ARA LAW
ADVOCATES & SOLICITORS

"GAAR": *A THREAT TO COMMERCIAL TAX STRUCTURING?*

*Well described in precise words, "**the difference between tax avoidance and tax evasion is the thickness of a prison wall**". However with the changing landscape of Indian tax regime and proposed introduction of GAAR, soon the said words would become futile under Indian legal scenario. Hitherto the concepts of "tax evasion" and "tax avoidance" were segregated by a thin line of legal sanctity, but post Vodafone verdict by the Apex Court, there has been a switch in legislative outlook and various amendments under existing Income Tax Act, 1961 and a series of renegotiations on existing Double Tax Avoidance Agreements (DTAAs) have taken place or are in line. Going ahead, a landmark budge is expected to be witnessed with the implementation of GAAR in April, 2017. This Article is an attempt to analyze the legal validity of tax planning/ structuring before and after the proposed advent of GAAR.*

There are different ways by which a tax payer can escape his tax liability. But there is a thin line difference of legality between "escaping tax liability" and "overcoming tax burden". In common parlance, **Tax Avoidance** is the legal utilization of the regime to one's own advantage, to reduce the amount of tax that is payable by means that are within the law. By contrast, **Tax Evasion** is the general term for efforts to not pay taxes by illegal means. Judiciary has time and again attempted to provide some distinction between an unacceptable tax evasion and acceptable tax avoidance under the ambit of "tax planning". However, there certainly exists a grey area between these two heads and the distinction has become increasingly blurred, in view of varying and often conflicting judicial pronouncements. Sometimes even improper drafting, ambiguities and gaps in the provisions of age old drafted statutes add to this uncertainty.

For instance, the Apex Court in the notable *Azadi Bachao Aandolan* case in 2002 observed: "*We are unable to agree with the submission that an act which is otherwise valid in law can be treated as **non est** merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests, as perceived by the respondents*." Going a step ahead, the court also upheld the principle that "*every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be*", making a clear departure from the famous McDowell verdict.

Owing to liberal outlook and activism shown by judiciary and favourable bilateral tax avoidance treaties with various jurisdictions, a very investor friendly regime has been in existence in India which gave a lot of scope of tax structuring and planning thereby encouraging the M&A and PE investors and other market players to route their investments to India, directly or indirectly. However with the successful renegotiation of Indo-Mauritius and Indo-Cyprus DTAA, the Government has already clarified its intentions to put an end to such investor biased tax regime which in long run may have an adverse affect on Indian economy.

One reason for the elevated scope of judicial activism on this issue is the absence of any direct provision on tax avoidance and planning under the existing Income Tax Act, 1961, except provisions relating to avoidance of tax in international transactions under Chapter X. However the Direct Tax Code (DTC) now proposes to introduce General Anti-Avoidance Rule (GAAR), which expressly merges the concepts of "tax avoidance" and "tax evasion" thereby making the tax regime stricter and less ambiguous.

Changes expected with the implementation of GAAR: GAAR is an anti-avoidance measure that gives the tax department blanket power to scrutinize transactions structured to deliberately avoid paying tax in India and declare it as '***impermissible avoidance arrangement'***. In all possibility, after all delays and debates, GAAR will be finally implemented with effect from April 01, 2017. Accordingly, as per the current announcements and status, it appears that investments made before April 01, 2017 will not come under scrutiny of the GAAR but any arrangement that predates this could come under the tax department's scanner if a tax benefit is claimed from next year. This means that existing arrangements that are aggressively structured to escape taxes in India, be it royalty payments, depreciation, interest payments or fees for technical services could come under the tax department's scrutiny irrespective of the date of entering into such arrangements if tax benefits continue to be claimed from financial year 2017-18.

The expression "*impermissible avoidance arrangement*" has also been defined under the DTC to mean essentially a step or an arrangement, whose main purpose is to obtain a tax benefit and lacks commercial substance, in whole or in part. The given scope of "impermissible avoidance arrangement" is very wide and there is a genuine apprehension in the mind of the taxpayer that it might even encompass bona fide commercial transactions. It allows revenue authorities to disregard, merge or re-characterize any step in any such arrangement, or re-characterize equity in to debt and vice versa. The demarcation between "tax evasion" and "tax avoidance" has been completely done away with and the "permissible tax avoidance transactions" are also impermissible now under GAAR.

GAAR also makes a presumption in favour of the tax department that an arrangement is entered into for the tax benefit alone, unless the same is rebutted by the taxpayer. The burden of proof has been shifted on to the taxpayer to establish that obtaining a tax benefit was not the main purpose of the arrangement; else the arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit. Hence GAAR is expected to bring a big change in the underlying tax treatment for all the market players whether big M&A players, foreign and domestic investors or an individual taxpayer.

Concerns over GAAR: Amongst others, set out below are the major concerns which are raised by the proposed implementation of GAAR from tax structuring perspective:

- GAAR has given **wide discretionary power** in the hands of tax authorities. Conferring so much power apprehends the misuse and abuse of powers.
- GAAR induces an element of subjectivity and therefore instead of imparting certainty, more **uncertainty and litigation** can be anticipated.
- Unlike other jurisdictions, DTC and GAAR does not provide for any **separate appeal mechanism** in cases after the notice has been served to the tax payers for the invocation of GAAR.
- Besides that, the legislation has been **over-prescriptive** as to how transactions are to be re-characterized by GAAR. It has gone beyond principles laid down in judicial pronouncements and even includes the incidental tax benefits within the scope. There is a genuine apprehension that in an attempt to deter a limited fraction of tax evaders and illegal tax structures, a huge chunk of bona fide and legally permissible tax structuring would also come under the wide discretionary ambit of GAAR and the possibility of such bona fide

transactions/structures getting hit by the subjective judgment of the tax department cannot be overruled completely. This is certainly going to **affect and interfere with the *bonafide* and genuine structuring and transactions**.

Way Ahead: If implemented with the clear objective of not targeting the genuine business transactions and structuring, then GAAR, in long run, can be expected to be a boon for Indian economy, irrespective of the short term affects on investors and existing tax planning. Set out below are few suggestive measures, which if included while implementing GAAR can prove to be game changer without affecting the investment flow in India beyond a considerable limit:

- Some objectivity and transparency should be induced in the entire GAAR mechanism. Wide discretion given to the tax department should either be curtailed down or **proper checks should be imposed**. One possible way could be having a supervising authority or proper appeal mechanism in place. **Advance ruling mechanism** can also act as a restrain on the unbridled powers given to the tax department. Further, *greater the transparency, minimal will be the possibility of any misuse of discretionary power.*
- Creating a separate **authority for appeal** may invite the criticism of increasing the scope for litigation, but in the long run the advantages would override the anticipated evils.
- The underlying principal that GAAR should not go against the interest of bonafide tax payers and commercial transactions needs to be strictly complied with and given effect to. If required, **necessary exceptions (like "*permissible tax avoidance*") and restrictions to the invocation of GAAR** should be imposed expressly. This is even more relevant in international transactions, considering that GAAR, as announced and framed, is expected to prevail over the **limitation of benefit clauses** of DTAAs as well.
- Lastly, it would also be beneficial to study the experiences of other jurisdictions where GAAR has been introduced *vis-a-vis* its effectiveness in curbing tax evasion and its impact on investment climate. Necessary amendments can be introduced so as to **safeguard the interest of foreign investors and genuine investment structuring**. If required**, grandfathering period** should be increased for the existing structures and investments.