India Tax Insights

Issue 2

July-September 2014

Rupak Saha

speaks on the changes required in GAAR to target abusive transactions

Philip Baker

throws light on offshore tax avoidance in India and the UK

In this issue

Is India ready for GAAR?

Global measures to combat tax avoidance

Building a better working world

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Welcome

I am delighted to share with you the second issue of our magazine, *India Tax Insights*, aimed at bringing insightful thoughts on current tax matters to business leaders.

This edition focuses on the shifting anti-avoidance landscape. Anti-avoidance rules in the tax law have been around for many years. While the concept of addressing avoidance transactions with either a specific anti-avoidance rule (SAAR) or a general anti-avoidance rule (GAAR) is hardly new, the increasing resort to such rules by many governments in an effort to combat what they perceive to be widespread tax avoidance is predictable in the current climate. With anti-avoidance rules now being introduced or enforced more actively by countries around the globe, what does this mean for business? Clearly the ability to plan and execute transactions with a high degree of certainty will be reduced where governments rely on the catch-all properties of an anti-avoidance rule.

Our lead feature titled '*International action plan on tax avoidance*' outlines how countries are now taking a different and more dramatic approach to anti avoidance and the recent global effort on tackling tax abuse.

Furthermore, Rupak Saha, Chair of Coalition on International Taxation in India, shares his views about the appropriateness of a GAAR in India as a tool to address emerging concerns about tax avoidance, the changes in the current GAAR in India that the businesses will like to see and the key questions that the corporate boards should be asking themselves regarding transactions that could potentially attract GAAR

In the article '*How will doing business in India change with GAAR*', Pranav Sayta outlines the significant shift in the approach to tax planning in various cross-border transactions and the business reorganisation strategies could get influenced given that GAAR has the potential of leading to significant uncertainty and litigation.

Our article '*Interaction between GAAR and tax treaties*' discusses the emerging landscape for double taxation avoidance agreements and treaties when many countries are unilaterally applying anti-avoidance measures to override tax treaties.

Noted British Barrister and Queen's Counsel, Philip Baker, traces the historical and colonial roots of anti-avoidance rules of the specific anti-tax avoidance rule, that already exists in the Indian legislation to deal with tax avoidance by transfer of assets abroad.

The regular features – *Global news and EconmoMeter* – provide a snapshot of key global tax developments and key economic indicators, respectively.

We hope you find *India Tax Insights* thought provoking and useful. We look forward for your feedback and suggestions.

Sudhir Kapadia
National Tax Leader
EY India

Sudhir Kapadia

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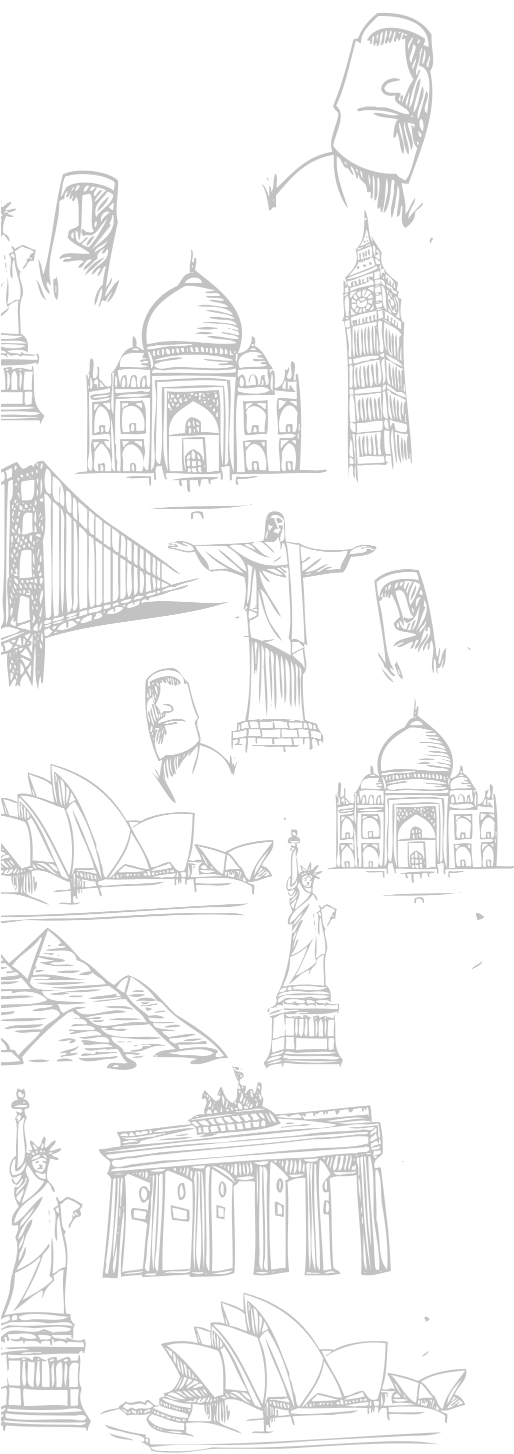

China issues draft administrative guidance on GAAR for public comments[1]

1

China's State Administration of Taxation (SAT) issued a draft administrative guidance on GAAR (Draft Guidance) for public comments on 3 July 2014. The Draft Guidance is intended to provide internal guidelines on procedure for implementation, in conjunction with existing GAAR provisions in China's tax law.

The main characteristics of tax avoidance arrangements specified by the Draft Guidance are:

- To obtain tax benefits as the sole purpose, main purpose or one of the main purposes
- The arrangements comply with tax laws, but their economic substance do not

Currently, the Draft guidance does not cover domestic or illegal transactions. Furthermore, specific anti-avoidance rules (such as transfer pricing provisions, and treaty provisions, e.g., beneficial ownership and limitation of benefit) will have preference over GAAR. Special tax adjustments should be made by adhering to the substance-over-form principle and by reference to similar arrangements with a reasonable commercial purpose and economic substance. It also provides methods of tax adjustments.

Draft guidance provides a list of documentation, which a taxpayer can provide, to prove that its arrangement does not constitute a tax avoidance arrangement at the time of investigation by the tax authority. It also imposes an obligation on tax advisors to provide information on their clients. The taxpayers will be notified by a letter if their cooperation/assistance is required.

Once in force, the guidelines will apply retroactively to tax avoidance arrangements carried out on or after 1 January 2008; unless cases have been settled before the Draft Guidance is finalised.

Spanish Supreme Court rules group company constitutes a PE in Spain[2]

2

In the facts of the case, a Spanish Company (Spain Co) formerly operated as a full-fledged manufacturer, importer and seller of products in Spain. Pursuant to business-restructuring, Spain Co sold all its stocks to its parent entity in UK (UK Co) and simultaneously entered two agreements with UK Co. such as,

(i) Spain Co acted as an independent sales agent for UK Co's products. Spain Co also promoted sales at terms and conditions set by UK Co.

(ii) Spain Co engaged and actively involved for provision of logistics, administration and packaging services to UK Co.

The entire business restructuring exercise resulted in a decline in Spain Co's tax base in Spain. Issue before the SC was whether Spain Co can be regarded as PE of UK Co.

In its decision on 18 June 2014, the SC took a view that a comprehensive analysis of the structure and behaviour of parties supports that a "complex business set up" in Spain was "at the disposal" of UK Co, which created a Fixed PE as well as Agency PE of UK Co in Spain under the Spain-UK tax treaty. This is based on the following factors:

- There were no substantial changes to Spain Co's structure upon the transition.
- Functional analysis provided to the Court demonstrated that Spain Co assumed a substantial part of the functions related to UK Co's distribution role.
- In practice, there was no clear separation of functions and resources between Spain Co and UK Co.
- Activities carried out by Spain Co were a combination of auxiliary activity, which added value and were same as core-activity of UK Co. These activities do not qualify for PE exclusion under the treaty.
- Spain Co's human resources were at the disposal of UK Co.
- Spain Co was contractually bound to follow UK Co's instructions and hence, it could not qualify as an independent agent of UK Co.

The SC reached at this conclusion by combining the general clause (fixed place of business) and the dependent agent clause of Article 5 of the treaty. The SC upheld the Spanish tax authorities' functional approach with regard to post-restructuring schemes and commissionaire dealings involving complex business structures in Spain.

Global news

Korean decisions on beneficial ownership

3

The Supreme Court (SC) of Korea, on 10 July 2014, adjudicated on the concept of "beneficial ownership"[3]. In this case, Dutch BV earned capital gains on sale of shares of its Korean subsidiary. Korean tax authorities alleged the Dutch BV to be a mere "conduit" established for tax avoidance purposes and that its French parent to be the beneficial owner of capital gains. Accordingly, by applying France-Korea treaty, such gains will be taxable in Korea (it may be noted that Netherlands-Korea treaty exempts such capital gain income from tax in Korea). The SC ruled in favour of the taxpayer. It observed that a beneficial owner is the entity, which possesses control, management or disposal rights over certain income and these rights should be differentiated from the right/power to exert influence over the decision-making process. In the present case, although the French parent company did exercise influence over the Dutch BV's decision-making process in respect of certain legal actions, the French parent company cannot be deemed the beneficial owner because it did not have control/management/disposal rights in connection with the capital gains at issue. Accordingly, SC accepted that Dutch BV is the beneficial owner of the capital gains income and ruled in favour of the taxpayer by allowing exemption under the Korea-Netherlands treaty.

In another ruling delivered on 29 May 2014, Korea's National Tax Tribunal held that the term "ownership" of a Korean company for taxation of dividend under the US-Korea treaty is not limited to direct ownership, if an indirect shareholder has the right to dividends, provided that the indirect shareholder satisfies the 10% ownership requirement and is a US resident for treaty purposes[4].

EU report on digital economy[5]

4

On 28 May 2014, the European Commission received the final report of the High level Expert Group on Taxation of the Digital Economy (the Group). The Group was asked to examine key issues related to taxing the digital economy in the European Union (EU), and to present their ideas on the best approach to various challenges and opportunities in this field. The report covered both the direct and indirect taxation issues linked to the digital economy, as well as broader issues on how tax policy can help maximise the opportunities that the digital economy offers. Key findings in the report are:

- No separate tax regime is required for the digital economy though current rules may need to be adapted to respond to digitisation.
- Digitisation significantly facilitates cross-border business. Removing barriers to the single market, including tax barriers, and creating a more favourable business environment through neutral, simplified and coordinated tax rules is therefore, more important than ever.
- In corporate taxation, the Group recognises that the G20/OECD BEPS (Base Erosion and Profit Shifting) project will be fundamental to tackling tax avoidance and aggressive tax planning globally. Priority areas for the EU within the BEPS project are countering harmful tax competition, revising transfer pricing rules and

reviewing the concepts for defining and applying taxable presence.

- There is currently no valid justification for a fundamental change in provisions for taxable presence specifically for digital activities. The Group acknowledges the OECD BEPS work on review of rules to determine taxable presence in digital business models and suggests that such review should focus on two elements in the definition of the existing concepts of PE – (i) remote contracting and distinction between dependent agent and commissionaire and (ii) re-define "preparatory or auxiliary activities" exemption in view of digital business models.
- The Common Consolidated Corporate Tax Base provides an opportunity for the EU to expand on new international standards (such as transfer pricing profit split methods) and achieve additional simplification within the EU.
- More radical reforms of the tax system could also be looked at in the longer term, including a destination-based corporation tax. This mirrors other thinking that a wider OECD-led review of international tax may be required over and above BEPS issues, once the BEPS project has been completed.

The next step is for the European Commission to consider the report and decide on policy impacts in due course.

Peru reporting requirements on indirect transfers[6]

The Peruvian tax authorities have issued new reporting requirements for resident entities to communicate to the tax administration regarding the issue, direct and indirect transfer or cancellation of Peruvian shares [Resolution No. 169 & 200 of June 2014]. In February 2011, new capital gain rules were introduced in Peru to capture indirect transfer of Peruvian shares and it required the resident legal entities to report such indirect transfer to tax administration to facilitate compliance and collection of the applicable capital gains tax. Hitherto, there was no formal guidance available to comply with the above reporting obligation. The June 2014 guidance requires a resident legal entity to electronically report an indirect transfer of its shares in the prescribed form giving information about the transferor, acquirer, details of shares transferred in terms of unit value, percentage of shareholding transferred, etc. The new reporting requirement is effective from June 2014 and it applies to transactions undertaken from 2011 when indirect transfer rules were introduced in Peru.

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1 www.ibfd.org, EY Global Alert on 'China issues draft administrative guidance on GAAR for public comments' dated 18 July 2014

2 EY Global Alert on 'Spanish Supreme Court issues resolution upholding existence of PE in Spain' dated 31 July 2014

3 www.ibfd.org

4 For further details refer EY Global Tax Alert on "Korea's National Tax Tribunal holds indirect US shareholder is a beneficial owner" dated 14 July 2014

5 www.ec.europa.eu, EY Global Tax Alert on "EU Expert Group presents final report on taxation of the digital economy" dated 4 June 2014

6 EY Global tax alerts on the development dated 10 June 2014 and 3 July 2014

International action plan on tax avoidance

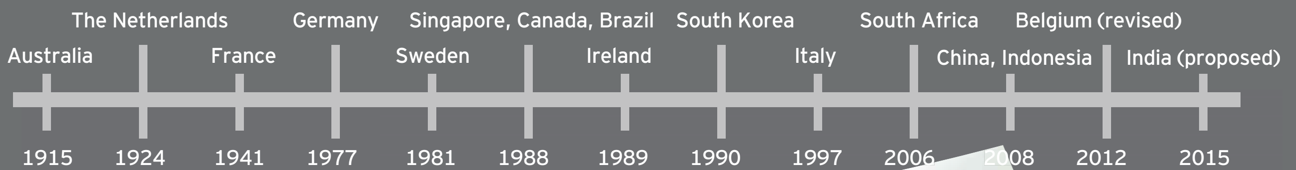
Complexity in the global tax systems has grown in tandem with the challenges of doing business in an increasingly connected global economy. As a result, some laws do not operate as originally intended, or create uncertainties that were not foreseen. At their extreme they can impede desirable business activity. In other instances, taxpayers may be seen as taking advantage of some laws in ways that tax administrators find undesirable. These resulting uncertainties can limit economic growth and impede tax administration. Businesses increasingly fear that countries that once used GAAR only reluctantly, and in the most extreme circumstances, are beginning to use it more extensively than it was originally designed to be used. They have a good reason to be worried. While judges in several GAAR cases have defended businesses against overly broad application of the rule, some countries that lose in court have responded by proposing new laws to make their GAAR tougher. In countries without a GAAR, tax authorities are increasingly challenging business arrangements on grounds that they lack substance, even if such arrangements comply with the applicable law. GAAR's growth as a favoured enforcement tool, however, has the potential to increase the uncertainty businesses already feel while operating in the challenging global economy; a poorly designed or administered GAAR is in neither the taxpayer's nor the government's interest. The recent focus on tackling "tax abuse" can also be attributed to increasing deficits and declining tax revenues that have resulted from the global financial crisis. Governments have been spurred to act by multilateral organisations, including the G20, the OECD and the European Commission. Tax activist groups have turned a spotlight on tax havens, high-net-worth individuals and, now, the seemingly low effective tax rates reported by some multinational companies. A series of steps, including improved information exchange, expanded disclosure requirements, and joint and simultaneous tax audits have been put in place to address what countries view as unacceptably aggressive tax planning.

In the following paragraphs, we take a look at some of the measures taken to combat tax avoidance.

Widening the anti-abuse net

- Anti-avoidance rules can broadly be divided into two main categories – "general" and "specific." A General Anti-Avoidance Rule (GAAR) is a set of broad principles-based rules within a country's tax code designed to counteract the perceived avoidance of tax. GAAR is a concept within law that provides the taxing authority a mechanism to deny tax benefits of transactions or arrangements believed not to have any commercial substance or purpose other than to generate the tax benefit(s) obtained. Tax law designed to deal with particular transactions of concern are termed as Specific Anti-Avoidance Rules (SAARs).

Exhibit 1. GAAR introduction timeline[1]



GAAR provisions were first proposed to be introduced in India as part of the Direct Taxes Code Bill (DTC), 2010. However in 2012, GAAR provisions were introduced in the present domestic tax law even prior to implementation of DTC. An Expert Committee under the chairmanship of Dr. Parthasarathi Shome was constituted to submit its recommendations on GAAR. As a consequence, GAAR provisions were amended in 2013 to give effect to some recommendations. Furthermore, its applicability was deferred to tax year 2015-16.

When compared with GAAR, SAAR fares better in tracking specific cases of abuse. One area of SAAR that has generated considerable global attention in the last few years is the practice in some countries such as India, China and Chile, of looking through holding company structures and attempting to tax indirect transfer of assets. This trend began with the position taken by India in the Vodafone case, a position that was ultimately rejected by the highest Indian court. This resulted in introduction of SAAR in 2012, that too with retroactive effect. Since this proposal had not gone too well with investors, the Indian tax administration has recently set up a high-level committee to scrutinise fresh cases arising out of retrospective amendments of 2012 with respect to indirect transfers.

BEPS action plan to curb tax avoidance worldwide

The Base Erosion and Profit Shifting (BEPS) action plan, issued by the Organisation for Economic Co-operation and Development (OECD) on 19 July 2013, complements measures to tackle aggressive tax planning, while also addressing issues that can only be effectively dealt with at an international level. The BEPS Action Plan acknowledges that in many circumstances existing domestic law and treaties yield the correct result, but states that without coordinated action in areas that give rise to policy concerns, countries that wish to protect their tax base may resort to unilateral action that could result in a resurgence of double taxation as well as global tax uncertainty.

The BEPS action plan sets out 15 specific actions to re-adjust international standards in taxation, so that they are better equipped for the changing global economy. Each of these actions is linked to specific outputs that are to be completed in 2014 or 2015.

On 1 August 2014, the OECD released the first part of a report on BEPS in developing countries, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries*. This was discussed during the G20 Development Working Group meeting in May 2014. The Report focuses on developing countries and their key challenges in addressing BEPS, their priority items in the "OECD Action Plan on BEPS," and their other BEPS-related tax issues.

India is currently not a member of the OECD, but continues to play an important role in the work of the OECD as a country having an "observer" status and also as part of G20 and BRICS countries, i.e., Brazil, Russia, India, China and South Africa.

Use of automatic exchange of information

On 21 July 2014, the OECD published the Standard for Automatic Exchange of Information in Tax Matters (the Standard). The Standard consists of a Model Competent Authority Agreement, intended as a template for intergovernmental agreements, and a Common Reporting Standard (CRS) on reporting and due diligence for financial account information. It contains a detailed commentary on both components and technical solutions for information exchange.

The Standard is intended to be a "step change" in the way in which jurisdictions share tax information to combat tax evasion. The Standard is intended to be global in scope and to focus on a universal set of information relating to financial accounts, drawing heavily on the intergovernmental approach adopted under the Foreign Tax Account Compliance Act (FATCA).

Though the Standard has no direct legal force, it is expected that jurisdictions will follow it closely in adopting local rules and regulations, with many countries such as the EU nations, the UK, and India, already agreeing to early adoption in 2016. To facilitate this process, India has already incorporated[2] certain provisions in the domestic tax law to enable such information exchange and is also a signatory to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This Convention explicitly provides for automatic and spontaneous exchange of information.

Expansive reporting requirements, greater corporate transparency norms

The US and Australia have put in place disclosure regimes[3]. Broadly, these regimes require disclosure of tax positions where there is some level of uncertainty as to whether the taxpayer would prevail if challenged.

Canada[4] has introduced additional requirements for Canadian taxpayers with foreign income or properties to report more detailed information and extend the amount of time available to reassess those who have not properly reported this income.

The UK[5] has rules, which require potential suppliers over a certain threshold limit under UK Government contracts to certify, as part of the procurement process, that they have not been involved in certain tax avoidance arrangements. Non-compliance also occurs if a tax return is found to be incorrect because of the failure of a transaction, which was, or should have been, notified under the Disclosure of Tax Avoidance Scheme (DOTAS) rules, or the supplier's tax affairs have given rise to a conviction for tax-related offenses or to a penalty for civil fraud or evasion.

India also has been enhancing reporting requirements on foreign assets in tax returns.

Rewarding informants for information on tax evasion

On 15 January 2014, the Canada Revenue Agency (CRA) officially launched its new Offshore Tax Informant Program (OTIP). The new program (originally referred to as the Stop International Tax Evasion Program) is one of the measures aimed at strengthening the CRA's ability to crack down on international tax evasion and aggressive tax avoidance. It allows the CRA to pay individuals with information about major international tax non-compliance a percentage ranging from 5% to 15% of the federal tax collected as a result of the information provided.

A number of other countries such as the US, the UK and Germany, already provide rewards for information regarding taxpayer non-compliance.

Tax administration authorities working together to uncover information

Tax information involving a multitude of trusts and companies holding assets on behalf of residents in various jurisdictions is often sought to determine instances of tax evasion. The US Internal Revenue Service (IRS), Her Majesty's Revenue & Customs (HMRC) and the Australian Tax Office (ATO) have each reportedly[6] acquired a substantial amount of data revealing extensive use of such entities organised in a number of jurisdictions, including the British Virgin Islands, the Cayman Islands and the Cook Islands. The data contains the identities of individual owners of these entities. Statements by the three tax administrations indicate they have been working together to analyse the data for some time and have uncovered information that may be relevant to tax administrations of other jurisdictions. They report that they have developed a plan for sharing the data, as well as their preliminary analysis, if requested by other tax administrations.

In the Indian context, as part of the Sixth BRICS Summit, the Fortaleza Declaration was adopted on 15 July 2014. The Declaration categorically states that the BRICS countries (of which India is a part) believe that sustainable development and economic growth will be facilitated by taxation of revenue generated in jurisdictions where there is economic activity. Concern over harmful impact of tax evasion, transnational fraud and aggressive tax planning on the world economy was expressed. Commitment to continue a cooperative approach on issues related to tax administrations and to enhance cooperation in international forums targeting tax base erosion and information exchange for tax purposes was affirmed.

Build in fairness and equity of the tax system to enhance public confidence

The importance of equity and fairness as essential attributes for an effective and efficient tax system cannot be undermined. It is well recognised across various tax systems, that equity and fairness should be given due consideration in both the framing and administering of tax laws. Achieving this will better equip governments in their clamp down on corporate tax avoidance.

With an objective of bringing in more credibility among tax payers and streamlining income tax procedures, India will also set up Tax Administration Reform Commission (TARC) comprising senior government officials and private sector tax professionals under the chairmanship of Dr. Parthasarathi Shome. The first report of the TARC, which was released to the public in June 2014, expresses an overwhelming need for fundamental reform in tax administration and contains various recommendations to achieve desired tax reforms. The report contains refreshingly significant recommendations for a "comprehensive" transformation of tax administration founded on accountability and recognition of taxpayer as a "customer".

Concluding thoughts

In framing a legislation that is sufficiently all-embracing to deter tax avoidance, there is always the danger of penalizing those who have genuine reasons to enter a bona-fide transaction. International experience suggests that taxpayer uncertainty is often a consequence of GAAR. The business community prefers laws to be enunciated by the legislature in clear and unambiguous terms in order that they could structure their commercial affairs with a high degree of certainty and are not taken by surprise by unforeseen tax liabilities.

References

1. EY publication dated February 2013, titled "GAAR rising - Mapping tax enforcement's evolution"
2. See Finance (No.2) Act, 2014 amendments.
3. EY publication dated February 2013, titled *GAAR rising - Mapping tax enforcement's evolution*
4. EY Global Tax alert dated 17 January 2014 titled "Canada launches Offshore Tax Informant Program"
5. EY Global Tax alert dated 22 March 2013 titled "UK Government issues new rules on tax avoidance and Government contracts"
6. EY Tax alert dated 13 May 2013 titled "CRA announces measures to counter international tax evasion and aggressive tax avoidance"

Tracing the colonial roots of the **anti-avoidance provision in India**

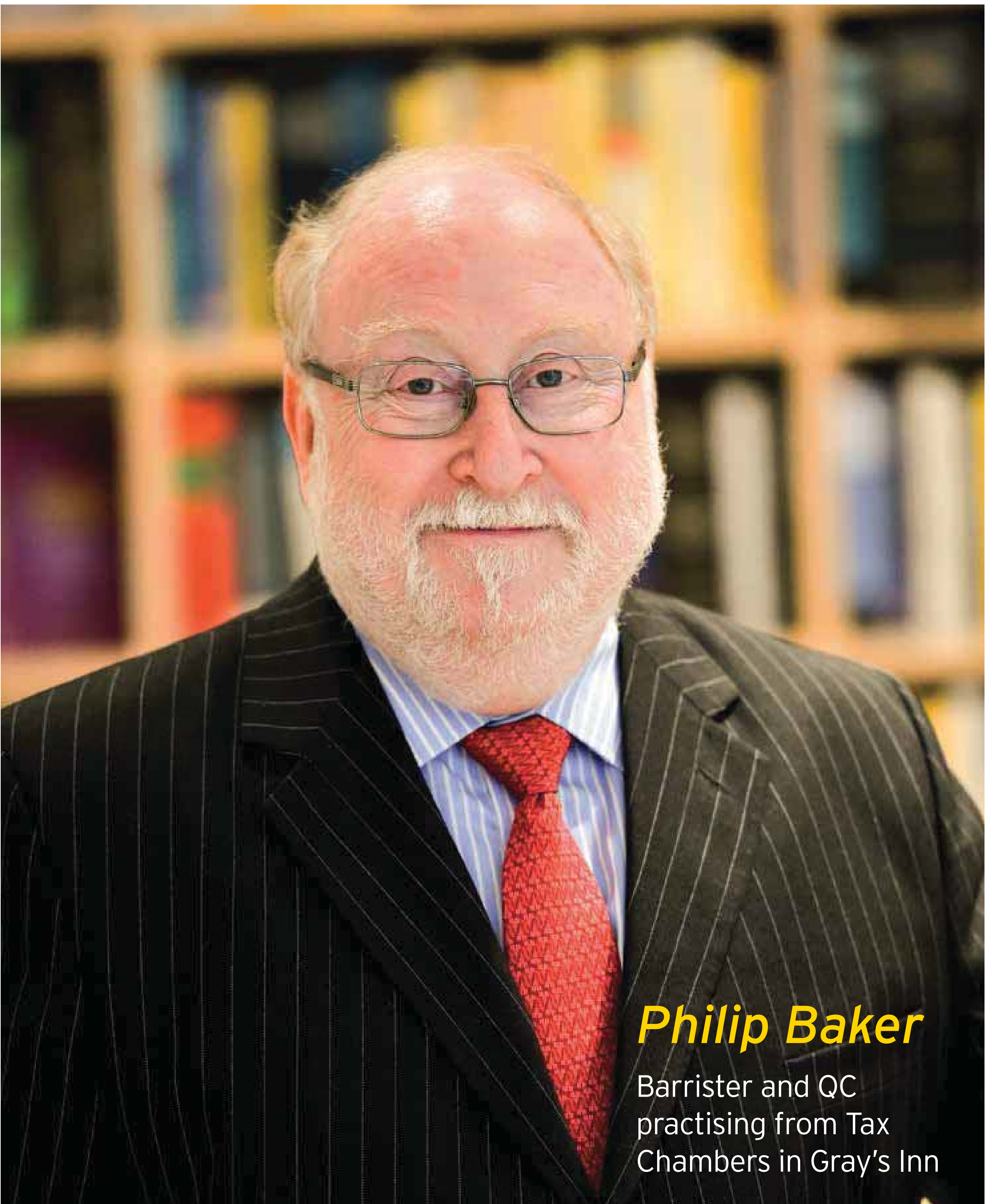
Show to an English tax lawyer the text of section 93 of the Indian Income Tax Act, and you will produce an interesting reaction. The younger of them will say that is exactly like s714 of the Income Tax Act 2007 (and the following 40 or so sections). Those who are a little older will instantly cry out, "That's section 739 ICTA 1988". A few of the older ones may say, "That reminds me of section 478 ICTA 1970". It's unlikely that anyone these days would say, "That's section 412 ITCA 1952". One suspects that there are few people alive now who would immediately react by saying, "That's clearly based on section 18 of the Finance Act 1936".

They are, of course, all referring to the fact that section 93 of the Indian Act has a very similar wording, because it has the same origin historically, to a provision that was first introduced in the UK in 1936 and which has been re-enacted, with a series of amendments, consistently since then. The current version is the chapter in the Income Tax Act 2007, most commonly referred to as the "transfer of assets abroad" provisions.

These provisions represent the main defence in the UK against the offshore avoidance of income tax by individuals. They work - like the equivalent provisions in India - by disregarding the offshore company or trust or foundation, and making the taxpayer pay tax on the income of the offshore entity.

The similarity and the common historical origin of the provisions under Indian and UK Tax Law prompt a number of thoughts about how tax systems sometimes develop differently, but all of them are facing similar issues of dealing with tax avoidance, and particularly offshore tax avoidance.

The provisions that are now in the UK "transfer of assets abroad" code and in section 93 in India, owe their origins to the position in the UK in the mid-1930s. Historical research at the UK National Archive shows that all these provisions originated due to a concern in 1934 by the Chairman of the Board of Inland Revenue that "tax evasion" (and he really did use the term "evasion" which, at the time, was not particularly clearly distinguished from tax avoidance) had got out of hand. His particular concern was the impact of the decision of the House of Lords in the Duke of Westminster (1934) case, which in his view had given support to these tax evasion strategies. There were three particular evasion strategies that he was concerned about – settlements for the benefits of the settlor and his children; close companies; and the transfer of assets abroad. With a war with Germany becoming increasingly likely, concerns that assets would



Philip Baker

Barrister and QC practising from Tax Chambers in Gray's Inn

be transferred out of the UK to avoid tax were particularly high on the government's concerns.

The answer to these concerns was a series of anti-avoidance provisions enacted in the UK in the Finance Act 1936. Subsequently, some of the provisions were also enacted in India in 1940. Interestingly, with the exception of the Republic of Ireland, most other British Dominions and Commonwealth countries did not adopt these anti-avoidance measures. At this instance of time, it is quite difficult to see why the UK, India and Ireland were the only countries to adopt equivalent provisions – it was common for the Colonial Office to circulate drafts to all colonies and dominions and for equivalent legislation to be enacted in each territory. It may have been a reflection on the territorial scope of different tax systems, or on the circumstances of the war time, that these overseas avoidance provisions were not more widely enacted.

What is perhaps more interesting is to see how these provisions have developed differently in India and in the UK.

So far as India is concerned, the original legislation is still very much in the form in which it was enacted in 1940. There appears to have been only one leading, Supreme Court decision on the case – Chidambaram Chettiar (1966) – and very little further litigation on the meaning of the provision.

By contrast, the equivalent code in the UK has been the subject of a long series of cases, many of them going to the House of Lords (the former UK Supreme Court). Several of those decisions have prompted subsequent amendments to the legislation, with the result that the existing transfer of assets abroad code is almost unrecognisable as the descendant from the common ancestor of the UK and Indian provisions. A series of House of Lords cases such as Congreve (1946), Herdman (1967) and Willoughby (1997) has identified a series of deficiencies or ambiguities in the original legislation. Legislation in the 1980s introduced separate charges on non-transferors, once it became clear that the original legislation could only apply to persons who made the transfer abroad. In addition, legislation in 2005 changed the nature and scope of the defence based upon the lack of a tax avoidance purpose. Finally, a redraft of the legislation, in accordance with the Tax Law Rewrite in 2007, has produced a code of some 40 or more sections.

What is perhaps most interesting is the way in which India and the UK have followed a route with a common starting point but with diverging paths to deal with overseas avoidance. The possibilities for avoiding tax by transfer of assets abroad are very significant. The income from assets that are located outside a jurisdiction has the potential to escape tax. Locating assets abroad also raises the possibility of tax evasion where the income is simply not declared. The problem of black money abroad is one that has become particularly high profile in India in recent years. Both countries are also reacting to the Duke of Westminster principle that "a tax payer may so arrange his affairs as to lawfully reduce the amount of tax due".

The similarity and the common historical origin of the provisions under Indian and UK Tax Law prompt a number of thoughts about how tax systems sometimes develop differently, but all of them are facing similar issues of dealing with tax avoidance, and particularly offshore tax avoidance.

The result of these developments is that the transfer of assets abroad code has become, in the case of the UK, the primary anti-avoidance measure concerned with combating overseas avoidance by UK resident individuals. There are parallel provisions for combating avoidance of Capital Gains Tax, and some provisions that relate to Inheritance Tax as well. However, the transfer of assets abroad provisions remain, in the case of the UK, the first line of defence against tax-motivated transfers of assets with the purpose of avoiding UK Income Tax.

It is not so clear that section 93 has played an equally significant role in India. The limited amount of litigation suggests either that section 93 is being very effective, and Indian residents are not making transfers abroad to which this section might apply, or it suggest that the provision is little considered in practice. Of course, the existence of exchange control legislation preventing the transfer of assets abroad may well explain the reduced significance of the anti-avoidance legislation. In the UK, the introduction of the legislation in 1936 was followed by the subsequent introduction of stringent exchange control rules, which were not released until the 1970s. Transfers within the sterling zone, however, did give rise to issues within the scope of the legislation. In India, of course, restrictions on the transfer of funds outside of the company are still in place, though, I understand, have been reduced in recent years.

This leads on to perhaps one of the most significant developments, which has clearly affected the legislation in the UK and which, in a slightly different form, will no doubt affect the equivalent provisions in India. In the UK the transfer of assets abroad provisions now operate in the context of the European Union with its treaty-guaranteed free movement of capital, freedom of establishment, and freedom to provide and receive services. Therefore, for example, all restrictions on the movement of capital between member states of the European Union, and for that matter, between member states and third countries, are prohibited. From an era of exchange control, we now have an era of total free movement of capital between countries. Under these circumstances, a tax charge which applies to the income from capital that has been moved abroad, but where no equivalent charge applies to a similar arrangement in the UK, runs the risk of incompatibility with European Law. In the last few years, the transfer of asset provisions in the UK have had to be amended in order to seek to bring them into conformity with the fundamental freedoms of the European Union. Four years ago the European Commission commenced an infringement action against the UK on the grounds that the transfer of assets provisions restricted the exercise of these freedoms. In response, in 2013 the UK Government has had to enact changes to the code, which are intended to bring it into conformity with EU Law. Many people are not convinced that the changes go far enough.

In a sense, this is a common challenge shared by both the UK and, in a slightly different form, by India. As restrictions on capital movement are removed, it becomes easier and easier for individuals and companies to invest abroad and transfer their assets abroad. This is perfectly appropriate – the theory of comparative advantage encourages capital to find the best return wherever that may be, and that may not necessarily be in the country of the original investor of the capital. However, at the same time, the opportunities for overseas avoidance of tax still remain. In those circumstances, effective measures to counter that offshore avoidance are essential for any tax system. "Effective" here is not synonymous with "sledgehammer" or "over restrictive". The anti-avoidance legislation has to be sufficiently well-grounded in policy, well-structured and precise in its drafting, that it establishes not just the clear line but also the correct line between acceptable enjoyment of overseas opportunities for investment and unacceptable tax avoidance.

In this respect, basing the first line of defence against offshore avoidance on legislation that was originally conceived in the mid-1930s, under very different economic circumstances, does not look at first sight to be the best approach. Time may well have come for both India and the UK to fundamentally reassess these measures designed to counter overseas tax avoidance. No doubt, India can learn considerably from the UK experience, particularly what not to adopt and what to avoid. With a common historical background and a common point of departure, there may be something that both tax systems can learn from one another.

Interaction between GAAR and tax treaties

Jayesh Sanghvi

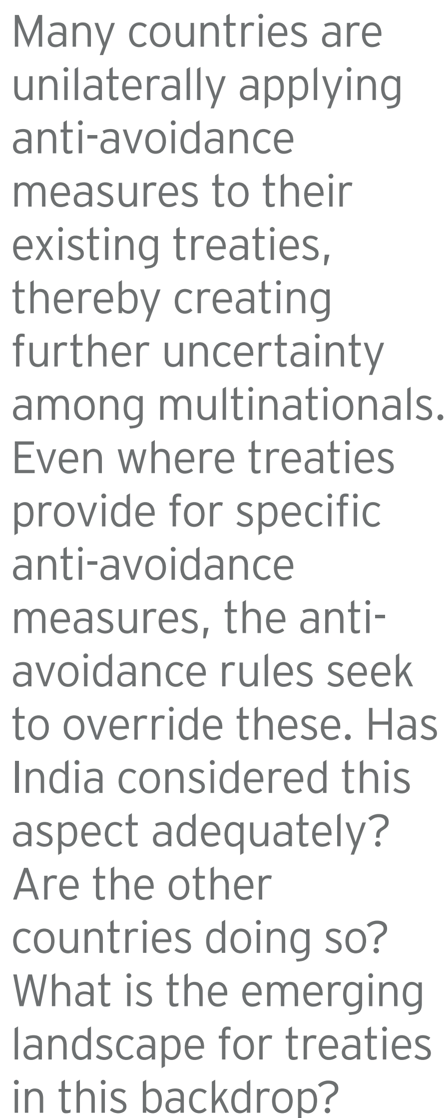
Partner & National Leader – International Tax Services, EY India

The debate surrounding the interplay between a country's General Anti-Avoidance Rules (GAAR) and its treaties has been long standing. There is a mixed trend internationally on the matter. In countries where there is a domestic GAAR law, some use it to disallow treaty benefits[1], while in others the possibility to override treaty benefits is being debated[2]. Some countries seek to include specific provisions in their treaties to ensure their domestic GAAR law may apply[3]. Some countries[4] have introduced strict documentation requirements as a prerequisite for the application of treaty benefits.

India's current position on this matter[5] seems clear that benefit of treaty can be availed only subject to overcoming its domestic GAAR law. This appears to be along the lines of Australian rules. However, in the context of Australia, this provision was inserted in 1981 and most treaties of Australia were signed after 1981. In case of a few treaties of Australia, which are signed prior to 1981, a doubt has been raised whether the other contracting state can be regarded as having knowledge about GAAR.

India's tax treaties contain specific anti-avoidance rules (SAARs), such as place of effective management for deciding the residence of non-individuals in article 4, the restricted force of attraction rule as per article 7(1), article 9 dealing with associated enterprises, articles 10, 11, and 12 dealing with dividends, interest and royalties with respect to beneficial ownership[6] for concessional tax treatment, the special relationship rule with respect to interest and royalties in articles 11 and 12, alienation of shares of real estate entities in article 13 (4), and artistes/sportsmen companies in article 17(2). Recently, in some treaties[7] there is a general limitation on benefits (LOB) article patterned along the lines of a mini GAAR while in some treaties[8] there is subjective and objective LOB criterion prescribed. It is thus evident that the India's tax treaties are subject to numerous SAARs and there is a growing body of evidence that new/re-negotiated tax treaties will have more elaborate LOB and specific anti-abuse insertions. It therefore, behoves consideration whether in the context of tax treaties the domestic GAAR provisions should have a role.

The Standing Committee on Finance[9] has cautioned that uncertainties with regard to applicability of tax treaty provisions (vis-à-vis GAAR) should be removed so that India's credibility as a reliable treaty partner is not affected. Particularly with respect to interplay of GAAR in the domestic law with specific anti-abuse provisions in the treaty (i.e., Limitation of Benefits/Entitlement of



Many countries are unilaterally applying anti-avoidance measures to their existing treaties, thereby creating further uncertainty among multinationals. Even where treaties provide for specific anti-avoidance measures, the anti-avoidance rules seek to override these. Has India considered this aspect adequately? Are the other countries doing so? What is the emerging landscape for treaties in this backdrop?

Benefits clause), remains a matter of doubt and uncertainty. The Shome Committee[10] recommendations[11] on this conflict are that where the treaty itself has anti-avoidance provisions in the form of limitation of benefit (as in the India-Singapore treaty), such provisions should not be substituted by GAAR under the treaty override provisions, as well as where a SAAR is applicable to a particular aspect/element, then GAAR should not be invoked to look into that aspect/element. After considering the report of the Shome Committee, the Finance Minister, in a statement[12], mentioned decisions taken by the Government including *inter alia* that where GAAR and SAAR are both in force, only one of them will apply to a given case. While the Committee recommended for a preference of SAAR over a GAAR, the statement of the Finance Minister does not go as far. On the contrary, the law provides that GAAR will apply in addition to or in lieu of any other basis of taxation[13]. These recommendations still have to see the force of law.

Under OECD's *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, this debate is actively engaging the minds of policy makers and business. The recommendations in a recently released discussion draft (the Draft)[14] on the subject has proposed incorporating, in tax treaties, both LOB rules similar to those found in US tax treaties and broad anti-abuse rules similar to the "main purpose" tests found in UK tax treaties. The Draft includes the proposed language for a LOB rule and further states that detailed commentary will explain the main features of the rule. On the general anti-abuse rule (GAAbR) that is based on the "main purpose test," treaty benefits will be denied when one of the main purposes of arrangements or transactions is to secure a benefit under a tax treaty and obtaining such benefit in these circumstances will be contrary to the object and purpose of the relevant provisions of the tax treaty. It is intended that the "main purpose test" should supplement the LOB rule, i.e., a benefit denied under the LOB rule will not then be subject to analysis under the main purpose test and, conversely, a benefit allowed under the LOB rule will be denied if the main purpose test is not satisfied. The Draft, in several places also references the use of domestic law GAAR to override treaties.

The Standing Committee on Finance has cautioned that uncertainties with regard to applicability of tax treaty provisions (vis-à-vis GAAR) should be removed so that India's credibility as a reliable treaty partner is not affected.

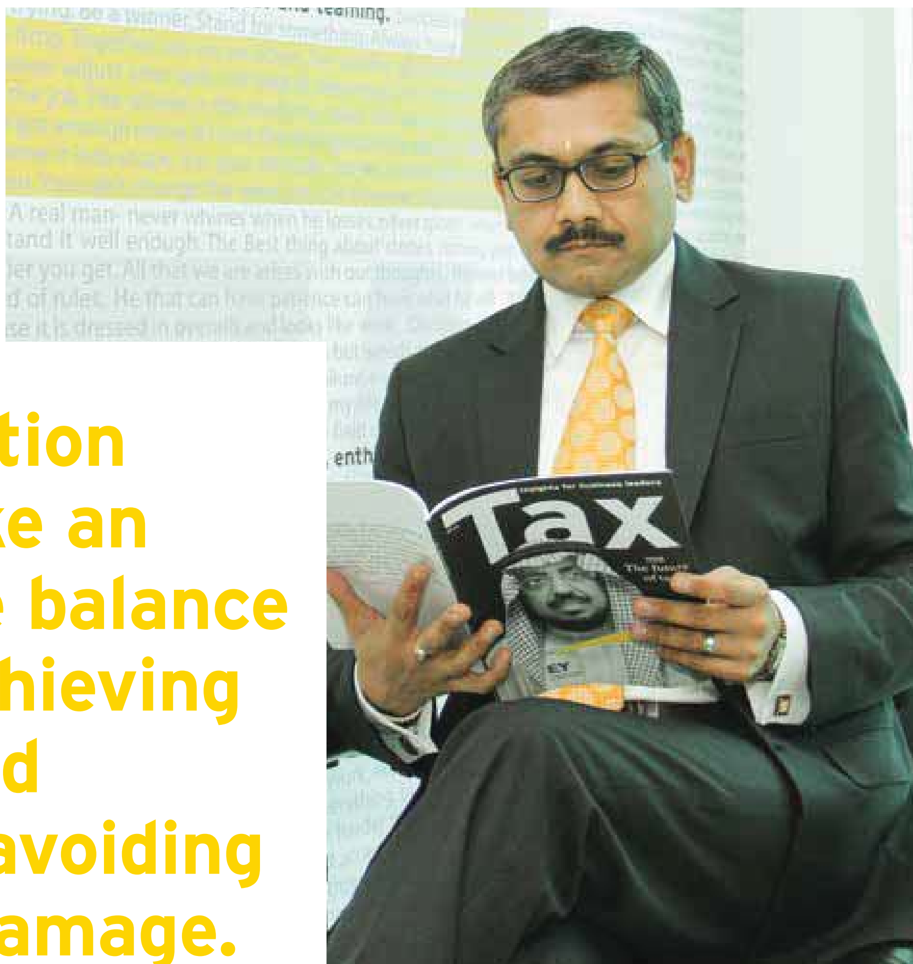
LOB provisions, structured as a series of alternative mechanical tests that are objective in nature, are welcome provided they are expansive in coverage to include a wide range of circumstances. Such LOB provisions should be further supplemented with a discretionary benefits provision, which should operate effectively in practice, to redress situations that befit treaty application but fail the mechanical tests of LOB. As compared to LOB provisions, a GAAR/GAAbR styled on the "main purpose" test is likely to create significant uncertainty regarding applicability of the treaty benefits. The main purpose test is substantially broad for the intended purpose of backstopping the recommended LOB provision. A much more narrowly targeted rule is best suited to this objective. Under the India-Singapore treaty, the subjective LOB provision styled as a GAAbR can conflict with the objective criteria and can make the application of treaty benefits uncertain and complex. Furthermore, absence of an effectively operating discretionary resolution mechanism can only make matters worse.

The domestic law GAAR should have no place in treaty matters, particularly where the treaties have specific LOB and/or general "main purpose" based anti-abuse rules. The anti-abuse rules with respect to tax treaty benefits must be included in the treaty itself.

It is no doubt true that tax treaties operate to facilitate cross border trade and investment. The imposition of domestic law GAAR on tax treaties would breed uncertainty; serve as a drain on time and resources of both the taxpayer and tax administrators. It is important that when considering anti abuse rules for treaty situations, priority should be given to such rules embedded within the treaty and, even there, the preference should be for more targeted and objective anti abuse rules as opposed to more subjective rules. Any legislation has to strike an appropriate balance between achieving the intended result and avoiding collateral damage. India should tread the path cautiously; probably targeting truly abusive and egregious cross border transactions through treaty-based targeted/specific anti-abuse rules. Excessive legislation is likely to prevent abuse but in the process will also stifle genuine transactions/ investments. India's development agenda will ill-afford such a consequence.

References

1 Belgium, Italy, Finland, Norway, Spain, Vietnam
2 China, Germany, South Africa
3 Germany, UK
4 Mexico, India, Hong Kong, Vietnam
5 Section 90(2A) and 90A(2A) of the Income Tax Act, 1961
6 2014 Update to The OECD Model Tax Convention including the beneficial ownership changes reflected revised discussion draft on that topic
7 UAE, Kuwait, Iceland, Luxembourg
8 Singapore
9 Report of the Standing Committee on Finance on The Direct Taxes Code Bill 2010, March 2012(ref page 308)
10 Final Report on General Anti Avoidance Rules (GAAR) in Income-tax Act, 1961 - Expert Committee headed by Dr Parthasarthi Shome
11 Para 3.16/ 3.19 page 44/ 49 of the Final Report on GAAR (supra)
12 January 14, 2013
13 Section 100
14 Released on March 14, 2014



Any legislation has to strike an appropriate balance between achieving the intended result and avoiding collateral damage.

Businesses do not fear preparing for GAAR; **but how GAAR will be used**

Rupak Saha

India Tax Leader - GE and Chairman, Coalition on International Taxation in India

India Tax Insights team talks to Rupak Saha, on changes in the current GAAR he will like to see so that it is better targeted and its scope is restricted to only exceptional and abusive transactions. He opines that quite often the uncertainty hits honest taxpayers more than the dishonest ones, so enforcement of current laws, better risk profiling, and good pre-transaction disclosure laws are important.

The current version of GAAR in India is a diluted version of the one introduced in the Budget 2012. However, even now, concerns remain about its wide scope. Shome Committee had also cautioned that GAAR, as an instrument to check tax avoidance, should only be used by experienced hands. The Finance Minister has assured that GAAR and the date of its implementation will be revisited. On the global front, countries such as the UK and China have opted for GAAR route recently, while South Africa, Canada and Australia, which already have GAAR in place, are becoming more assertive in applying these rules.

To check "aggressive" tax planning or tax abuse, many countries are now proposing or adopting anti-avoidance statutes. Some countries, such as the UK, China and India have recently adopted GAAR. Some others such as South Africa, Canada and Australia, which already have a GAAR in place, are becoming more assertive in applying these rules.

What do these developments around the globe mean for businesses? Has the spread of anti-avoidance rules added to the uncertainty that the global businesses currently experience?

It all depends on the particular GAAR construct. For example, in India the law as it stands today will add to the prevailing uncertainty that exists even today with respect to Treaty benefits, indirect sale of Indian assets and the like. In contrast, in the UK, where the target unlike India is at truly egregious tax avoidance, it may not have much effect on standard tax management. However, where GAAR can be used as a weapon, especially by local inspectors to garner revenue, it will lead to much increased uncertainty.

Globally, GAAR is driven by same issues as surrounding base erosion and profits shifting. Is GAAR the appropriate tool to address these concerns? Is it targeted well?

It is part of the puzzle – but only part. Quite often the uncertainty hits honest taxpayers more than the dishonest ones, so enforcement of current laws, better risk profiling, and good pre-transaction disclosure laws (among other things) are also important. To answer the last question, separately, no - it is never well-targeted - the fact that it is "general" makes that inevitable. At one level a general anti-avoidance rule is almost an admission by revenue authorities that they cannot intellectually cope up with emerging business and transactional realities and effectively stem their abuse through specific anti-avoidance rules. Taking an even lesser charitable view, drafting of GAAR in the Code is bit of a slothful alternative to well thought through prescriptive tax provisions that augment clarity and certainty in compliance. Either way, the honest taxpayers suffer.

In the Indian context, is GAAR driven by same concerns as in other jurisdictions or different concerns? And if the concerns in India are different, is GAAR the only way to address them?

For example, BEPS has identified some key areas of tax avoidance, for instance, tax challenges in the digital economy, hybrid mismatch arrangements, abuse of tax treaties and artificial avoidance of permanent establishment status and transfer pricing outcomes in respect of intangibles, risk and capital, and other high-risk instruments - Which of these tax avoidance areas are more relevant in India? - Can these be addressed through GAAR?

It is somewhat difficult to keep pace with the BEPS debate given the many draft reports brought out. However, I have gone through the Report on tax avoidance through treaty abuse. It seems to me that the G20 as a whole and the OECD's concerns essentially stem from base erosion and profit shifting from high taxed operating countries to low tax jurisdictions in a manner that is resulting in double non taxation or close to double non taxation. For example, where revenues that should arguably be booked in countries where sales activities are being undertaken are being booked in low taxed countries, with the source countries possibly being compensated only on a marginal cost plus basis. Or for example, situations where say income is stripped from any operating country through royalties, interest, etc. to a low tax jurisdiction.

In contrast however, I do not think India's concerns are quite the same - many of India's international tax disputes are with respect to resident investor countries such as the US, Korea, and others who are not low taxed in any way. In that way India is almost unique (or almost close to unique, as lately China seems to be joining the India bandwagon) in being aggressively protective (and expansive) of its own tax base, disregarding whether the taxpayer really benefits from a transaction where the counterparty may have a substantial tax rate of its own in its residence. So to your first question, GAAR cannot be the way to address these disputes in India, as in these cases the taxpayer is not deriving any apparent benefit. For example, by shifting income base from India to the US, say because of transfer pricing compulsions under the US law, the taxpayer isn't benefitting by offering reduced income to tax in India.

On the second part of your question, GAAR is a wide sledgehammer, and the way the law is currently drafted in India many transactions - and not only those that are confined to being genuinely anti-avoidance ones - in a holistic sense of the term, will get affected. It will increase uncertainty that will make taxpayers pause in all of those areas. And, of course, if uncertainty increases beyond what is intended for preventing tax avoidance, again I repeat, in the holistic sense of the term, that may also hit genuine business activity, especially inward investment.

Many countries allow their GAAR provisions to override existing tax treaties, either by overriding the treaty unilaterally or by agreeing in the treaty to allow application of domestic GAAR. In your experience, how do MNCs deal with the uncertainty of the potential application of domestic anti-avoidance rules in the tax treaty context?

This is unfortunate. This significantly undermines Treaties and investors' confidence from such Treaty partners takes a hit. To the extent possible, all bilateral treaties should be respected and not be unilaterally disturbed. That being said and as you note, many treaties do have provisions that allow supersession of the Treaty by domestic GAAR rules of contracting countries. The OECD has suggested a GAAR (or main purpose test) just for treaty purposes, which would supersede any domestic GAARs. While personally I am disappointed with the wide ambit of such main purpose test which is in addition to the significant tightening of screws in the LoB provisions, a uniform GAAR across trading partners help uniformity and set expectations upfront. MNC's always wish for certainty in tax laws, even if they are not helpful. Uncertainty is the worst part in any risk management. If a Treaty is subject to any form of GAAR, a taxpayer will have to be that much more careful on ensuring there is a sound business purpose behind the transaction or an arrangement involving the Treaty partner.

In March 2014, OECD released a discussion draft relating to Action 6 of the BEPS Action Plan on preventing the granting of Treaty benefits in inappropriate circumstances. In your view, do the OECD recommendations strike an appropriate balance that allows tax treaties to achieve the objective of facilitating cross-border trade and investment or could they go too far to interfere with the proper functioning of tax treaties?

It's a little early to say. As I indicated in the answer to the earlier question, I am disappointed with the current draft, as the OECD seems to have leaned too far towards one side to accommodate all concerns of countries at both ends of the residence – source spectrum to the detriment of the taxpayer. As I have noted elsewhere, a GAAR is always fraught with uncertainty and some crystal ball gazing on part of the taxpayer, requiring an enormous degree of judgment, to ascertain upfront whether it falls foul of such a rule. I had hoped that with the significant tightening of the LoB rules, the need for a wider GAAR is perhaps only in exceptional situations, therefore not warranting specific provisions in the Treaty. However, clearly the policy makers think otherwise. We are hoping that the new draft of the treaty paper due in a few weeks will get the balance better than the original draft.

The current version of GAAR in India is a diluted version of the one introduced in the 2012 Budget. However, even now, concerns remain about its wide scope. Shome Committee had also cautioned that GAAR as an instrument to check tax avoidance should only be used by experienced hands.

The Finance Minister has assured that GAAR and the date of its implementation will be revisited. What further changes in the current GAAR will you like to see so that it is better targeted and its scope is restricted to only exceptional and abusive transactions?

I believe that some of the low hanging fruits are whatever have been recommended by the Shome Committee but not yet incorporated in the law should be accepted in the GAAR code. In this connection, carve outs for transactions such as restructures permitted under other provisions and within the contours of the domestic law is possibly warranted. Equally, India needs to demonstrate that she is a reliable treaty partner, and therefore, should refrain from any unilateral measure including GAAR to constrain treaties, and instead rely bilaterally on existing LoB clauses. With OECD also recommending anti-avoidance as a major objective for Treaty renegotiations now, India should pursue her Treaty partners if she believes that the existing treaty facilitates tax avoidance by any residents of the treaty partner.

Do the businesses in India need more time for GAAR preparedness?

I do not think the businesses need as much time for preparedness, as is their apprehension on how the Revenue will use this provision as it stands in the law book today. Clearly, as a business we would want the laws to be more tightened further, and a safe-guard eco system, e.g. like the Approving Panel to be in place before GAAR becomes operational. It should be noted and appreciated by all concerned, that accounting, disclosure and overall governance norms of businesses have increased manifold in recent times. Any tax proceeding, even if disputed, and howsoever considered unjustifiable by the taxpayer requires full disclosure and consequential explanation to many constituents, e.g., independent directors, lenders, and other regulators who need not necessarily be tax savvy to appreciate and undermine an egregious claim. This, in turn, can have adverse and increased impact on operational aspects of the overall business.Therefore, it is not a situation anymore where a tax claim and its defence is ring-fenced from the broad operations of a company, where the management sans Finance remains unaffected by the proceedings.

What are the businesses doing to GAAR-proof their business structures and strategic investments?

I expect everyone now to be careful in structuring any transaction, commercial or restructure, and ensure there is - at least a strong business purpose behind them and any part thereof. I would expect substantial debate in companies around the country with respect to their extant organizational structure and contracts to ensure that if they have been entered after August 2010, they are respected from a GAAR prism.

Will the structures involving low tax jurisdictions (for instance Mauritius and Singapore) need a revisit by the MNCs to be GAAR-safe?

It is difficult to give a generic answer to this question as the facts and circumstances in individual cases will be key determinants to the answer. The fact of the matter is countries such as Singapore, and perhaps lately Mauritius, are attractive regional destinations from a regional HQ perspective and otherwise. International banks, infrastructure, connectivity and a whole host of reasons make these countries attractive to many MNC's for setting up regional bases.

According to you, what are the key questions that the corporate boards should be asking themselves and their tax directors regarding transactions that could potentially result in the application of a GAAR regime?

We should ask the question we always ask ourselves - is this a commercial transaction with substance that is part of our normal business? We don't do transactions for tax purposes, and therefore, we do not want GAAR to significantly affect the way we think about business and resulting tax. And I guess that should equally be the outlook of the Revenue. It cannot be the case that a large swathe of taxpayers in a particular country is indulging in tax avoidance and worse. And in case the Revenue of any regime does think that a large number of taxpayers are indeed indulging in such practices, I would ask the Revenue to look at their tax policies and question whether those are at par with international norms and conventions.

Pranav Sayta

Partner – Tax & Regulatory Services, EY India

How will doing business in India change with GAAR?

Several issues need to be considered for investing in India including foreign direct investment norms, choice of entities, incentives, access to tax treaties, corporate and capital gains tax, transfer pricing and indirect taxes. In recent times, the tax legislation in India has been in the forefront of controversies and is cited as one of the predominant apprehensions by foreign investors for doing business in India. One of the reasons for the uncertainty in the tax environment is the introduction in the domestic tax law of General Anti Avoidance Rules (GAAR). Although rife with expectations, the new government's maiden budget was silent on deferring the applicability of GAAR and providing guidance on ambiguities attached in its current provisions. However, the honourable Finance Minister has mentioned that the Government will review the implementation of GAAR.

Historically, while indeed there have been several Specific Anti-Avoidance Rules (SAARs) in its tax law, India did not have a codified GAAR and most anti-avoidance principles were based on judicial precedents. The introduction of GAAR in India's Income Tax Act, 1961 (ITA) impacts decades of jurisprudence and could also impact existing investment and operating structures. According to the current situation, the GAAR provisions would become effective from 1 April 2015.

Globally, several countries have introduced general anti-avoidance provisions, albeit in different forms – and of late this trend has gathered further momentum.

Whatever be the fate of GAAR, given the environment it seems clear that we are moving slowly but surely towards more substance-based legitimate tax planning.

The extant GAAR provisions have the impact of regarding an arrangement as an Impermissible Avoidance Arrangement, when its main purpose is to obtain a tax benefit and it contains any of the following tainted elements – is not at arm's length; results in misuse or abuse of provisions of tax laws; lacks commercial substance; is carried out in a manner not ordinarily employed for bona fide purposes. The domestic tax law expressly provides that GAAR provisions would override all Tax treaties. The GAAR provisions vest Tax authorities with wide powers to, inter-alia, disregard, look through or re-characterise arrangements, ignore arrangements, etc. What is further concerning is the apparently open-ended residual power in the statute, that the tax consequences will be determined in a manner, which is deemed appropriate. Therefore, invocation of GAAR could have very wide and far reaching ramifications. Where GAAR is applied in the case of a taxpayer, there is no corresponding or consequential relief available to the counterparty irrespective of whether or not such a counterparty is a related party or part of the same group as the taxpayer. In fact there is no provision for grant of corresponding relief even to the taxpayer for say a different year.

Providing a silver lining to the dark GAAR cloud, last year the Central Board of Direct Taxes notified Rules that would govern GAAR. The Rules, to an extent addressed the concerns of tax payers by grandfathering investments made prior to 30 August 2010, introducing a tax benefit threshold of INR30 million and carving out exceptions for investors in foreign

institutional investors (FIIs) and also for FIIs itself, if they do not claim tax treaty benefits.

The use of treaties to claim tax exemptions has tested the Indian legislative waters successfully. An administrative circular was issued (in case of Mauritius) stating that a Tax Residency Certificate of a Mauritian entity is sufficient evidence of its residential status as well as of beneficial ownership. India's apex court has also upheld the validity and efficacy of this circular. While the question on applicability of the aforesaid Circular in a post-GAAR scenario remains unanswered, taxpayers should also bear in mind, the possible impact of any renegotiation of the India-Mauritius Tax Treaty to bring in some form of Limitation of Benefit (LOB) clause, which press reports indicate is being revived. The Financial Services Commission (FSC) of Mauritius recently issued amendments to enhance the level of substance required to be demonstrated by Mauritius-based entities. This indicates FSC's effort to build substance requirement under the domestic law of Mauritius. However, it seems unlikely that these requirements will be enough to pass the GAAR test. Recently investors have also been considering Singapore as a jurisdiction to invest into India. Applicability of GAAR in a case where the LOB or similar clause in tax treaties is satisfied continues to pose doubts (separately discussed in detail in this issue).

GAAR, by its very nature, has the potential of leading to significant uncertainty and litigation. It therefore, becomes critical to put in place adequate safeguards to ensure that GAAR will be applied objectively, judiciously and in a fair, consistent and uniform way. It is hoped that the Government will soon issue clear and detailed guidelines explaining various aspects of GAAR including the circumstances in which they will or will not be invoked and how the GAAR provisions will be applied (in terms of their consequences), incorporating practical illustrations covering contentious issues, which will serve as guidance both for taxpayers and Tax authorities. In fact the statute itself explicitly provides that the GAAR provisions will be applied in accordance with prescribed "guidelines". Furthermore, one hopes that the Government will first release a draft of the guidelines inviting comments, before finalising them.

Moreover, it should be ensured, through appropriate clarifications, that a payer is not burdened with the consequences of GAAR being invoked on the recipient. For instance, if an acquirer is required to consider GAAR invocation possibility on the seller while determining withholding tax liability it may lead to considerable uncertainty and may become a significant impediment to legitimate business transactions.

It is also hoped that GAAR does not lead to unreasonable consequences, and that adequate measures are put in place to provide for, corresponding adjustments in, for example, a different year for the tax payer or for corresponding adjustments in the hands of a counter party, as the case may be, in cases of GAAR being invoked. It should also be clarified that where SAAR (such as LOB) is applicable, GAAR will not be invoked (China also has provided this in draft administrative guidance released recently), the premise being that where a specific rule is available, the general rule should not apply.

A significant shift in the approach to tax planning in various cross border transactions will be imperative once the GAAR provisions become effective (probably much earlier – given that the impact of what is done before March 2015 may well be on the income for the period after 1 April 2015).

The basic thresholds to be met before invoking GAAR are still unclear, due to absence of clear guidance from the Government. For instance does GAAR mean the taxpayer loses his right to choose how a transaction is executed or implemented? It seems difficult to comprehend that the requirement of the law could be interpreted to mean that a taxpayer, far from being permitted to choose the most tax-efficient manner of consummating a transaction, actually needs to necessarily adopt that mode, which maximises his taxes! Instances could be many – having decided to exit a business, does the taxpayer

have the right to choose to implement this as either a share sale or a business transfer? And in a business transfer, can he not choose between a slump sale or an itemised sale or a demerger? Can a taxpayer entering India, choose an entity being a subsidiary (company) or an LLP or to just have a branch? Do taxpayers have a choice to consider distribution by way of dividend v. buy-back or capital reduction? Does a Taxpayer who for good business reasons needs a holding co (or SPV) have the right to choose the most efficient jurisdiction in which to house the SPV?

Businesses often face a situation of opting for equity or debt for funding Indian ventures. While currently, India does not have any form of thin capitalisation norms, choice of funding instrument could come within the purview of GAAR. For instance, in cases where the overseas parent has funded the Indian subsidiary through fully convertible debentures (FCDs), there could be an attempt to re-characterise the interest on FCD's as dividend by invoking GAAR especially if the debt-equity ratio is considered skewed.

Even business reorganisation strategies could come under the radar of GAAR. For example, depending on facts, a merger of a loss-making company and a profit-making company of a group, with the resultant consequence of a reduced tax liability, could be questioned.

In order to bring certainty in the GAAR regime, taxpayers could consider various dispute resolution methods such as private rulings from the Authority for Advance Ruling, advance pricing agreements and in appropriate cases mutual agreement procedures, while determining their litigation strategy. Some of these methods may provide fast and more effective resolutions of potential tax controversies, and also avoid exposure to protracted litigation, which is cumbersome in India.

The introduction of GAAR does not mean that there would be no place for any thinking on bringing about

It is advisable to ensure that robust tax governance procedures i.e., planning, provisioning, compliance and controversy are in place to keep enterprise from being unnecessarily exposed to the application of GAAR and the significant penalty, interest or reputational ramifications that may follow.

savings in taxes; nor does it mean an end to tax planning. However, it does call for a paradigm shift in thinking and in mindset, about what would now be acceptable as tax planning and as to how that would be demonstrated. Tax will not be seen to be driving businesses any more - it should be business driving tax. Business reasons and commercial rationale will be central to any planning in a GAAR environment. Increasingly one will see real substance-based planning, closely aligned with the taxpayers' business and operating model. Documentation indeed will be key – meticulous maintenance of clear and consistent documentation demonstrating the business purpose and intent will acquire critical significance as never before. Again it is advisable to ensure that robust tax governance procedures (for the entire tax life cycle, i.e., planning, provisioning, compliance and controversy) are in place to keep enterprise from being unnecessarily exposed to the application of GAAR and the significant penalty, interest or reputational ramifications that may follow.

While there can be considerable debate about the need for a statutory GAAR, especially considering the potential uncertainty it could create in an already not-so-easy business environment. If indeed it is to be implemented, one would hope that there is appropriate and clear guidance provided well in time, that it is invoked judiciously and administered fairly and finally that there is expeditious resolution of any disputes that may arise. Admittedly there can be no objection to the objective of wanting to prevent tax avoidance, but care should be taken to ensure that the attempt to do so does not drive away legitimate business that we do not throw the baby away with the bathwater. Whatever be the fate of GAAR, given the environment it seems clear that we are moving slowly but surely towards more substance-based legitimate tax planning.

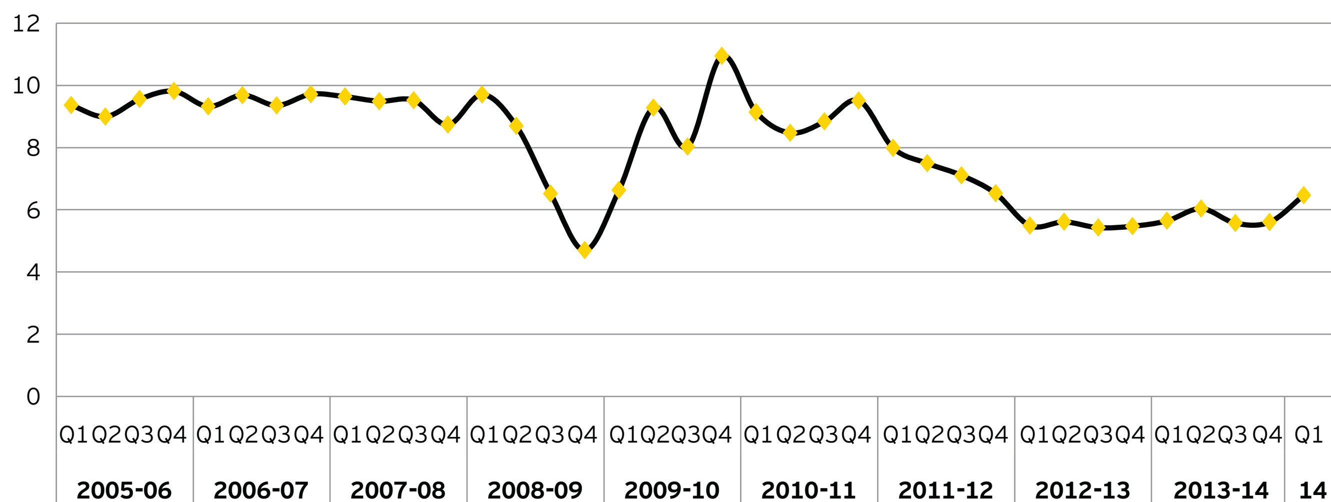
EconoMeter

Exhibit 1. GDP growth and sector share

Sector	Growth					% share in GDP				
	2011-12	2012-13	2013-14	2013-14 (Q1)	2014-15 (Q1)*	2011-12	2012-13	2013-14	2013-14 (Q1)	2014-15 (Q1)*
Agriculture, fishing and forestry	5	1.5	4.8	4.0	3.8	14.6	13.9	13.9	13.6	13.4
Industry	7.8	1	0.4	-0.4	4.2	27.9	27.3	26.1	26.6	26.2
Mining and Quarrying	0.1	-2	-1.4	-3.9	2.1	2.2	2.0	1.9	1.9	1.8
Manufacturing	7.4	1.1	-0.7	-1.2	3.5	16.2	15.8	14.9	15.2	14.8
Electricity, Gas and Water Supply	8.4	2.3	5.9	3.8	10.2	1.9	1.9	1.9	2.0	2.1
Construction	10.8	1.1	1.7	1.1	4.8	7.6	7.7	7.4	7.6	7.5
Services	6.6	7.0	7.0	7.2	6.8	57.5	58.8	59.9	59.8	60.4
Trade, hotels, transport and communication	4.3	5.1	3	1.6	2.8	27.3	26.9	26.4	26.1	25.4
Financing, insurance, real estate and business services	11.3	10.9	12.9	12.9	10.4	17.3	19.1	20.6	21.2	22.1
Community, social and personal services	4.9	5.5	5.8	10.6	9.1	12.9	12.8	12.9	12.5	12.9
GDP at Factor Cost	6.7	4.5	4.7	4.7	5.7	100	100	100.0	100.0	100

Source: Statement 22, quarterly estimates of GDP, CSO
* q-o-q growth and share

Exhibit 2. Growth rate of GDP factor cost (%)



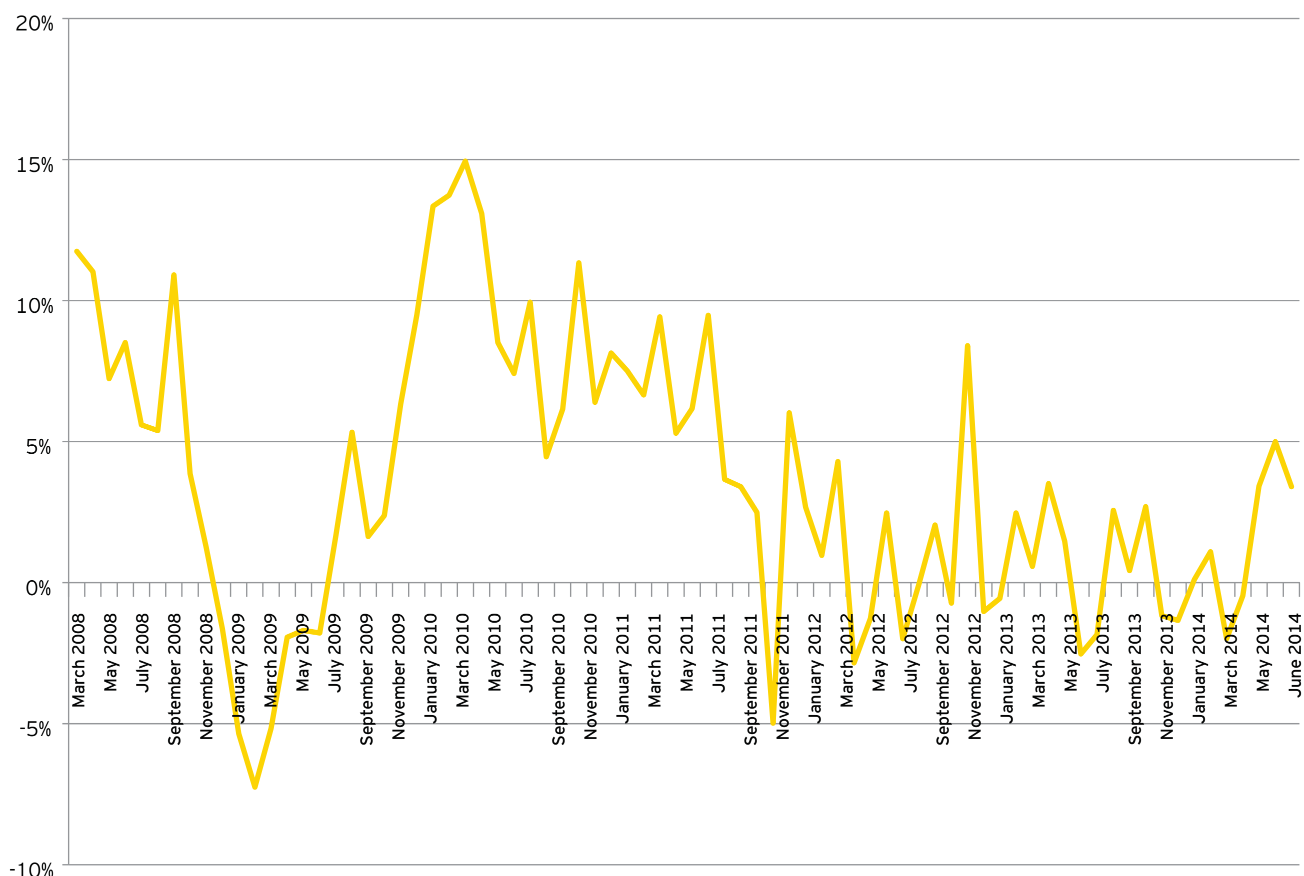
Source: Statement 22, quarterly estimates of GDP, Central Statistical Organisation

Exhibit 3. Percentage change in index of industrial production

Industry group	April-June FY14	April-June FY15	June 2013	June 2014
General index	-1	3.9	-1.8	3.4
Mining	-4.6	3.2	-4.6	4.3
Manufacturing	-1.1	3.1	-1.7	1.8
Electricity	3.5	11.3	0	15.7
Basic goods	-0.3	7.6	-1.9	9
Capital goods	-3.7	13.9	-6.6	23
Intermediate goods	1.6	3.1	1.3	2.7
Consumer goods	-2.1	-3.6	-1.5	-10
Durables	-12.7	-9.6	-10.1	-23.4
Non-durables	7.1	0.7	6.2	0.1

Source: Monthly Economic Report, July 2014, Ministry of Finance

Exhibit 4. Year-on-Year growth (%) of IIP



Source: Monthly Economic Report, July 2014, Ministry of Finance

Exhibit 5. Policy rates and ratios

Item/week ended	2013		2014	
	15 July	20 September	14 June	9 August
Cash Reserve Ratio	4.00	4.00	4.00	4.00
Bank Rate	10.25	9.50	9.00	9.00
Repo Rate	7.25	7.50	8.00	8.00
Reverse Repo Rate	6.25	6.50	7.00	7.00
Base Rate	9.70/10.25	9.80/10.25	10.00/10.25	10.00/10.25
Deposit Rate	7.50/9.00	8.00/9.00	8.00/9.05	8.00/9.05
Call Money Rate (Weighted Average)	7.09	10.29	8.00	7.97
Statutory Liquidity Ratio	23.00	23.00	22.50	22.00
Credit-Deposit Ratio	76.25	78.27	77.08	76.06

Source: Database on Indian Economy, RBI

Exhibit 6. Exports and imports (USD million)

Item	2011-12	2012-13	2013-14	July 13	July 14	April-July 13	April-July 14	% Change in July-14	% Change YTD 14
Exports	305964	300401	312610	25835	27728	99281	107840	7.33%	8.62%
Imports	489320	490737	450068	38326	39956	159195	153152	4.25%	-3.80%
Oil Imports	154968	164041	165148	12732	14355	51700	55140	12.75%	6.65%
Non-Oil Imports	334352	326696	284920	25595	25601	107495	98012	0.02%	-8.82%
Trade Balance	-183356	-190336	-137458	-12491.00	-12228.00	-59914.00	-45312.00	-2.11%	-24.37%

Source: Press release on India's foreign trade dated 14 August 2014, Ministry of Commerce and Industry

Exhibit 7. Foreign currency assets

	Amount		Variation	
At the end of (over last year)	INR crore	US$ million	INR crore	US$ million
March 2008	1196023	299230	359426	107306
March 2009	1231340	241676	35317	-57554
March 2010	1150778	254935	-80562	13259
March 2011	1225999	274580	75221	19645
March 2012	1333954	260742	107955	-13838
March 2013	1418339	260775	84385	33
March 2014	1661190	276406	242851	15631
August 2014 (over last month)	1767040	291318	105850	14912

Source: Database on Indian Economy, RBI

Exhibit 8. Inflation

Months	WPI	CPI-IW
	Base 2004-05	Base 2001
April 2013	4.77	10.24
May 2013	4.58	10.68
June 2013	5.16	11.06
July 2013	5.85	10.85
August 2013	6.99	10.75
September 2013	7.05	10.7
October 2013	7.24	11.06
November 2013	7.52	11.47
December 2013	6.4	9.13
January 2014	5.11	7.24
February 2014	5.03	6.73
March 2014	5.7	6.7
April 2014	5.2	7.08
May 2014	6.18	7.02
June 2014	5.43	6.49
July 2014	5.19	6.33

Source: Monthly Economic Report, July 2014, Ministry of Finance and CSO, Ministry of Statistics and Programme Implementation

Exhibit 9. FII net investment (INR crore)

Year	Equity	Debt	Total
2005-06	48801	-7334	41467
2006-07	25236	5605	30840
2007-08	53404	12775	66179
2008-09	-47706	1895	-45811
2009-10	110221	32438	142658
2010-11	110121	36317	146438
2011-12	43738	49988	93726
2012-13	140033	28334	168367
2013-14	79709	-28060	51649
2013-14 (April-July)	10470	-33870	-23400
2014-15 (April-July)	50709	50237	100948

Source: Key Economic Indicators, August 2014, Office of Economic Advisor, Ministry of Commerce and Industry

Exhibit 10. FDI inflow*

Month	US$ million	INR crore
April 2013	2321	12623
May 2013	1631	8974
June 2013	1444	8432
July 2013	1657	9903
August 2013	1408	8899
September 2013	4132	26351
October 2013	1226	7556
November 2013	**1638**	**10257**
December 2013	1101	6819
January 2014	2189	13589
February 2014	2017	12557
March 2014	3533	21558
April 2014	1705	10290
May 2014	3604	21373
June 2014	1927	11508

Source: DIPP, Ministry of Commerce and RBI
* Reflect equity component only

Exhibit 11. Union Government accounts as at the end of July 2014 (INR crore)

	FY13	April-July FY14	April-July FY15
Gross Tax Revenue	1138832	245323	258873
Corporate Tax	394677	60890	319763
Income Tax	237789	56805	64905
Service Tax	154630	35051	41628
Customs	172132	56042	53881
Union Excise	169469	33769	32264

Source: Monthly Accounts, July 2014, Controller General of Accounts

Exhibit 12. The fiscal position; Union Government accounts as at the end of July 2014

		Budget estimates FY15	Actuals upto July 2014*	% of actual to budget estimates	
		INR crore	INR crore	Current	COPPY**
1	Revenue Receipts	1189763	175632	14.80%	-16.70%
2	Tax Revenue (Net)	977258	146865	15.00%	-16.40%
3	Non-Tax Revenue	212505	28767	13.50%	-18.00%
4	Non-Debt Capital Receipts	73952	3384	4.60%	-6.60%
5	Recovery of Loans	10527	3262	31	-32.50%
6	Other Receipts	63425	122	0.20%	-1.70%
7	Total Receipts (1+4)	1263715	179016	14.20%	-16.10%
8	Non-Plan Expenditure	1219892	371891	30.50%	-33.50%
9	On Revenue Account	1114609	338048	30.30%	-33.40%
	(i) of which Interest Payments	427011	118615	27.80%	-23.30%
10	On Capital Account	105283	33843	32.10%	-33.80%
	(i) of which Loans disbursed	739	9941	1345.2	-2949.00%
11	Plan Expenditure	575000	132049	23.00%	-27.00%
12	On Revenue Account	453503	104003	22.90%	-27.40%
13	On Capital Account	121497	28046	23.10%	-25.10%
	(i) of which Loans disbursed	22813	7622	33.40%	-30.10%
14	Total Expenditure (8+11)	1794892	503940	28.10%	-31.30%
15	Fiscal Deficit (14-7)	531177	324924	61.20%	-62.80%
16	Revenue Deficit (9+12-1)	378348	266419	70.40%	-73.00%
17	Primary Deficit {15-9(i)}	104166	206309	198.10%	-148.00%

Source: Monthly Accounts, July 2014, Controller General of Accounts
* Actuals are unaudited provisional figures
**COPPY: corresponding period of the previous year

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