Tax Hotline

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INDIAN GAAR: RULES NOTIFIED

The Central Board of Direct Taxes has recently notified Rules that would govern India's new General Anti-Avoidance Provisions ("**GAAR**"). Although the Rules introduce some safeguards, the real concerns surrounding GAAR remain unaddressed. Ambiguities continue to remain with respect to concepts such as lack of commercial substance, substantial commercial purpose, bona fide objects, abuse and misuse of law. One remains clueless about the interplay between GAAR and other anti-avoidance and anti-treaty abuse provisions, as well as the fate of Mauritius and other popular investment routes. The limited grandfathering of specific investments (prior to August 30, 2010) makes GAAR more retroactive than prospective.

India like every other country is justified in defending its tax base, and is in sync with the global move to curb money laundering and abusive tax schemes. However, these concerns have to be balanced with the need for greater taxpayer certainty, eliminating double taxation on a global basis and enhanced accountability on behalf of tax administrations.

The primary concern with GAAR may be summarized as thus: Is there a real guarantee that GAAR shall not end up as another "weapon to intimidate taxpayers" (borrowing the UK GAAR Committee's words of caution)? This concern has special relevance in an environment conventionally known for protracted litigation, retroactive law making, high pitched tax assessments and corruption.

The GAAR Rules have been notified as a follow-up to the Government's announcement in January this year accepting specific recommendations of the Shome Committee constituted in 2012 to critically analyze the GAAR provisions. Earlier, the provisions were also reviewed by the Parliamentary Standing Committee on Finance which had also made some important recommendations. Apart from the limited grandfathering, the Rules introduce a few procedural safeguards and some relief for P-note holders. However, several key recommendations by the Shome Committee and the Standing Committee including certain safe harbours, and clarity on the Mauritius route have been left out.

BACKGROUND TO GAAR

GAAR was introduced into India's tax statute in 2012 and has been criticized widely on account of the ambiguities in its scope and application, lack of safeguards and possibility of misuse by the tax authorities. GAAR empowers the Revenue with considerable discretion in taxing 'impermissible avoidance arrangements', disregarding entities and recharacterising income and even denying tax treaty benefits.

The introduction of GAAR led to immense hue and cry among investors, which prompted the Government to appoint an Expert Committee under the renowned economist Dr. Parthasarthy Shome to consult with stakeholders and review GAAR. (Click here for our hotline with insights and analysis of the Shome Committee's report.) In its detailed report, the Expert Committee had recommended a substantial narrowing down of the scope of GAAR and other protections in the interest of fairness and certainty.

Following the recommendations of the Shome Committee, various amendments were introduced through the Finance Act, 2013 including the following:

- GAAR shall be effective from April 1, 2015;
- GAAR would apply only if the main purpose of an arrangement is to obtain a tax benefit;
- Factors such as the holding period of the investment, availability of an exit route and whether taxes have been paid in connection with the arrangement may be relevant but not sufficient for determining commercial substance;
- GAAR cases shall be scrutinized by an Approving Panel chaired by a retired High Court Judge, a senior member of the tax office (of the rank of Chief Commissioner of Income Tax) and a reputed academician or scholar with expertise in taxation or international trade and business.

The recently notified Rules seek to provide a few exclusions and address certain procedural and other matters not covered by the Finance Act, 2013.

APPLICATION OF GAAR: SPECIFIC CLARIFICATIONS

The Rules provide the following clarifications with respect to the application of GAAR in India:

1. *De minimis rule*: GAAR shall not be applicable to any arrangement where the tax benefit arising to all parties to the arrangement does not exceed a sum of INR 30 million in the relevant financial year.
2. *Limited grandfathering and retroactivity*: Investments made prior to August 30, 2010 have been grandfathered and GAAR shall not apply to exits from such investment. This was date when the Government introduced the Direct Taxes Code Bill (still pending before Parliament) which initially proposed GAAR. The grandfathering is

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very limited since GAAR may still apply to a range of transactions, structures and arrangements set up prior to August 30, 2010. Further, investments made subsequent to August 30, 2010 will be subject to GAAR. One could therefore say that GAAR is retroactive in most contexts. For GAAR to be truly prospective, it should only apply to arrangements initiated subsequent to implementation of GAAR.

3. *Relief for FIIs?*: The Rules also provide that GAAR shall not apply to a Foreign Institutional Investor ("FII") that does not claim benefits of a tax treaty and subjects itself to taxation under domestic law. The Rules do not provide any real relief for FIIs, and difficulties with respect to treaty relief in the face of GAAR would continue to cause concern. FIIs (especially tax exempt investors such as foreign pension funds, endowments and mutual funds) also have to be cautious about availability of credit in the home country against any taxes paid in India on account of GAAR.

4. *Relief for P-note holders*: GAAR would not be applicable to any investment made by a non-resident that directly or indirectly invests in offshore derivative instruments or otherwise through an FII. Even though some relief has been provided to P-Note holders, difficulties may arise if the FII passes on the tax costs to the P-Note holders.

5. *Timelines & procedure*: The Rules lay down the procedure for invocation of GAAR. If the tax officer is of the view that an arrangement is an 'impermissible avoidance arrangement', he is required to issue a notice to the taxpayer asking him to state reasons for the non-applicability of GAAR. The notice to the taxpayer has to contain details of the arrangement, the tax benefit, basis and reason for considering that (i) the main purpose is to obtain tax benefit; and that (ii) the arrangement is an impermissible avoidance agreement; along with a list of supporting documents and evidence. The tax officer is also required to make a reference to the Commissioner of Income Tax ("CIT") in Form 3CEG.

   If relying upon the reference of the tax officer, the CIT is of the view that GAAR need not be invoked; the CIT is required to issue directions to the tax officer in the Form 3CEH within a period of 1 month from the end of month in which the reference was received by him. If the CIT reaches this conclusion on the basis of taxpayer's response to the notice, the CIT shall issue directions to the tax officer within a period of 2 months from the end of month in which the taxpayer furnishes objections to the notice received by him.

   If the CIT does not accept the taxpayer's objections, he can make a reference to the Approving Panel after declaring the arrangement as an impermissible avoidance arrangement in Form 3CEI within 2 months from the end of the month in which the final submission of the taxpayer was received.

CONCLUDING COMMENTS

The following suggestions should be considered before GAAR is finally implemented:

1. *Need for safe harbours*: It would be helpful to provide statutory safe harbours identifying specific scenarios where GAAR will not apply. For instance, it may be clarified that GAAR should not apply to question commercial substance of a listed entity (domestic or foreign), certain commercially driven structured finance arrangements, court sanctioned merger or demerger schemes, choice of funding through debt or equity, or arrangements where foreign tax has been paid. Not-for-profit organizations can also be outside the purview of GAAR. The Government has recently introduced specific safe harbours for transfer pricing which, though limited in scope, was welcomed by the industry.The Government may consider introducing something similar for GAAR as well.

2. *More clarity on commercial substance*: A number of terms have been used in the GAAR provisions which still remain ambiguous. It is hoped that the Government will also release detailed explanations, along with illustrations, on the meaning of expressions such as 'commercial substance', 'substantial object', 'bonafide', 'misuse or abuse' and other ambiguous terms that are used in the provisions. The guidance provided by countries such as Australia, UK and South Africa are far superior to what is presently available in India.

3. *Mauritus et al- GAAR and tax treaty relief*: In the tax treaty context it would be preferable to include bilaterally negotiated anti-abuse provisions rather than a unilaterally enforced GAAR. The Shome Committee rightly recommended that GAAR should not be invoked if the treaty has a Limitation of Benefit ("LoB") provision limiting treaty entitlement in specific cases. For instance, the tax treaty with Singapore has an LoB clause because of which the capital gains tax exemption on share transfers may not be available to a Singapore entity that lacks commercial substance or is a shell or conduit company. Certain expenditure or listing requirements may be fulfilled so that the entity is not treated as conduit or a shell company. To the extent the entity satisfies the LoB criteria in the treaty, GAAR should not apply to it.

   It is reported that the India-Mauritius tax treaty is currently being renegotiated and it is possible that certain substance requirements may be introduced. Interestingly, Mauritius has recently identified certain additional criteria for companies (having Global Business 1 licenses) to be considered as being 'managed and controlled' in Mauritius[1]. The additional considerations include having an office premise in Mauritius, fulltime employment of administrative/technical personnel one of whom shall be a resident in Mauritius, settlement of disputes by arbitration in Mauritius, holding of assets worth at least USD 100,000 in Mauritius, relevant qualifications and involvement by resident directors, and reasonable expenditure in Mauritius which is expected from any similar corporation which is controlled and managed from Mauritius. Companies are expected to comply with these changes from January 1, 2015.

4. *GAAR and specific anti-avoidance rules*: Several countries including UK, Canada and Australia consider that GAAR should be used sparingly and as a last resort. GAAR should not be invoked in situations where specific anti avoidance rules (like transfer pricing) are applicable.

5. *Change in mindset and increase in accountability*: Ambiguous legal provisions such as GAAR create further tension in the existing adversarial environment in India characterized by the large backlog of cases. It is estimated that over a trillion rupees is stranded in various stages of tax litigation. It is therefore not surprising that the Parliamentary Standing Committee had recommended disciplinary action for officials who made irrational and unreasonable tax assessments that are eventually set aside by the Courts.

   To introduce GAAR and obtain a buy-in from stake holders it is essential to eliminate adversarial approach towards taxpayers, reduce compliance costs, remove ambiguous legal standards and introduce a charter of taxpayer rights which guarantees enforcement of tax laws in a fair, equitable and non-arbitrary manner.

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– Ashish Sodhani & Mahesh Kumar
You can direct your queries or comments to the authors

[1] The Financial Service Act, 2007 provides certain conditions that the FCS shall consider to determine whether a GBC1 is 'managed and controlled' in Mauritius

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