provisions are attracted where even one of the main purposes of the arrangement is to obtain a tax benefit. The Committee has recommended that only those arrangements wherein the main purpose *(and not one of the main purposes)* was to obtain a tax benefit should be covered under GAAR.

Abolition of tax on gains arising from transfer of listed securities

The tax on gains arising from transfer of listed securities (both capital gains and business income) in the hands of residents as well as non-residents should be abolished. The rate of securities transaction tax may be increased appropriately to make the proposal tax neutral.

As an alternative to the aforesaid, the Committee has further recommended that the Circular 789 of 2000 accepting Tax Residence Certificate (TRC) issued by the Mauritius authorities may be retained until the abolition of tax on transfer of listed securities.

Grandfathering of investments

The investments (though not arrangements) made by residents or non-residents and existing as on the date of commencement of the GAAR provisions should be grandfathered so that these regulations are not invoked for examination or denial of tax benefit on subsequent sale of such investments.

GAAR not to override Circular 789 of 2000

GAAR provisions not to apply to examine the genuineness of the residency of an entity set up in Mauritius, where Circular No. 789 of 2000 is applicable i.e. furnishing of TRC should be sufficient for accepting the status of residence of a person. Thus, though explained to be an unassailable proof of residence, Circular 789 seems to be an effective shield against any charge.

The Mauritius treaty should be revisited if policy so dictates, rather than challenging it indirectly through the use of GAAR provisions.

GAAR not applicable where Specific Anti Avoidance Rules in the Act or anti-avoidance provisions in tax treaties exist

The GAAR provisions should not be invoked to look into an aspect/element, where Specific Anti Avoidance Rules (SAAR) is applicable to that particular aspect/element. Similarly, GAAR provisions not to apply in cases where anti-avoidance provisions are already present in the tax treaty (*for example, limitation of benefit clause in the case of India–Singapore tax treaty*).

Furthermore, the tax treaty should be revisited in case there are evidences of violations of anti-avoidance provisions present in the tax treaty.

Applicability of GAAR at the time of tax withholding

While processing an application for nil/lower tax withholding under sections 195(2) or 197 of the Act:

- GAAR should not be invoked where the taxpayer submits a satisfactory undertaking to pay taxes along with interest in case GAAR provisions are subsequently found to be applicable in relation to the remittance.

- GAAR may be invoked (*with the prior approval of Commissioner*) in case the taxpayer does not submit any satisfactory undertaking as aforesaid.

Foreign Institutional Investors

The GAAR provisions should not be applied to an Foreign Institutional Investors (FIIs) in case it chooses not to take tax treaty benefit and subjects itself to tax in accordance with the domestic law provisions.

Furthermore, GAAR provisions should not be invoked in the case of a non-resident who has invested, directly or indirectly, in the FII (*i.e. where the investments made by FII in India are the underlying assets of the investment of the non-resident*) irrespective of the fact whether the FII chooses or does not chose to take tax treaty benefit. However, this exemption should be available to a non-resident only in respect of investment in listed securities made by the FII in India.

Expert opinion of transfer pricing officer for arrangement not covered by existing transfer pricing regulations

A mechanism needs to be provided for the tax officers to ascertain whether rights, or obligations, created in an arrangement *(not covered by existing transfer pricing regulations)* are the same as ordinarily created between persons dealing at arm's length. As a result of the mechanism, the tax officers should be able to seek an expert opinion from the transfer pricing officer.

Tax consequences to be limited to the impermissible part of arrangement

In instances where only a part of the arrangement is impermissible, the tax consequences of an “impermissible avoidance arrangement” will be limited to that portion of the arrangement only.

Factors for determination whether an arrangement lacks commercial substance

Section 97 of the Act should be amended to provide that the following factors are relevant but may not be sufficient and these factors will be taken into account in forming a holistic view as to whether an arrangement lacks commercial substance or not:

- The period of time for which the arrangement (including operations therein) exists
- The fact of payment of taxes, directly or indirectly, under the arrangement
- The fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement

Furthermore, the Committee has recommended that when the tax officer intimates the taxpayer for invoking GAAR, he should include as to how the above factors have been considered and why they have failed to convince him for not invoking GAAR.

Prospective application of GAAR

GAAR provisions should be applicable to income of the taxpayers on or after the date they come into force.

Corresponding adjustments

While determining tax consequences of an impermissible avoidance arrangement, a corresponding adjustment should be allowed in the case of the same taxpayer in the same year as well as in different years, as the case may be. However, corresponding adjustment should not be allowed in case of any other taxpayer. Although absence of corresponding adjustment in case of other taxpayer may make GAAR a revenue generating tool, against its stated principle but considering the complexity involved in giving corresponding adjustment this deviation may have to be accepted

Requirement of detailed reasoning by the tax officer

The tax officer may be required to provide detailed reasoning in the show cause notice issued to the taxpayer in relation to invocation of GAAR. The show cause notice should cover the following aspects:

- What is the arrangement and why it results in any tax avoidance in the case of the taxpayer?
- What is the amount of likely tax benefit and how it is initially calculated?
- Why obtaining the tax benefit is the main purpose of the arrangement, with the detailed explanation thereof, including full and exhaustive background information in the possession of the Revenue?
- What are the tainted element(s) of the arrangement?

Reporting requirements

The tax avoidance schemes should be reported in the tax audit report wherein threshold of tax benefit is INR 30 million or more. This reporting requirement will arise wherein the tax auditor is of the view that the arrangement is "more likely than not" to be held as an impermissible avoidance arrangement.

Definition of 'commercial substance' to be incorporated

The generic definition of 'commercial substance' may be introduced in GAAR provisions.

Scope of 'connected person' to be reduced

The definition of 'connected person' may be restricted only to 'associated person' definition in section 102 of the Act and 'associated enterprise' defined in section 92A of the Act.

Time frame for passing ruling by Authority for Advance Ruling

The administration of Authority for Advance Ruling (AAR) should be strengthened so that an advance ruling may be obtained within the time frame of six months.

Prescription of statutory forms

The Committee has prescribed statutory forms[1] *(same as were prescribed under the draft guidelines published on 28 June, 2012)* for making internal references by the tax officer and the Commissioner of Income-tax to ensure principles of natural justice, consistency and transparency in the procedures.

Prescribing the time limits

The Commissioner should be provided a period of 6 months from the end of the month in which reference is received from the tax officer to decide as to whether GAAR provisions would be applicable or not. In case Commissioner is of the view that GAAR provisions are applicable, then reference needs to be made to the approving panel within 60 days of the receipt of the objection from the taxpayer with a copy to the taxpayer. However, if he is of the view that GAAR provisions are not applicable, then his decision needs to be communicated to the tax officer within 60 days of receipt of the taxpayer's objection with a copy to the taxpayer.

Implementation issues

The following should be undertaken in order to minimise the deficiency of trust between the tax administration and taxpayers

- Concerted training programmes should be initiated for all tax officers in the area of international taxation

[1] The statutory forms prescribed still inadvertently contained a query that whether "tax benefit" is the "main purpose" or **"one of the main purposes"** of the arrangement

- Maintain officials in the field of international taxation for elongated period
- Placing details of all GAAR cases in an encrypted manner on the intranet

Furthermore, the provisions of large taxpayer units should be made compulsory for a specified class of taxpayers reflecting international practice.

Constitution of approving panel

The approving panel for GAAR should consist of five members including Chairman. The constitution of approving panel would be as under:

- The Chairman should be a retired judge of the High Court;
- Two members should be persons of eminence drawn from the fields of accountancy, economics or business with knowledge of matters of income tax. They should be from outside the Government; and
- Two members should be Chief Commissioners of Income-tax or one Chief Commissioner and one Commissioner.

Illustrative cases under GAAR

The report provides for indicative list of examples to illustrate the scenarios wherein GAAR provisions would, or would not, apply. The illustrative cases laid down are summarised as below:

GAAR applicable	GAAR not applicable
Raising funds through loan wherein rate of interest is a function of profits made by the borrower.	Tax mitigation by taking advantage of a fiscal incentive provided under the Act e.g. setting up the unit in a SEZ.
Arrangement wherein Indian holding company receives funds from a bank in a low tax jurisdiction. The foreign subsidiary of Indian company places deposit with the foreign bank which in turn provides loan to Indian company.	Cases of tax evasion wherein tax benefit is taken by misrepresentation of facts e.g. showing production of non-tax holiday unit as production of a tax holiday unit, diversion of profits to a subsidiary set up in tax exempt jurisdiction for import and export of goods when actually the business is being done from India.
Round tripping cases wherein an Indian company infuses equity in its foreign subsidiary (located in tax exempt jurisdiction and having no other activity) and the latter gives loan to its holding Indian company or another company in India on which interest is charged.	Cases wherein transfer pricing provisions are applicable e.g. diversion of profits from a non-tax holiday unit to a tax holiday unit, claim for enhanced deduction of expenditure by incorporating a service company for the group which charges the recipient of service at cost plus, compensation to be received by Indian company for activities carried on by it for its subsidiary set up in tax exempt jurisdiction.

GAAR applicable	GAAR not applicable
Capital gains tax exemption to a company interposed in a low tax jurisdiction wherein shares of Indian company are held by such company but all rights of voting, management, right to sell, etc are vested in its holding company.	Cases wherein specific anti avoidance provisions are applicable to that transaction e.g. shifting/reconstruction of business to show higher profits in tax holiday unit.
Capital gains tax exemption to a company interposed in a low tax jurisdiction wherein shares of Indian company are held by such company. The company interposed in low tax jurisdiction does not undertake any activity. However, GAAR may not be invoked in case interposed company is Mauritian company and has TRC or it is a Singapore company and fulfills criteria specified in *limitation of benefits* clause in India-Singapore tax treaty.	Cases wherein limitation of benefits clause provided in the tax treaties is fulfilled e.g. capital gains tax exemption on sale of shares of an Indian company held by a company located in a low tax jurisdiction which received funds for investment in India from its holding company located in another jurisdiction.
Capital gains tax exemption on selective buy back of shares by a company located in low tax jurisdiction.	Cases wherein Controlled Foreign Company provisions are applicable e.g. such as parking of income by an Indian group (from multiple subsidiaries) in a subsidiary set up in low tax jurisdiction.
Tax benefit on interest on loan finalised from one country and assigned to another country to take benefit of a favorable tax treaty.	Cases wherein income parked in a foreign subsidiary (in low tax jurisdiction) of an Indian company is brought to India by cross border merger of foreign subsidiary into Indian company.
Capital gains tax exemption on sale of shares of Indian entity where shares are held by multiple foreign companies and the individual shareholding is below the threshold limit to take benefit of tax treaty (There are a few treaties where capital gains tax liability triggers on non-resident on sale of shares only once threshold limit is exceeded).	Examples covered by illustrative negative list for not invoking GAAR: • Merger of loss making entity with profit making entity and vice versa. • Decision of leasing vis-à-vis purchase of an asset • Raising funds through equity vis-à-vis loan • Declaration of dividend vis-à-vis buy back of shares. • Amalgamation of subsidiary company with holding company in order to claim tax deduction in respect of interest payable on money borrowed by the holding company to acquire the shares of the subsidiary company.
Tax benefit arising to employee on transfer of preference shares (either by redemption at premium or sale to a group company of the employer) issued by	Sale/purchase transactions through stock market wherein company sets off losses against profits.

GAAR applicable	GAAR not applicable
where consideration for sale/redemption reflects a portion of salary or bonus of the employees. However, if there is an option to take salary or bonus in form of shares and the employee bears the risk attached to the price of shares, GAAR would not be applicable.	
Tax benefit to a company through set off of short-term capital losses arising on sale of shares of its subsidiary companies where the shares were acquired by it an inflated cost provided the transaction is not covered by SAAR (section 56 of the Act). The funds for acquisition of shares were borrowed by the company and it finally reaches the group company of the lender through series of aforesaid transactions.	Capital gains tax exemption to a company located in low tax jurisdiction wherein shares of Indian company are transferred to it on liquidation by consent of its subsidiary another Indian company which in turn holds shares of this Indian company.
Tax benefit on realisation of actionable claims by a company when such claims belonged to a group entity and were acquired by it through series of transactions at nominal value of the claim.	Pooling of resources by multiple investors in a special purpose vehicle (SPV) formed in a no tax jurisdiction to invest funds in India. This choice of jurisdiction for SPV was chosen on commercial considerations such as ease of operations, low compliance cost, easy migration, good treaty network etc.
Formation of firm by a company on paper without any commercial necessity and rendering services through employees seconded to the firm in order to claim tax treaty benefit available to the firm.	
Transfer of property to a related entity at less than fair market value, which in turn shortly transfers the property to a third party at fair market value and sets off the resulting capital gains with its carried forward capital loss.	
Formation of firm by a company and transferring listed securities to the firm at cost price to save itself from the minimum alternate tax liability on gains arising on sale of shares.	
Tax benefit by purchasing unlisted securities from an entity and agreeing to sell them back to the same entity in future at a price agreed on the basis of a specified rate of return, thereby disguising a financing arrangement as a forward contract	

GAAR applicable	GAAR not applicable
resulting in long-term capital gains instead of interest income. However, where there is put option available to the buyer at a specified price then GAAR provisions would not be invoked as it would be a purely commercial transaction.	
Tax benefit by allocating higher value to offshore supplies *(non-taxable)* and correspondingly allocating lower value to taxable services in a composite contract.	

Conclusion

The Shome Committee report is clearly a step in the right direction and would surely revive the lost confidence of the tax community at large. The pragmatic recommendation on abolishing the tax on income from transfer of listed securities would go a long-way to give fillip to the market.

Moreover, the guidelines introduce certain new trends such as having independent members in the Approving Panel, restricting the right of the tax authorities to invoke GAAR if they do not act in time, reporting by tax auditors on the line of FIN 48 – "more likely than not", etc. These measures are forward looking and should go a long way in improving the current tax environment.

However, the suggestion to invoke GAAR at the stage of withholding of taxes is retrograde and even crosses the boundaries of the present GAAR law, where GAAR examination can only be in the course of assessment of tax. It should be reconsidered given the adequate safeguards already present in the domestic tax laws in the form of requiring the taxpayer or its representative to file the return and undergo the assessment.

Our Offices

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Ahmedabad	Bangalore	Bhubaneswar	Chennai	Hyderabad
President Plaza, 1st Floor Plot No 36 Opp Muktidham Derasar Thaltej Cross Road, SG Highway Ahmedabad, Gujarat 380054 Phone +91-79 3091 7000	6th Floor, Millenia Tower 'D' 1 & 2, Murphy Road, Ulsoor, Bangalore 560 008 Phone +91-80 4079 7000	IDCOL House, Sardar Patel Bhawan Block III, Ground Floor, Unit 2 Bhubaneswar 751009 Phone +91-674 253 2279 / 2296	8th Floor, Prestige Palladium Bayan 129-140 Greams Road, Chennai 600 006 Phone +91-44 4228 5000	#8-2-293/82/A/113A Road no. 36, Jubilee Hills, Hyderabad 500 034, Andhra Pradesh Phone +91-40 6624 6600
Kolkata 56 & 57, Block DN. Ground Floor, A- Wing Sector - V, Salt Lake. Kolkata - 700 091, West Bengal, India Telephone: +91-33 2357 9101 / 4400 1111 Fax: (91) 033 2357 2754	**Mumbai** PwC House, Plot No. 18A, Guru Nanak Road - (Station Road), Bandra (West), Mumbai - 400 050 Phone +91-22 6689 1000	**Gurgaon** Building No. 10, Tower - C 17th & 18th Floor, DLF Cyber City, Gurgaon Haryana -122002 Phone : +91-124 330 6000	**Pune** GF-02, Tower C, Panchshil Tech Park, Don Bosco School Road, Yerwada, Pune - 411 006 Phone +91-20 4100 4444	For more information contact us at, pwctrs.knowledgemanagement@in.pwc.com

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