The balancing act that is GAAR

With the goods and services tax (GST) having completed the first 100 days, it is time for taxpayers to turn their focus towards another “G”—General Anti-Avoidance Rules (GAAR), which has been made effective from 1 April 2017 in Indian tax law, and which is the other watershed event in the evolution of India’s tax policy and legislation. “Judicial” GAAR has been around and applied in the past in India, but the introduction of the “legislative” GAAR gives a new twist to this interesting topic of tax discussion, and requires both taxpayers and tax practitioners to realign their approach to tax planning.

Given the global developments around base erosion and profit shifting (Beps), the pushback of the implementation date (this was first sought to be introduced in April 2012) has helped in projecting India as being aligned with global trends similar to this development. Other welcome measures in the roll-out of the legislation include:

—Grandfathering provisions, under which investments made (but not structures set up) prior to 1 April 2017 would be protected from the applicability of GAAR in respect of income arising on transfer of such investments,

—A carve-out for a foreign portfolio investor (FPI) from the applicability of GAAR, provided no treaty benefit has been claimed, and for non-resident investors investing in participatory notes in an FPI entity,

—A minimum threshold limit of a tax benefit of Rs3 crore before GAAR is applicable, and

—The two-stage approval process before GAAR can be initiated by a tax officer.

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India has tax treaties with certain countries where specific anti-avoidance conditions need to be met before treaty benefits can be claimed—an example would be the minimum expenditure threshold test under the Singapore and Mauritius treaties. While these treaties have been amended to remove the benefit of the capital gains protection on shares, these phase out over two years, and there are other benefits which may continue to be available under these treaties. Similarly, India is a signatory to the Multilateral Instrument initiative under which certain treaty-related minimum standards are to be met to counter treaty abuse—one of these is the inclusion of a “principal purpose test”, wherein tax treaty benefits can be denied if one of the principal purposes of an arrangement or a transaction was to directly or indirectly obtain a tax benefit.

On the aspect of whether GAAR would apply where specific conditions are included in a treaty, the Central Board of Direct Taxes (CBDT) has clarified that where a case of avoidance is “sufficiently addressed” by the treaty, GAAR should not be invoked. While this clarification is helpful, the use of the term “sufficiently addressed” could leave room for interpretation, besides opening up a new phenomenon of domestic tax law seeking to override a treaty in case the treaty conditions are held to be insufficiently addressing the avoidance.

Another aspect related to benefits under tax treaties is around investments which have been made in the grandfathered period, but which have resulted in a different or new instrument post 1 April 2017. Some examples would be instruments compulsorily convertible from one form to another, shares brought into existence by way of split or consolidation of holdings. The circular seeks to provide grandfathering benefits to such investments with the caveat that in the case of convertibles, the conversion happens at terms finalized at the time of issue of such instruments. However, there could be other similar instances where this benefit may not be available, such as shares acquired in an overseas company prior to

1 April 2017, one which subsequently merges with another company.

The CBDT, in its circular No.7 dated 27 January 2017, has clarified that GAAR will not interplay with the right of a taxpayer in selecting a method of implementing a transaction. It will be interesting to see how this plays out in specific circumstances. Illustratively, let’s take a case where the merger of a profit-making company and a loss-making company within a group is driven by non-tax commercial reasons. The question that would arise here is whether it would be open for the group to proceed with the merger of the profit-making company into the loss-making one, rather than the other way around, especially if there are tax benefits associated with the former option. This gets accentuated by the provision which deems an arrangement to have been carried out with the main purpose of obtaining a tax benefit if the main purpose of a part of the arrangement is to obtain a tax benefit, notwithstanding that the main purpose of the whole arrangement is not to obtain a tax benefit.

There is a line, at times thin, dividing the case of a taxpayer availing of tax benefits legally available under the law from that of what appears to be an artificial transaction undertaken with the main purpose of tax avoidance. Given the long disposal time at present for cases with the Authority for Advance Ruling, a fast-track mechanism for pre-clearance of transactions would aid in reducing the inherent uncertainty in these provisions.

As is commonly understood, GAAR applies to an arrangement where the main purpose is to obtain a tax benefit, and which, among others, lacks commercial substance. All in all, it will be an interesting road ahead where the key aspect for all stakeholders would be to follow the intent of the GAAR provisions in their true spirit.

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