GAAR & BEPS– Crusade against Tax Avoidance

Tax avoidance and evasion has been an area of concern globally. Post 2008 global financial crisis, various countries have taken steps to reduce tax avoidance in their jurisdictions by introducing the General Anti-Avoidance Rules (GAAR) in their domestic tax laws. However, the interplay between a country's GAAR and tax treaties has been debatable and without any global consensus. While some countries permit treaty override over domestic tax law provisions, some countries like India specify when such override may not happen. The author in this article analyses the scenario of tax avoidance and evasion in India vis-à-vis the framework of GAAR under the Direct Tax Code. Read on to understand the issues in international taxation including BEPS, MLI and TP in the national economy…

Introduction

Internationally, tax avoidance and evasion have been an area of concern and debate, which has led to apprehensions across the globe. After the global financial crisis in the year 2008, various countries have taken steps for reducing the tax avoidance in their respective jurisdictions by introducing the General Anti-Avoidance Rules in their domestic tax laws.

Interplay between a country's General Anti-Avoidance Rules (GAAR) and tax treaties has been a debatable subject since long with no global consensus on position. While some countries permit treaty override over domestic tax law provisions, some countries like India specify when such override may not happen. In India, the GAAR provisions have now finally come into force from 1st April 2017, through provisions contained under sections 95 to 102 of the Act. The provisions of GAAR shall permit the Tax Authorities to deny the tax benefits in relation to a transaction/arrangement which do not have any commercial substance other than obtaining tax benefit. However, the Tax Authorities have to comply with various approvals and permissions before invoking the GAAR provisions and the same shall have to be within the framework of the Rules stipulated by the Central Board of Direct Taxes.

Global financial recess during 2008 led the G20 nations to empower the *Organisation for Economic Cooperation and Development* (OECD) to embark on a project to counter Base Erosion and Profit Shifting (BEPS) by Multinational Enterprises (MNEs). Erosion of nation's tax base by MNEs riding on the tax arbitrage scope permeated by tax treaties and divergent domestic tax laws of various countries, especially tax incentive regimes, have led to formulation of 15 action plans by the OECD to tackle such tax dodging menace (the BEPS Action Plans). While anti BEPS measures focus on multiple aspects viz. substance, transparency in disclosure of global operations, coherence between domestic tax laws and treaties, centre of economic activity, GAAR complements as a measure to curb tax avoidance by adopting colourable/ dubious methods.

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The ensuing paras focus on certain aspects of the presently co-existent GAAR and BEPS initiatives in their journey to curb tax avoidance/tax base erosion.

Genesis of GAAR in India

GAAR has been enacted in some countries such as Australia, the Netherlands, Canada, New Zealand, China, Poland, the United Kingdom, the United States, France and Germany, and over the years and jurisprudence on this subject is also available. Before the introduction of GAAR in India, India tax laws had certain specific anti-avoidance rules such as transfer pricing rules, dividend stripping, etc. which had limited applicability. Such rules could not be applied to various other situations where the primary motive of the transaction was tax avoidance. This resulted in such transactions being allowed even though it was evident that the intention of the law was not to grant the tax benefit to such type of transactions as there was no law to restrict such transactions. The landmark Supreme Court decision in the case of Vodafone wherein it was held that Vodafone was not liable to capital gains tax in India as the transfer of shares was of a company outside India. The tax authorities in this case took an argument that the said transaction should be taxable in India as the underlying assets in relation to the shares of the foreign company which was transferred was located in India. The aforesaid decision was one of the main reasons for the introduction of GAAR vide Finance Bill 2012 under the Income-tax Act, 1961 so as to curb such transactions, the primary motive of which is to avoid tax in India.

The elementary motive of GAAR is to allow taxation on the basis of substance over form which will result in *looking through* the transactions/ arrangement which are formed with a primary intention of tax avoidance. Tax avoidance transactions are basically carried out within the framework of the law but not within the spirit of the law, viz. transactions such as forming a company in a particular tax jurisdiction only to take the advantage of lower applicable taxes without having any commercial justification. Post 1st April 2017, any discussion on structuring of a transaction or an arrangement would be incomplete without debating its potential exposure to the provisions of GAAR.

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Shome Committee's Recommendations on GAAR Application

When GAAR provisions were first introduced in the Act by the Finance Act 2012, through Chapter XA of the Act, it was provided in the Act that GAAR provisions would be applied in accordance with certain guidelines and subject to such conditions and the manner as may be prescribed. A number of representations were received against the provisions contained in Chapter XA and the draft guidelines issued by the CBDT during June 2012. Hence, on July 13, 2012, the then Prime Minister approved the constitution of an Expert Committee on GAAR chaired by Dr. Parthasarathi Shome to examine the concerns expressed by the stakeholders, finalise the guidelines for GAAR and suggest the roadmap for implementation of GAAR. The Shome Committee submitted its final report on September 30, 2012, recommending amendments in the Act, Income Tax Rules and issuance of clarifications and guidance by the CBDT.

It is important to note that the Shome Committee endorsed the viewpoint of the committee which formulated the draft GAAR Guidelines, that GAAR provisions should not be invoked in case of tax mitigation but should be applied in case of legal structures or transactions designed solely to avoid tax.

Some of the noteworthy recommendations in the Shome Committee report as accepted by the Governments since then are:

a) deferral of GAAR,
b) prescription of a minimum threshold for invoking GAAR at INR 3 crores,
c) obtaining tax benefit be the main purpose instead of one of the main purposes of any step or part of any arrangement,
d) grandfathering of investments (though not arrangements) from application of GAAR as reflecting on the date when GAAR provisions become effective,
e) limiting application of GAAR provisions only to the part of the arrangement which is treated to be for impermissible avoidance, and
f) framework of the Approving Panel and allied procedures for invoking GAAR provisions, etc.

Amongst many other recommendations, certain illustrations on business reorganisations transactions captured in the Shome Committee report explain the applicability of GAAR provisions on certain corporate restructuring arrangements. For instance, round tripping cases, cases of interposition of entities in low tax jurisdictions for obtaining tax treaty benefits, selective buybacks in low tax jurisdictions, booking of capital losses on sale of shares acquired at artificially inflated costs, disguised financing arrangements whereby a company purchases unlisted securities with a condition to sell back at a future date factoring a specific rate of return and records long term capital gains instead of interest income, etc. are cited as cases of tax avoidance, subject to application of GAAR. The merger of a profit making company into a loss making company or *vice versa* may result in offsetting losses against the profits thereby reducing the tax liability. If this scheme of merger has been sanctioned by a High Court after due consideration of all aspects including taxes, such arrangement ought not attract GAAR as per the Shome Committee.

It is important to note that while the Governments thus far have amended the Indian tax law as per most of the recommendations of the Shome Committee report on GAAR provisions, some of the recommendations in the report are yet to be considered. Due to the subjectivity associated with the extant draft of the GAAR provisions, some of these unaddressed recommendations assume importance.

The Committee also recommended that unless a tax avoidance arrangement is abusive or artificial or contrived, GAAR provisions should not apply. Thus the Committee recommended that an illustrative negative list of transactions viz. setting up of units in SEZs, amalgamations and demergers through court approved scheme, purchase or lease of capital assets, intra group transactions not resulting in altering consolidated group revenue, etc. may facilitate greater understanding and certainty about the applicability of GAAR provisions. Such a negative list is yet to feature in the extant Indian income tax law. Non-adoption of the above recommendations on GAAR provisions leaves enough scope for debate or litigations about the applicability of GAAR in these arrangements. Hence, till the Government clarifies its stand in this regard, it may be incumbent upon on courts to decide on principles about the applicability of GAAR provisions in these cases. However, the views of the Shome committee on the various situations of corporate restructuring should certainly have a persuasive value as it represents views of an empowered committee comprising of different stake holders.

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Genesis of BEPS Project

Incongruences in the current international tax rules can make profits "disappear" for tax purposes, or allow the shifting of profits to no or low-tax locations in cases of businesses with little or no economic activity. These activities are typically referred to as base erosion and profit shifting (BEPS) activities. Apart from some cases of blatant abuses, the tax rules themselves, provide scope for unintended tax arbitrage. Instead of making investments for economic reasons, companies are often tempted to choose investments purely for tax reasons, leading to an inefficient allocation of resources. This impacts the integrity of the tax system, an issue which is particularly important at a time of fiscal consolidation and social hardship in many countries. BEPS results in a loss of revenue for governments that could otherwise be invested to support resilient and balanced growth.

The OECD upon the insistence of the G20 nations launched the BEPS project with an ambitious goal to revise the rules to align them to developments in the world economy and ensure that profits are taxed where economic activities are carried out and value is created. The Action Plan on Base Erosion and Profit Shifting identified 15 actions, along three fundamental pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards and improving transparency, as well as certainty for businesses that do not take aggressive positions. While understanding BEPS entail deep analysis of the 15 Action Plans along with the country/stakeholder comments and reservations on positions, in a nutshell, the BEPS project is all about the following key aspects.

Key changes to the Model Tax Convention have been suggested to ensure that treaties solely aim at elimination of double taxation, rather than being medium of structuring transactions leading **to erosion of country's tax bases viz. through dual residency, splitting up contracts, artificial avoidance of PE status etc.**

Digital Economy Taxation

Taxpayers will no longer be able to effectively establish structures that separate the income from the value-added activities of their business, a phenomenon that was particularly impaired by the key features and the business models of the digital economy. Possible technical options have been proposed to deal with the broader challenges raised by the digital economy, i.e. those that go beyond BEPS. The country of taxation of business profits and the allocation factors in light of the economic reality is a subject matter of great debate in the context of digital economy and BEPS Action Plan, seeks to address these aspects. The options include alternatives to the existing threshold for taxing non-residents (a "significant economic presence" test); the imposition of a withholding tax on certain types of digital transactions; and the introduction of an "equalisation levy." India being a part of the G20 and a key proponent of the BEPS project has been quick to incorporate provisions on equalisation levy, significant economic presence as part of its domestic tax law.

Modifications to Tax Treaties through MLI

Key changes to the Model Tax Convention have been suggested to ensure that treaties solely aim at elimination of double taxation, rather than being medium of structuring transactions leading to erosion of country's tax bases viz. through dual residency, splitting up contracts, artificial avoidance of PE status etc. As per BEPS Action Plan 6, the minimum standard in the area of treaty shopping will ensure that treaty benefits are only granted to those entities that are entitled to them. The definition of Permanent Establishment has been modified to better reflect current business reality and avoid widespread circumvention of the principle that underlines it. The amended provision will ensure that a business' core activities cannot inappropriately benefit from the exception for preparatory and auxiliary activities, and that the PE status will no longer be circumvented via the use of commissionaires or similar structures, or via the fragmentation of activities among different group entities. Other aspects of modification include adoption of revamped MAP norms by countries and inclusion of an arbitration window. OECD and UN have been prompt to embrace the BEPS recommendations through their revamped articles and commentaries in relation thereto. The Multi-Lateral Instrument (MLI) is a medium to effect simultaneous modification of tax treaties on the suggested lines.

Strengthened Transfer Pricing Rules and Compliances

From transfer pricing perspective, (specifically BEPS action plans 8 to 10) the guidance on the arm's length principle has been strengthened to ensure that economic realities solely form the basis of the transfer price in transactions between MNE. The OECD Transfer Pricing Guidelines now contain a clear and distinct framework indicating that while contractual arrangements are important, and serve as the starting point of any transfer pricing analysis, the arm's length principle is not based on superficial and untrue conduct of the parties. To this end, MNEs will be required to submit information regarding their global business operations and transfer pricing policies in a *Master File*, as well as more detailed information regarding relevant related party transactions and the amounts involved in such operations in a "Local file." The country-by-country reporting (CbCR) will provide a clear overview to revenue authorities worldwide about the situs of profits, sales, employees and assets and where taxes are paid and accrued. Guidance and tools to ensure a swift and consistent implementation of country-by-country reporting across countries have been developed, to ensure the widest possible dissemination of information among tax administrations, while respecting the agreed safeguards on confidentiality, appropriate use and consistency.

Minimum Standards to Ensure Consistent Practices

Minimum standards were agreed in particular to create a level playing field across the OECD and G20 countries and to tackle issues in cases where no action by some countries would have created

negative overlaps (including adverse impacts of competitiveness) on other countries. The minimum standards pertain to the areas of preventing treaty shopping, Country-by-Country Reporting, fighting harmful tax practices and improving dispute resolution.

BEPS and GAA– A Meticulous Coexistence

With the GAAR provisions gaining importance world over, the Organisation for Economic Cooperation and Development (OECD) introduced the Base Erosion and Profit Shifting project, that resulted in a collaboration of various countries across the world with a common motive of taxing transactions based on the location of economic activity generating the profits and curtailing the shifting of such profits to low or no tax jurisdictions. While the concept of GAAR introduced by various countries were diverse, the introduction of BEPS is with a motive to align the tax regulations across countries and bring consistency in tax treatment of cross-border transactions. The basic motive of GAAR and BEPS is the same – transaction to be taxed in the country where it derives its value from through the conduct of the economic activities. BEPS being more specific whereas GAAR being a general provisions encompassing all kind of transactions which are entered with a primary motive of tax avoidance.

While introducing the GAAR provisions, the Finance Minister clarified the primary objective of such introduction was to combat generation of black money and also treaty abuse. Imperatively, lot many allied intents were unsaid, viz. commercially bonafide transactions, optimum reporting practices, etc. It is pertinent to note that some BEPS Action Plans in certain instances recognise and recommend the need for appropriate anti-avoidance measures within its proposals and that the adoption of these measures in tax treaties is not sufficient to address tax avoidance strategies that seek to circumvent provisions of domestic tax laws. It is not unconstitutional to have laws against tax evasion or highly aggressive tax avoidance attempts. However, it also needs to be ensured that the objective of revenue collection is backed by fair administrative practices to instill confidence in a progressive business environment. Over-legislation, which prejudices the ease of doing business and spurs litigation, complexity and uncertainty, may be counter-productive.

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It is important for taxpayers to appreciate the nuances between the BEPS and GAAR provisions and the Multi-Lateral Instruments upon being effective would certainly reveal the interplay between BEPS and GAAR lot better.

Conclusion

In India, as GAAR is presently effective, it will interesting to watch how these provisions of law are implemented by the tax authorities while conducting the tax audit of the corporates. While it is important for taxpayers to plan their affairs commercially, it is true that on occasions non-commercial considerations also play a critical role. It is also noteworthy that the provisions for GAAR apply only basic onerous criteria satisfied by tax authorities as well.

India has also taken prompt steps in the implementation of BEPS recommendations such as section 94B of the Act relating to Limitation on interest deduction in certain cases, which is a specific anti-avoidance rule. Besides, the adoption of concepts of equalisation levy, significant economic presence, modified business connection rule through expanded agency rule in Indian income tax law only signify India's desire to align with the global tax reforms to counter tax avoidance. Following the formation of OECDs inclusive framework (of which India is an active participant) to monitor implementation of BEPS measures worldwide and the release and signing of the Multilateral Instrument (MLI) during June 2017, there remains a lot to be done as yet by the involved nations. Multilateralism is not easy in this divergently thinking world of sovereignty marked by endless complexities around negotiation or consensus on the treaty modification or even modification of respective domestic laws. Therefore, it would be in best interests of tax payers to track the transformation of the international tax and domestic laws in order to remain compliant under evolving laws under BEPS and GAAR. ■