The gaar and income tax regulations law equity essay

Law

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Introduction

It is common practice amongst taxpayers to arrange their affairs in a manner such that it would result in tax benefits. Such measures however, have often raised the eyebrows of revenue authorities who have not only questioned the legitimacy of such transactions, but have even tried to look through them. The issue as to whether reduction in tax liability through a transaction or a series of transactions is 'tax planning' or 'tax avoidance' has been the subject matter of debate both in India and overseas for the past several decades. Although, the Judiciary has attempted to define the principles for determining tax avoidance, the most recent being the case of Vodafone B. V., however considering the mindset of revenue authorities, the introduction of and the powers prescribed under the proposed anti-avoidance provisions are likely to have significant implications, both positive and negative. At present, India has specific anti-avoidance provisions engraved both in the domestic tax laws and in some of the tax treaties through the 'limitation of benefits' clauses. However, in a bid to curb tax avoidance and enforce the concept of 'substance over form', the Indian revenue policymakers propose the introduction of one of the most significant contemporary tax reforms - The General Anti Avoidance Rules (" GAAR"). Although originally forming a part of the Direct Taxes Code (" DTC"), however, given the postponement of DTC, GAAR is a part of the tax reforms proposed to be introduced through the Union Budget 2012.

Recommendations

Though the Indian lawmakers have taken due care in creating a law that is broadly in line with the internationally accepted standards of anti-avoidance measures. However, it may be noted that some of the important recommendations of the Standard Committee on Finance have not been taken into account while introducing the GAAR provisions: Suitable grandfathering provisions may be made to protect the interest of the tax-payers who have entered into structures / arrangements under the existing law; Uncertainties with regard to applicability of tax treaty provisions to be removed so that India's credibility as a reliable treaty partner is not affected; The proposals should not lead to any fiscal uncertainty or ambiguity; It should be ensured that any of the proposals do not pave the way for increased and avoidable litigation.

Example to GAAR

To make it easier to understand GAAR; we can say that suppose a person or a company is setting up business in Gulf Country and its clear intention is to claim exemption from capital gains tax, in such a scenario Indian govt has the right to deny the legitimate claim for exemption provided under DTAA as it falls under tax avoidance and Indian govt is trying to plug the loopholes.

GAAR & Income Tax Regulations

While introducing the provisions of General Anti Avoidance Rule (GAAR) in the Income-tax Act, it was mentioned in the Explanatory Memorandum to the Finance Bill, 2012 that the question of substance over form has consistently arisen in the implementation of taxation laws. In the Indian context, judicial decisions have varied. While some courts in certain circumstances had held that legal form of transactions can be dispensed with and the real substance of transaction can be considered while applying the taxation laws, others have held that the form is to be given sanctity. There are some specific anti-avoidance provisions, but, prior to introduction of GAAR, general anti-avoidance has been dealt in specific cases only through judicial decisions. In an environment of moderate rates of tax, it is necessary that the correct tax base be subject to tax in the face of aggressive tax planning. Internationally, several countries have codified the " substance over form" doctrine in the form of General Anti Avoidance Rule (GAAR) and are administering statutory GAAR provisions. The General Anti Avoidance Rule (GAAR) is a codification of the proposition that while interpreting the tax legislation, substance should be preferred over the legal form. Transactions have to be real and are not to be looked at in isolation. The fact that they are legal does not mean that they are acceptable with reference to the meaning in the fiscal statute. Where there is no business purpose, except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have otherwise been part of jurisprudence in direct tax laws as reflected in various judicial decisions. The GAAR provisions codify this substance over form rule. The basic criticism of a statutory GAAR which is raised worldwide is that it provides a wide discretion and authority to the tax administration which can cast an excessive tax and compliance burden on the taxpayer without commensurate remedies. One of the methods by which this can be addressed is to provide guidance on what the provisions entail and how they would be administered. These guidelines are meant to provide explanations and clarity regarding the GAAR provisions. Tax avoidance vs. Tax Evasion: Tax evasion is generally the result of illegality, suppression, misrepresentation and fraud. Tax avoidance is the result of actions taken by the assesse, none of which or no combination of which is illegal or forbidden by the law itself. The GAAR provisions do not deal with cases of tax evasion. Tax evasion is clearly distinct from tax avoidance and is already prohibited under the current provisions of the Income-tax Act. Tax avoidance vs Tax mitigation: Tax mitigation is a situation where the taxpayer takes advantage of a fiscal incentive afforded to him by the tax legislation by actually submitting to the conditions and economic consequences that the particular tax legislation entails. An example of tax mitigation is the setting up of a business undertaking by a taxpayer in a specified area such as a Special Economic Zone (SEZ). In such a case the taxpayer is taking advantage of a fiscal incentive offered to him by submitting to the conditions and economic consequences of the SEZ provisions in the Income-tax Act e. g., setting up the business only in the SEZ areas and export from the SEZ area. Tax mitigation, as distinct from tax avoidance, is allowed under the tax statute. The GAAR provisions also do not deal with case of tax mitigation.

Illustrative cases where GAAR provisions will be considered applicable or not applicable

Example 1:

Facts:

A business sets up a factory for manufacturing in an under developed tax exempt area. It then diverts its production from other connected manufacturing units and shows the same as manufactured in the tax exempt unit (while doing only process of packaging there). Is GAAR applicable in such a case?

Interpretation:

There is an arrangement and there is a tax benefit, the main purpose or one of the main purposes of this arrangement is to obtain a tax benefit. The transaction lacks commercial substance and there is misuse of the tax provisions. Revenue would invoke GAAR as regards this arrangement.

Example -2:

Facts:

A foreign investor has invested in India through a holding company situated in a low tax jurisdiction X. The holding company is doing business in the country of incorporation, i. e. X, has a Board of Directors that meets in that country and carries out business with adequate manpower, capital and infrastructure of its own and therefore, has substantial commercial substance in the said country X. Would GAAR be invocable or would the arrangement be permissible?

Interpretation:

In view of the factual substantive commercial substance of the arrangement, Revenue would not invoke the GAAR provisions.

Example -3:

Facts:

An Indian company has set up a holding company in a low tax jurisdiction outside India which has set up further subsidiary companies which pay dividends to the holding company and such dividends are not repatriated to the Indian company. Would the deemed dividend be treated as income using GAAR?

Interpretation:

Declaration/repatriation of dividend is a business choice of the companies and GAAR provisions would not apply. Based on further facts such as the degree of Indian Ownership, the location of the subsidiaries (in low tax jurisdictions) and the nature of income (most of the income being passive income like interest, dividend etc.), many jurisdictions have anti-deferral and avoidance provisions in the form of Controlled Foreign Company (CFC) provisions. Specific anti-deferral/anti-avoidance provisions are proposed in the Direct Taxes Code Bill, 2010. Accordingly, GAAR would not be invoked in such a case.

Example -4:

Facts:

A company has raised funds from an unconnected party through borrowings, when it could have issued equity. Would the interest be denied as an expense deduction under GAAR?

Interpretation:

A number of jurisdictions have specific thin capitalization rules to deter erosion of the tax base through excessive interest payments. There is no specific provision dealing with this (thin-capitalization) in the I. T. Act. An evaluation of whether a business should have raised funds through equity instead of as a loan should generally be left to commercial judgment and GAAR would not be attracted. Interest payments to connected parties would be subject to transfer pricing provisions. However, based on whether the payments are made to connected parties, the source of funds in the case of the connected parties and the location of these connected parties in low tax jurisdictions, the arrangement could be examined under GAAR provisions.

Example -5:

Facts:

" Y" company, a non- resident, and " Z" company, a resident of India, form a joint venture company " X" in India. " Y", incorporates a 100% subsidiary " A" in country ABC of which " Y" is not a resident. The India-ABC tax treaty provides for non-taxation of capital gains in the source country and country ABC charges a minimal capital gains tax in its domestic law. " A" is also designated as a " permitted transferee" of Y. " Permitted transferee" means that though shares are held by „ A‟, all rights of voting, management, right to sell etc., are vested in " Y". As provided by the joint venture agreement, 49% of X`s equity is allotted to company " A" (being 100% subsidiary and " permitted transferee" of „ Y‟) and the remaining 51% is allotted to the " Z" company. Thereafter, the shares of " X" held by " A" are sold by " A" to " C" (connected to the „ Z‟ group).

Interpretation:

The controlling rights of company " A" were with " Y". A direct transfer of these shares by company " Y" to company " C" would have attracted capital gains tax in India read with the relevant treaty of Y’s country of residence. The company " A" was interposed with main purpose of taking advantage of India-ABC treaty. The arrangement results in misuse or abuse of tax provisions. Revenue would invoke GAAR as regards this arrangement.

Scope of Provisions

The scope of Indian GAAR is very wide as it seeks to cover within its ambit nearly all the arrangements (the term 'arrangement' is very widely worded to cover almost every transaction scheme, understanding etc.) which have an element of 'tax benefit' accruing to the taxpayer. In other words, the principle condition along with the four additional tests could have the effect of bringing each and every transaction resulting in a lower tax liability for the taxpayer under the purview of GAAR. Further, while a transaction as a whole may be a bonafide one, however the tax authorities can invoke GAAR provisions if any of the steps on a standalone basis are undertaken to obtain a tax benefit. Consequently, even genuine business transactions might fall on the wrong side of GAAR. In fact, it seems that while taking all commercial decisions and determining the manner of their implementation, the tax implications of these provisions would play a pivotal role. However, principally speaking, it should be the other way round i. e. if a transaction as a whole is justifiable; the question of invoking GAAR should not arise.

Burden of Proof

Unlike the Indian GAAR, the onus is divided between the revenue authorities and taxpayers depending on the circumstances. In order to limit the tax benefit arising from an avoidance transaction, the burden is on the revenue authorities to prove abuse/misuse of domestic tax law or treaty provisions.

GAAR - A Divergent View by a Common Man

A common man gets hit from both sides as he gets lesser money in form of pay and also ensures that he pays the tax timely and correctly by way of tax deduction at source. Our eminent GAAR also took birth by way of the thought process of the politicians to teach a lesson to Vodafone or similar other business who did not toe their line and that too when they got a boot from Supreme Court who exposed the hollowness of tax rules. Now same has been abandoned due to pressure from other politicians who might have been functioning as a stooge for these corporate houses. Now as a nation we need to wake up and make sure that we have strict tax regimes and we do not toe the line of corporate houses that fund the parties for their election campaigns and get the rules twisted in their favor.

Conclusion

Both the scope of the proposed GAAR provisions and the powers given to the tax authorities in case of GAAR being invoked are inordinately wide and clearly not in line with international best practices. That coupled with the sort of rulings that are passed by tax authorities (particularly at lower levels), is likely to result in misuse of the GAAR provisions. One can only hope that specific and objective criteria are introduced with respect to applicability of these provisions.