1. **Global Background**

1.1 Since the liberalisation of the Indian economy, sophisticated forms of tax avoidance/planning are being adopted by tax payers and their advisers. It is common for tax payers to arrange their affairs in a way that will entitle them to receive tax benefits. The problem has been further compounded by tax avoidance arrangements spanning across several tax jurisdictions which has led to severe erosion of the tax base. As a result, over the past few years it has been noticed that the Revenue authorities have attempted to deny tax benefits whether under the tax treaty or domestic laws by disregarding the form and looking through the transactions.

1.2 Courts, in some cases have held that legal form of a transaction can be dispensed with and the real substance of transaction can be considered while applying the taxation laws, while in some other cases it has been held that the form is to be given sanctity. This has led to two disadvantageous scenarios for both the assessee as well as the Revenue viz (i) on the one hand, in some cases, genuine transactions consummated in a tax efficient manner are treated as sham transactions or colourable devices used for evading tax which in turn has led to protracted litigation and uncertainty (ii) on the other hand, in some other cases, appellate authorities and courts have been placing a heavy onus on the Revenue in matters of tax avoidance (even though the relevant facts which are in the exclusive knowledge of the tax payer remain undisclosed).

1.3 With the increasing globalisation of economies and growth in cross border transactions, some countries have introduced legislation which has empowered the Revenue authorities to question transactions and arrangements and disregard their form to deny tax benefit unless the tax payer can establish the commercial legitimacy of the transaction. Different countries have taken different approaches in this regard. Australia was in the forefront of introducing General Anti Avoidance Rule (‘GAAR’) as early as 1981. Mature economies such as Canada, New Zealand, Germany, France, the United Kingdom and South
Africa have also introduced GAAR. Emerging economies have also started introducing GAAR with the phenomenal growth of their economies.

1.4 There are distinct instances of anti-avoidance provisions prevailing across economies, yet ordinarily, these provisions can be identified into the following categories:

(i) Transfer of residence: These entail fictitious residence upon the transfer of residence abroad and exit taxes. For instance, a company incorporated in a country continues to be a tax resident of that country even though the effective management is relocated to another country.

(ii) Base companies: These rules address the offshore income of base companies and are embodied in controlled foreign companies (CFC) legislation. The US was the first country to introduce a CFC regime. These rules attribute income earned by a CFC to the shareholder of that entity or deem the shareholder to have received dividends from the entity. These rules may be adopted for certain specific low tax jurisdictions.

(iii) Base erosion: This category includes thin capitalisation rules, earnings stripping rules and rules limiting the deduction of interest payments to a percentage of assets. For example, deductibility of expenses paid to non-residents may be restricted or exemptions, otherwise applicable to non-resident companies, may be disallowed if such companies are held, as stipulated by residents.

(iv) Character of income: This entails re-characterization of income depending upon the domestic laws of each country. For instance, in Australia thin capitalization rules may re-characterise disallowed interest into dividends, but for withholding tax purposes, dividends may also be re-characterized as interest.

2. GAAR - In India

2.1 India, too has taken the initiative of introducing GAAR within its tax laws. The initiative first surfaced in the Direct Taxes Code Bill in 2009 which was to be the reformed Income-tax Law in India. The implementation of the Direct Taxes Code Bill was unsuccessful and accordingly, the Government introduced the provisions of GAAR vide Finance Act, 2012 with effect from April 1, 2014 which was later postponed by Finance 2013 to be effective from April 1, 2016. However, due to the ambiguity and uncertainty of the effect of the provisions, the same is now deferred to assessment year beginning April 1, 2018 relevant to financial year April 1, 2017 to March 31, 2018.

2.2 The GAAR provisions in India are contained in sections 95 to 102 of the Income-tax Act, 1961 (‘the Act’). Section 95 of the Act provides that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the tax arising therefrom would be imposed to the consequences as provided in the other sections contained under the Chapter. The Explanation to the Section provides that the GAAR provisions may be applied to any step in, or a part of, the arrangement as they are applicable to the entire arrangement.

The word ‘arrangement’ is defined in Section 102(1) of the Act to mean any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation scheme, agreement or understanding.

The word ‘step’ is also defined in section 102(9) of the Act to include a measure or an action, particularly one of a series taken in order to deal with or achieve a particular thing or object in the arrangement.

2.3 Section 96 of the Act provides for situations where an arrangement could be regarded as an Impermissible Avoidance Arrangement i.e. when its main purpose is to obtain a tax benefit and it contains any of the following tainted elements i.e. it:

i. Creates rights, or obligations, which are not created between persons dealing at arm’s length

ii. Results in misuse or abuse of the provisions of tax laws

iii. Lacks commercial substance

iv. Is carried out in a manner not ordinarily employed for bona fide purposes.

Tax benefit as contemplated under Section 102(10) seeks to cover any sort of reduction of tax or amount payable under the Act or increase in refund of tax or any other amount in the Act.
3. Some Undesirable Consequences of GAAR

3.1 The language used in the Act is extremely wide ranging and can have unanticipated consequences due to its subjectivity. Taxpayers would be burdened with a huge onus of proving that the transaction is based on rational and legitimate commercial substance and that consequently it is not an impermissible avoidance arrangement.

3.2 Also, where GAAR is applied in the case of a taxpayer, there is no corresponding or consequential relief available to the counterparty whether or not such counterparty is a related party of the taxpayer.

3.3 Let us take the following illustrative case where practically the GAAR provisions may be applied by the Revenue - A foreign company (Company A) sets up its subsidiary company (Company B) in another foreign company with which India has a DTAA which provides for non-taxation of capital gains in the source country. The holding company, A, has invested in an Indian company through its subsidiary company (Company B) which is the legal owner of the shares of the Indian company. On transfer of such shares, Company B earns capital gains which are exempt from tax considering the treaty benefits. It may be noted that the main purpose of setting up the foreign company may not be to avail tax benefit. However, due to the provisions of the treaty, the holding company is able to make a business choice of investing its funds in the Indian company through its subsidiary company B. An undesirable consequence of the above may be the application of GAAR by the Assessing Officer.

The question that now arises, if setting up a SEZ Unit with the main purpose of availing tax benefit is considered as a tax mitigating plan, why can’t availing the treaty benefit by way of investing through its subsidiary company be considered as tax mitigation instead of tax avoidance, considering the commercial substance in the subsidiary.

4. Safeguards against Application of GAAR

4.1 In certain situations there may be a thin line between tax mitigation and tax avoidance. In order that provisions of GAAR are not used by tax authorities arbitrarily, the Expert Committee has
recommended that an illustrative list of tax mitigation or a negative list for the purpose of invoking GAAR should be considered for introduction under the Act. The following illustrative (and not exhaustive) transactions or acts, according to the Expert Committee, should be included under the negative list:

i. Selection of one of the option offered in law.
   For instance:
   a. Payment of dividend or buy back of shares by a company;
   b. Setting-up of a branch or a subsidiary;
   c. Setting-up of a unit in SEZ or any other place;
   d. Funding through debt or equity
   e. Purchase of lease of a capital asset;

ii. Timing of a transaction, for instance, sale of property in loss while having profit in other transactions.

4.2 To protect the foreign inflow of investments, the Government vide Rule 10U of the Income-tax Rules, 1962, has made a specific exclusion by stating that GAAR would not be applicable to Foreign Institutional Investors, who do not avail of treaty benefits and who invest in listed/unlisted securities with the prior approval of the Securities and Exchange Board of India and to non-residents investing in India by way of offshore derivative instruments, directly or indirectly in an FII.

4.3 In fact, to comfort investor’s apprehensions, the Central Board Direct Taxes issued Notification 49/2016, dated June 22, 2016 which provides any income from the transfer of investments made before 1st April 2017 will not be subject to GAAR. [However, as regards other transactions (i.e. other than the transfer of grandfathered investments) GAAR will apply to any arrangement, irrespective of the date on which the arrangement was entered into, if the tax benefit from that arrangement is obtained on or after 1st April 2017.]

5. GAAR v Specific Anti-Avoidance Rule (‘SAAR’)

5.1 In the past, the Government inter alia has implemented various SAARs which form part of the provisions of the Act / Double Tax Avoidance Agreements. A few such examples are enlisted below:

- the limitation of benefits clause in the Double Tax Avoidance Agreements (‘DTAA’) and
- The concept of Controlled Foreign Corporations which combats the deferral of tax by allowing the country in which the controlling parent is resident to tax income accruing to the controlled corporation even before it is distributed.

- Section 2(22)(e), which in effect examines the substance of the transaction over its legal form;
- Section 9 of the Act which provides for instances where income is deemed to accrue or arise in India
- Section 14A of the Act preventing the assessee from claiming an expenditure in relation to income which is exempt under the provisions of the Act.

- Section 36(1)(ii) of the Act, which does not allow the payment of bonus to employees where such bonus was paid as profit or dividend

- Section 40(a)(i), 40(a)(ia), 40(a)(iii) disallowing payments on which tax due was not deducted

- Section 40b of the Act, disallowing interest and other expenses incurred by a firm unless the conditions prescribed in the section are fulfilled.

- Section 40A(2) and 40A(3) disallowing excessive amounts paid to related/interested parties and disallowing expenses paid in cash where in excess of Rs. 20,000, respectively.

- Section 43(1) of the Act, which overlooks the mere legal form and determines the actual cost of assets

- Transfer of income without the transfer of assets under Section 60 of the Act

- Clubbing provisions contained in Section 64 of the Act

- Section 68, 69 etc which requires the assessee to prove the genuineness of transactions undertaken by it.

- The Transfer Pricing provisions.

- Section 94(7) of the Act introducing the concept of dividend stripping to prevent
avoidance of tax by certain transactions in securities
xvi. Section 179 of the Act prescribing the liability of directors of a private company in liquidation.

5.2 It is a widely accepted principle that where a transaction is covered under both, a specific provision of law and a general provision of law, the specific provision would override the general provision. The same should apply in the instant case and therefore where a taxpayer is covered by SAAR and it is concluded that the transaction carried on by such taxpayer is not a means for anti-avoidance under the SAAR, a GAAR should not apply to the same transaction.

5.3 Even in the Final Report on GAAR issued by the Expert Committee it was noted that the Limitation of Benefit (LOB) clause in some of India’s tax treaties is a specific anti-avoidance rule to prevent tax abuse. It states that, where a specific rule is available, a general rule will not apply and that, a SAAR normally covers a specific aspect or situation of tax avoidance and provides a specific rule to deal with specific tax avoidance schemes. It further states that, where anti-avoidance rules are provided in a tax treaty in the form of limitation of benefit etc., the GAAR provisions shall not apply overriding the treaty. Similar logic should also be applied to the other SAARs.

6. Conclusion
6.1 Post GAAR, tax may not be seen to be driving businesses any more. In fact, it may be the other way around i.e. business reasons and commercial rationale will be central to any planning in a GAAR environment.

6.2 In the Indian context, considering the aggression of tax administration in some cases, the introduction of GAAR may be worrisome to a taxpayer unless implemented in a balanced manner with adequate safeguards for protecting the taxpayer. An arbitrary usage could be extremely cumbersome for tax payers receiving tax benefits out of legitimate transactions.

6.3 The success of GAAR would lie in its judicious, selective and sensible implementation. Inevitably GAAR has significant and punitive consequences and therefore it should be applied carefully so that they are designed to address real mischief only and go no further. To ensure the tax system does not fall into disrepute, GAARs must be administered transparently and with abundant due process commensurate with their often draconian consequences.

You don’t have to be great to start, but you have to start to be great.

– Zig zagler