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GAAR will give sweeping powers to tax authorities

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The provisions of the General Anti-Avoidance Rules (GAAR) in the Union budget will give tax authorities in India sweeping and discretionary powers, experts said in a panel discussion. The participants included Rajendra Chitale, managing partner at MP Chitale and Associates; Ketan Dalal, joint tax leader at PricewaterhouseCoopers India; and Bijal Ajinkya, co-head, International Taxation at Nishith Desai Associates. Edited excerpts:

We heard the finance minister outline what would fall under his definition of application of GAAR. Now wouldn't most of these FII (foreign institutional investor) participatory notes (PNs) fall under the definition of what he is talking about?

Chitale: I think there is too much confusion on this whole issue. The way the GAAR provisions are currently before the Parliament, they are very far reaching and deep, and the empowerment is practically equivalent to a weapon of mass destruction in the hands of tax authorities.

Therefore, unless there is a real walking of the talk and a lot more clarity in terms of fixing the provisions about where we stand, I am afraid the concerns won't go away.

The concerns are not necessarily on PNs, the whole issue is being focused on PNs, but the key issue is that the current provisions are so far reaching that it's not just about the main purpose.

Any fund which is set up in Mauritius, could potentially be exposed to a GAAR attack. In that case you are actually talking about direct investments coming into the tax net. So it's not just about PNs.

The GAAR provisions say it involves the location of an asset or of a transaction or of the place of residence of any party which would not have been so located for any substantial commercial purpose other than obtaining tax benefit for a party. Let's forget about Mauritius, let's look at Singapore or any of these tax havens. Is it not true that most of the operations that are happening there do not actually come within the definition of commercial substance and, therefore, there's a question mark on all of them?

Chitale: You are absolutely right. Any kind of a conduit or any kind of a set up where even if one of the purposes is to claim tax benefits, then clearly, even if the substance test is satisfied, there would be an issue of the tax authorities saying that there is an abuse or misuse of the tax law.

So every structure of this kind is going to get into the GAAR attack. And it's not a question of Singapore, wherever you go, this issue will haunt you.

If that be the case, do you agree with what Mr. Chitale is saying and with the finer points of what is outlined?

Dalal: I completely agree with Rajendra on the point that many of these structures may not have commercial substance.

But the point is that, at least as far as Mauritius is concerned, the circular of the CBDT (Central Board of Direct Taxes) itself was there as the tax residency, being the

condition for granting the exemption.

But yes, under the existing GAAR or rather the way the GAAR is currently worded, this could be under attack. I am not so sure about Singapore and to that extent I may not agree with Rajendra, in fact, I know many structures in Singapore where there is an actual full fledged office and decision makers are based there, but perhaps in most cases in Mauritius it may not be so.

The other point that I want to raise is the way the GAAR is worded, it's so sweeping and so discretionary.

In fact, after the so called clarification from the unnamed sources in the ministry of finance, the markets perked up. That so called clarification was nothing but a reproduction of the language of GAAR, and the language is very subjective.

For example, it says the arrangement creates rights and obligations which are not normally created between parties dealing at arm's lengths, in simple words, it means you are doing a transaction which is unusual and not at arm's length.

So these are very subjective terms. Remember the condition for invocation of GAAR is not all these conditions but just one of these conditions, which makes it even wider. Then they say that only if the threshold of the main tax benefit test is crossed it will apply. But the tax benefit itself has been defined as anything which reduces tax.

So, you can imagine the sweep and ambit of this provision and Rajendra referred to it as a weapon of mass destruction, which I think it will be because it is very discretionary, there are no objective factors to what is essentially a very subjective and sweeping provision and within that provision (a) the language is much wider and (b) the onus of proof is on the tax payer and not on the tax department, quite unlike in most other countries.

In fact, the UK actually said that in the GAAR provision, the onus of proof should always be on the tax department, at least that's currently drafted. So, yes many of these things will be under attack.

When we say commercial substance as far as the international taxation rules apply it means that the entity should not just be an entity out there, but even the decision making of the entity should be based out of that location. Is that right?

Ajinkya: When you are looking at decision making and looking at structure which is more in the form of a company, in such a case the decision making is done by a board of directors and most jurisdiction will have a concept that they require a majority of the board of directors to be situated in that particular country.

Of course, you do have a certain board of directors who would be situated out of the country and to that extent wherever the board meeting is chaired from is considered the seat of management.

So most tax-neutral jurisdiction has alluded to that and have made sure that the tax laws are worded in a way that the central control and management of that particular company is located in those countries.

To add to what other panelists have just said, when you are looking at most of these countries, there is a big question mark as to whether investors will get a credit for Indian taxes paid in their own country.

When you are looking at the sweeping effect of almost 50% of your investment or gains going in paying both foreign taxes and your own country taxes, it is a question mark and therefore you have most of these tax-neutral jurisdictions.

You have heard what the finance minister was talking in Parliament and he seems very clear that if you are coming in just to take tax advantage I'm not going to let that happen. If that be the case, in the current system do you see a large number of benefit, which you have talked of, going away and therefore people pulling out, you

have already seen some of the FIIs saying they are going to stop cutting fresh P-Notes till there is any clarification.

Ajinkya: It has created a big stir even amongst our clients and they have been questioning as to whether they should continue investing in India or whether they should pull out. What they really want is certainty.

And, what have you been telling them?

Ajinkya: The important consideration is tax can only be one of the reasons and you have far more commercial considerations when you are conducting your business.

It is accepted at least among the FII community that the finance minister would come out with a clarification either looking at portfolio investment scheme being exempt or removing the particular clause in which the general anti-avoidance has been worded.

It's far reaching to say that if any of the reasons why you have set up is to obtain a tax benefit then GAAR can be applied on such a structure.

So, the question arises whether you look at the substantial reason to set up is a tax reason, then there should be a question mark. But if it is only one of the reasons then is it not the business of every company or any management to actually make sure that expenses and taxes are as reduced as possible so as to give maximum benefit to its shareholder. So it is a much larger question and I would not say it is necessary to pull out of the market.

So, are you telling them to wait and watch?

Ajinkya: Yes, I think that makes more sense.

Let's get into the FII and the PNs bit. We know that there is an issuer of that PNs and then there is the ultimate investor, who could be sitting in any jurisdiction. The person who is issuing the P-Note could either be based here, registered in one of these tax heavens. How would that play out, according to you?

Chitale: I think it is useful for a minute to step back and understand how the PNs are actually structured as a contract and not much has been talked about it.

But the way it works is, a P-Note is either designed as a total return swap under the ISDA (International Swaps and Derivatives Association) document between the issuer and the holder of the PNs or it is structured as a prepared, cash settled call option.

Both these contracts are often entered into not necessarily by the entities set up in Mauritius. Often these contracts are entered into with the parent bank whose subsidiary is the FII in Mauritius.

So that is the ground reality and, therefore, to think that this particular PNs is not going to get exposed to a tax issue is a bit optimistic.

Please understand, in all these ISDA-based contracts there is something called an adjustment event of various kind which are prescribed.

Though with adjustment event inter-alia include change in law. So, actually the PNs issue is a little different. The issuer of the PNs, which is the intermediary or which is the bank whose subsidiary is in Mauritius is actually going to hold the hedge position.

The risk relating to the underlying, the underlying of a PNs can be represented not necessarily as a cash position.

A large part of the FII position under PNs are represented by futures contracts in the India markets.

So, it is a fairly complex situation and the question is the entire tax treatment underlying under the P-Note contract has to flow through to the PNs holder.

That is really the crux of the issue, which has not been much talked about. So it is not

PNs as a standalone.

So under the current GAAR, most of these PNs could actually end up coming within the tax angle and therefore there would be a withholding tax, which would be confusing and therefore this pull out would be justified?

Chitale: It's not exactly a question of withholding tax, the question is how can an issuer, who is just holding an underlying and passing on the entire economic benefit to the PNs holder, retain any residual tax risk.

Therefore, it's been a mixed question of contract and the pressure point with the issuer is what would they do now to ensure that the risk is deflected.

The question is how do they exercise this adjustment event trigger. Do they terminate the contract, do they just tell the PNs holder that there is going to be an adjustment? That's really the issue.

What would you tell somebody to do right now?

Chitale: I think it's very clear that the issuer can't hold this risk. You already hear enough in the market to say that they are just clarifying to the P-Note holders that whatever it is, the consequences are on your account.

On a similar point that I made on the P-Note and the FII, the issuer and the ultimate holder. How do you see that panning out?

Dalal: First of all, I believe the PNs situation as Bijal alluded earlier maybe a little different.

The PNs situation on technical grounds is a little stronger. But as Rajendra mentioned the fact that there is an uncertainty cannot be doubted. The commercial risk will come on an intermediary like the FII and this will certainly create confusion.

What probably will happen is that there will be a day or two of wait and watch and then both the PNs holders as well as the PNs issuers will probably need to review the position and see what they re going to do.

If the position at that time is that the risk does look very real, than the issue can also be whether the tax department can say whether the FIIs are liable to withhold tax at source. So a possibility of a large number of technical issues coming out of that could arise.

But wait and watch for what? We have a situation here where the best the finance minister could have said, he said it in Parliament. We know this bill is not going to become law, at least till May.

Dalal: You are absolutely right. I was not suggesting that the wait and watch would be over a two-month period. I think the wait and watch would mean a day or two, so today the Sebi (Securities and Exchange Board of India) chairman and the revenue secretary are having a discussion with the FIIs and I think the one or two day wait and watch is probably what people will wait for.

If nothing is clarified, then the confusion will prevail and I won't be surprised if the investment flow gets impacted seriously.

How would you explain the difference between the two and what could the impact be, given the fact that we are in a situation of confusion? What is it that the SebI chairman can say to FIIs? What is it that a revenue secretary can say to FIIs when the matter is before Parliament?

Ajinkya: We need to differentiate between the General Anti-Avoidance Regulations and the indirect taxation provisions which have been brought about in the budget.

Between the ODIs (offshore derivative instruments) and the FIIs itself, who actually hold the hedge positions or either the cash or under the F&O (futures and options)

segment.

When you're looking at it from an ODI perspective for GAAR to be triggered, one of my main objective is to get a tax benefit.

Today, when you are really looking at it, and you are looking at an ODI client, his main reason as to why he's taking an ODI is either he doesn't want to be directly exposed to the Indian capital markets or he cannot take it for various reasons.

So, what he does at that point of time is he calls up a broker and sees who gives him the best price. So he's really not doing it for a tax reason. At the end of it, he just wants that exposure to the Indian capital markets.

But wouldn't that exposure get severely dented if we were to apply tax?

Ajinkya: The important point is that that is only a financial return and a commercial decision for him. I feel it would be very difficult for it to bring it to tax and perhaps that's not the intention.

As to say that they came in for a tax benefit is extremely difficult. Most of the times you actually enter into the contract not necessarily with the Mauritius or Singapore or Dutch entities, but with the parent.

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