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GAAR as a Deterrent to Tax Avoidance

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The ongoing global drive against convoluted tax structure, treaty shopping, and the convenient interpretation of loopholes in the law has finally pushed India to join the club of nations having a general anti-avoidance rules regime. This new regime is expected to create a robust deterrent against the practice of camouflaging tax avoidance as a business-driven decision.

The general anti-avoidance rules (GAAR) finally came into operation from 1 April 2017 after much opposition, postponement, and dilution. The long, arduous journey started way back in 1997, when the then Finance Minister P Chidambaram proposed GAAR, but the government failed to introduce it. After the 2008 global financial crisis, when there was an international movement against tax avoidance, GAAR resurfaced in the then proposed direct tax code.

Origin of GAAR

Between the two extremes of tax planning and tax evasion lies tax avoidance, a form of abusive tax planning complying with the letter, but not the spirit of the law; for instance, a transaction structured in a manner with the sole intention of tax benefit, but not for any substantial business consideration. Further, using convoluted structures, companies were set up in tax jurisdiction only to avail the benefits of the double taxation avoidance agreements (DTAAs), that is, treaty shopping was practiced. The objective of GAAR is to curb such practices.

The anti-tax avoidance drive came into the limelight when developed countries faced the pinch of tax avoidance as much as the developing countries. Soon, it was observed that tax avoidance results in dismal public finances and undue enrichment of the rich at the cost of the poor. This resulted in the Base Erosion and Profit Shifting (BEPS) project under the aegis of the Organisation for Economic Co-operation and Development (OECD) members, where over 100 countries collaborate to implement the BEPS measures to curb tax avoidance.

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GAAR is different from specific anti-avoidance rules (SAAR). SAAR captures specific instances of tax avoidance and lays down the consequent repercussions. For example, provisions like transfer pricing, dividend stripping, and cap on payment of interest on loans to overseas parent companies in the Income Tax Act, 1961 are instances of SAAR. However, in this game of cat and mouse, revenue has always been at the receiving end and the errant tax payer is miles ahead of the revenue department.

David Hartnett of Her Majesty's Revenue and Custom or HMRC (of the United Kingdom government) has aptly explained this situation as one of squeezing the balloon in one area only to see a new bulge appearing in another. Besides, it is next to impossible to contemplate all possible situations and frame SAAR to curb them.

To tide over these limitations, several economies in the world came up with the concept of GAAR, which has a much wider reach and can be applied to any situation that smells of tax avoidance.

Essence of GAAR

GAAR can be defined as statutory codification of the "substance" versus "form" rule to look through a given transaction piercing the form. GAAR can also be defined as a rule that empowers a taxman to negate a transaction structured by an unscrupulous taxpayer, which, in the absence of GAAR, would have been permitted under the law. The provisions of GAAR are to be applied to an impermissible avoidance arrangement (IAA), in simpler terms, an arrangement designed with the objective to avoid tax.

To determine an IAA, the following factors are to be considered: (i) purpose of the arrangement is to obtain tax benefit; (ii) it is not at an arm's length price; (iii) it lacks commercial substance; (iv) it results in abuse of the tax law; and (v) it is not carried out in an ordinary manner. Under the present provisions, if the main purpose of a leg of the transaction or a part of it is tax benefit, then there is a presumption that such arrangement is for tax avoidance, even if the whole purpose of the main arrangement is not tax avoidance. This presumption has to be rebutted by the assessee, which can be a daunting task. Once GAAR is applied, the whole or a part of the transaction can be negated or re-characterised.

Besides, GAAR has a non-obstante provision, which can override all other provisions of the Income Tax Act, 1961, including SAAR. Concerns have been raised that where specific rules operate, general rules should not be allowed to override. However, the government has adopted a different approach and, recently, the Central Board of Direct Taxes (CBDT) issued a clarification (on 27 January 2017). The clarification stated that SAAR is not sufficient to address all situations of abuse, and therefore, GAAR and SAAR can co-exist. This adds more to the list of worries of the taxpayers and their consultants.

So, does it mean that under the GAAR regime a company is restrained from tax planning

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and has to necessarily adopt the most disadvantageous option? The answer is “no.” However, the onus will be on the assessee to establish that the arrangement has commercial substance and tax advantage is not the sole guiding factor.

It is strange that most of the multinational companies operating in India, which are already subject to GAAR in overseas jurisdictions, are more worried than the domestic companies. There has been a lot of hue and cry in the past over the possible misuse of GAAR provisions. Therefore, procedural safeguards have been provided in the form of a three-tier mechanism to remove arbitrariness. The system starts with the assessing officer, the principal commissioner of income tax and, finally, the approving panel (which includes a retired high court judge). A period of six months is allowed to decide the applicability of GAAR.

The multi-tier decision-making process is also beneficial from the revenue perspective. It is a fact that there is a strong lobby that shrieks and alleges tax terrorism at the drop of a hat. Such a procedural safeguard is expected to instil confidence among the assessing officers for scrutinising the arrangements.

Now, whether GAAR can compel cleaner business practices is yet to be seen, but it will certainly influence the internal functioning of companies. For instance, in-house legal and taxation departments would have to work in tandem to avoid communication gaps while creating any arrangement. They would also have to exercise due caution in internal corporate communication via e-mails, telephone calls, etc, because these records can be used as adverse evidence against the company.

Since the burden would lie on the assessee to establish commercial substance in the transaction, a proper chain of documents would have to be maintained to rebut the presumption of an IAA invoked by the revenue department.

Concerns Remain

The present scheme of GAAR addresses most of the concerns raised by the industry, yet the anxiety in its implementation is apparent. The Indian text of the GAAR provisions is broadly worded and has a much wider scope of applicability as compared to other jurisdictions. Further, there are concerns such as the interplay between GAAR and DTAAs, the thin line of difference between tax planning and tax avoidance, the co-existence of GAAR and SAAR, the scope of conflicting interpretation over IAAs, the functioning of the approving panel, etc.

The past experience of aggressive application of transfer pricing provisions by the taxman shows a rising graph of litigation. Also, huge pressure on the taxman to augment the revenue collection often results in inappropriate use of discretionary powers. We need to factor in this ground situation to ensure GAAR does not end up choking efficient tax planning.

GAAR will require walking a tight rope to strike a balance between conflicting interests, like

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revenue collection and taxation planning, but this should not deter us from taking a progressive step. If our neighbour, Nepal, can have GAAR implemented since 2001, India is in a better position to develop balanced GAAR jurisprudence. Moreover, all nations are up in arms against tax avoidance.

As far as the application of GAAR to DTAAs is concerned, it must be noted that the principal purpose test, which is more stringent than GAAR, is soon to be incorporated in DTAAs through the execution of "multilateral instruments" under the BEPS project. Under the principal purpose test, treaty benefits can be negated if the main or even one of the purposes is tax benefit, as opposed to GAAR where the main purpose has to be tax benefit.

It would be naive to assume that GAAR can wipe out tax avoidance from tax lexicon, but the time is propitious for it to come into operation.