GAAR EXEMPTIONS AND UNCERTAINTIES

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It would be fair to make a statement that General Anti Avoidance Rules ('GAAR') is a global effort. Countries are either incorporating new anti-avoidance rules in their local tax legislations or strengthening the existing ones. Tax treaties are being re-visited to ensure a fair and 'moral' distribution of profits across jurisdictions. India too has taken an important step in this direction by incorporating GAAR in the Income Tax Act, 1961.

GAAR is a set of anti-abuse provisions which empower the revenue authorities to examine the underlying purpose in each transaction with a view to address the issue of tax avoidance. The Indian GAAR originated from the Direct Tax Code, 2009 and after some turbulence, was formulated in 2012. Given the subjective nature of the 2012 GAAR legislation, an Expert Committee was set-up under the chairmanship of Dr Parthasarathy Shome to recommend an appropriate implementation strategy in consultation with various stakeholders including the public at large. Subsequently, in 2016, specific rules were notified followed by a circular in 2017 containing FAQs on critical issues.

The GAAR legislation, as it now stands, provides a fairly exhaustive regulatory framework for governing transactions involving tax avoidance. In accordance with the agenda set out for this publication, our paper outlines the nuances relating to exemptions contained under rule 10U of the Income-Tax Rules, 1962 ('IT Rules') and addresses some potential issues that may arise in actual practice.

1. The 3 Cr Tax Benefit Threshold Decoded

Rule 10U(1)(a) provides that the GAAR provisions shall not apply to an arrangement where the aggregate tax benefit arising in a tax year is upto INR 3 Cr. It is stated that

"(1) The provisions of Chapter X-A shall not apply to—
(a) an arrangement where the tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed a sum of rupees three crore;"

This rule of exemption is apparently based on a recommendation made by the Expert Committee where the intent was to focus only on high value sophisticated structures. Their report explains the rationale of arriving at the said threshold i.e. of the 4,59,270 companies in India, only 6,141 reported a PBT of INR 10 Cr. At 30%, this resulted into a tax amount of INR 3 Cr which was considered material enough to trigger the GAAR provisions in India. This approach and the level of transparency is a laudable effort. Given the math, the threshold may be revised based on improved profit reporting by Indian companies in future years.

That said, the manner in which this provision has been drafted, gave rise to multiple interpretation issues. Some of these were clarified by the CBDT through FAQs in its Circular[1] ('CBDT Circular').

CBDT Clarifications

In order that GAAR provisions become applicable, the threshold of tax benefit of INR 3 Cr is stated to be

a.) arising in the Indian jurisdiction alone as the application of tax law is jurisdiction specific;
b.) in relation to a specific assessment year and lastly;

[1] Circular No7 dated January 27, 2017

c.) not tax payer specific but arrangement specific. In other words, only when the aggregate tax benefit arising in an arrangement meets the threshold, does GAAR apply.

Based on a plain understanding of Rule 10U read with the CBDT Circular, it can be stated that in order for GAAR provisions to apply, the threshold of INR 3 Cr is the aggregate tax benefit arising in India in an assessment year where the tax payers are party to an arrangement.

Other Issues Examined

Although the CBDT Circular addresses some very pertinent issues, a fine reading of all limbs of Rule 10U indicates specific areas which may require further clarification. These are

a.) The Period or Number of Years Relevant to Threshold of INR 3 Cr

As stated earlier, rule 10U(1)(a) requires determination of threshold in respect of a particular assessment year. The CBDT Circular supports this view. However, the definition of expression 'tax benefit' per section 102(10) provides a different view. It is stated that

102(10) "tax benefit" includes,—
(a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or
....
(f) an increase in loss,

in the relevant previous year or any other previous year;"

The expression 'in relevant previous year or any other previous year' appears to be in contradiction with 'relevant assessment year' quote in rule 10U. Since the quantification of tax benefit is a key criteria for trigger of GAAR provisions a clarification in this respect is deserving.

The CBDT Circular provides that a contrary view will not be taken in a subsequent year if such arrangement has been held to be permissible in earlier year and the facts and circumstances remain unchanged. Now, a fundamental issue which may be pertinent under the 'relevant assessment year' approach is that a different view could arise, based on threshold fulfilment, on the same arrangement in different years. Consider a case where an 'impermissible avoidance arrangement' is considered 'permissible' for want of threshold requirement. Now, would the same arrangement be viewed as 'impermissible' if in the subsequent year, the threshold limit is breached? Well, considering the key essence of GAAR, the answer appears to be 'Yes'. However, this issue would still require clarification, considering the taxpayer, on a plain reading of the Circular, would argue the arrangement to be out of ambit of GAAR.

A related issue here will arise in respect of single transaction, the tax benefit of which is spread across multiple years. While the cumulative tax impact may be well above the prescribed threshold, one could argue following the 'relevant assessment year' approach that tax benefit arising in one year only will be seen in examining the GAAR applicability in respect of each year. The CBDT Circular supports this position.

b.) Gross v. Net Tax Impact

It is clear that the quantum of tax benefit is seen in respect of an arrangement and not a tax payer. In this respect, the CBDT Circular has clarified that the tax benefit is not to be examined with respect to a single taxpayer only and what needs to be examined is the tax benefit arising to all the parties from the arrangement. It is stated that

"Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of Rs 3 crore cannot be read in respect of a single taxpayer only."

Where multiple tax payers are participating in an arrangement, a situation may arise that results into tax benefit to some and tax disadvantage to others. Consider an arrangement which results into tax benefit of INR 4.5 Cr to ABC Ltd and a tax loss of INR 2 Crore to XYZ Ltd. While the tax benefit to ABC Ltd. is above the prescribed threshold, the net tax benefit in India on such arrangement is below the prescribed threshold. In such a scenario, the revenue may argue that what is to be examined is only the tax benefit to all the parties from an arrangement and not the tax loss and thereby bring the above arrangement under the purview of GAAR.

That said, going by the true intent of the CBDT Circular and the GAAR provisions, tax disadvantage to a party from the same arrangement shall also be considered in computing the prescribed threshold. It would be useful if a clarification is offered on this specific aspect.

c.) Determining Tax Deferral

Per section 102(10), tax benefit includes any 'deferral of tax'. Such a situation could arise where the benefit available to the taxpayer is by delaying the payment of taxes to future years. The question here is the quantification of tax benefit threshold considering that the benefit would get realised in future years.

Interestingly, these concerns were also raised by some stakeholders after the initial draft guidelines, proposing a monetary threshold, were issued. In response to these concerns, the Expert Committee had recommended that such benefit be computed on the basis of 'discounted present value' considering the rate of interest payable to revenue authorities under section 234B as the inflation factor. This appears plausible and again a clarification would be useful.

d.) Whether Tax Includes Other Amounts Payable Under The Act

Section 102(10) states that tax benefit includes 'tax or other amount payable' under the Act. However, Rule 10U restricts the scope of tax benefit to the amount of 'tax' only. There is no mention of 'other amount payable'. This will lead to a conflicting situation wherein the tax payer would resort to computing the tax benefit threshold without considering other amounts payable under the Act such as (surcharge and cess). This has the potential to impact borderline cases.

It is interesting to note that the Expert Committee in its report had envisaged this situation and had suggested that the scope of tax benefit (for the purpose of computing threshold) be clearly restricted to income tax, dividend distribution tax and profit distribution tax and not other amounts like interest, income, etc. Since this is a known issue, a clarification by way of an inclusive list of taxes covered in computing 'tax benefit' would be useful. Reference is available in UK HMRC regulation which has provided an inclusive list of taxes to which UK GAAR shall apply.

e.) Whether Tax Benefit Restricted To Indian Jurisdiction?

As mentioned earlier in this note, the CBDT has clarified that in considering the quantum of tax benefit, only the benefit arising in the Indian jurisdiction is seen.

That said, the CBDT Circular does not seem to have envisaged a situation wherein a tax-payer derives incidental tax benefit by virtue of an impermissible arrangement outside India which is also the main purpose in such arrangement. Going by the plain reading of the CBDT Circular, such a scenario may lead to GAAR applicability in India unless the tax payer can establish that tax benefit in India was not the main purpose of such transaction.

2. Foreign Institutional Investors ('FIIs') – Exempted, and to What Extent?

Based on the recommendations of the Expert Committee the FIIs which have invested in Indian securities with prior permission of the competent authority have been kept out of the GAAR net. Rule 10U(1)(b) and (c) states that

"(1) The provisions of Chapter X-A shall not apply to—

(b) a Foreign Institutional Investor,—

(i) who is an assessee under the Act;

(ii) who has not taken benefit of an agreement referred to in section 90 or section 90A as the case may be; and

(iii) who has invested in listed securities, or unlisted securities, with the prior permission of the competent authority, in accordance with the Securities and Exchange Board of India (Foreign Institutional Investor) Regulations, 1995 and such other regulations as may be applicable, in relation to such investments;

(c) a person, being a non-resident, in relation to investment made by him by way of offshore derivative instruments or otherwise, directly or indirectly, in a Foreign Institutional Investor;"

Accordingly, FIIs who have not availed treaty benefits and a non-resident person in FII, whether such FII has claimed tax treaty benefits or not, have been exempted from applicability of GAAR. The manner in which this provision has been drafted clarifies the intent of the legislator that even in a multi-layer investments structure, only those investments which, directly or indirectly, are made by non-residents in such FIIs by way of offshore derivative instruments qualify for GAAR exemption.

Offshore derivative instrument includes participatory notes, a widely used instrument by non-resident individual investors to invest in the Indian securities markets through registered FIIs. Concerns were raised that participatory notes promote infusion of black money into the Indian system. Surprisingly, these concerns did not find merit with the Expert Committee and they went on to suggest that investment in participatory notes from FIIs should be exempt. However, the legislator took note and addressed this in a different manner - while they accepted the recommendation of the Expert Committee, SEBI tightened the noose on operation of participatory notes by notifying stringent fee requirements through a notification in July 2017. In hindsight, this appears to be a more practical approach which addressed the real concern by use of a simple regulatory yardstick.

CBDT Clarifications

The CBDT Circular has offered clarification in respect of two critical issues relating to FIIs. These are

a.) A pre-requisite for an FII to remain exempt from GAAR is that such FII should not have claimed any benefit under the tax treaty. Although not in as many words, the CBDT Circular has indicated that claim of such tax treaty benefit may be examined in respect of each year.

b.) GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. It is specifically stated that if the jurisdiction of such FII is based on non-tax commercial considerations and the main purpose of such an arrangement is not to obtain a tax benefit, GAAR will not apply.

Other Issues Examined

Though the exclusion of FIIs and clarifications offered thereafter indicate a conscious decision on the part of the legislator for not invoking GAAR in such cases, there are issues which need to be examined closely prior to making an informed decision. These are

Is there a Blanket Restriction on Availing Treaty Benefits by FIIs?

The rule clearly provides that in order to remain out of the GAAR net, the FII should not have availed treaty benefit. In absence of a specific direction, can it be argued that the restriction imposed under rule 10U operates only in respect of an arrangement tested for GAAR applicability? That said, the intent of the legislature in protecting FII investments from GAAR would ordinarily indicate a blanket restriction and therefore a clarification on this aspect is necessary.

Whether GAAR Operates Where Limitation of Benefit ('LOB') Clause Satisfied?

This is a fundamental issue. The CBDT has clarified in its Circular that if a case of avoidance is sufficiently addressed by LOB clause in the tax treaty, GAAR shall not be invoked. However, rule 10U(1)(b) provides that for an FII to claim exemption under GAAR, it should not have taken benefit under a tax treaty. This creates confusion and room for varied interpretation. Consider a case where an FII, having satisfied the LOB clause in a tax treaty, invites GAAR provisions due to specific provisions under rule 10U(1)(b). This is an issue deserving immediate attention.

3. Grandfathering of Existing Investments – Scope & Coverage

Under GAAR, incomes from transfer of investments made prior to April 1, 2017 ('cut-off date') are grandfathered. It is stated in Rule 10U(1)(d) that

"(1) The provisions of Chapter X-A shall not apply to—

(d) any income accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person from transfer of investments made before the 1st day of April, 2017 by such person."

The grandfathering provisions were considered imperative in light of benevolent exit provisions in some of the tax treaties that India had agreed, specifically with Mauritius and Singapore which had attracted substantial portfolio or direct investments in India. Accordingly, representations were made to operate GAAR provisions prospectively and thus the legislation was put in place only in respect of incomes arising on or after the cut-off date.

On the issue of whether it is the existing 'arrangement' that should be grandfathered or it is only the 'investment' which should be grandfathered, the Expert Committee recommended that grandfathering of an existing arrangement (instead of existing investments) may result in many future tax avoidance schemes out of examination under GAAR since a tax avoidance structure itself would receive indefinite protection and dilute the effectiveness of GAAR. Accordingly, it was recommended by the Expert Committee that all investments (and not the arrangements) made by a resident or non-resident and existing as on the date of commencement of the GAAR provisions should be grandfathered so that GAAR provisions are not applied at the time of exit resulting into examination or denial of tax benefits.

Clause 2 of Rule 10U further states that

(2) Without prejudice to the provisions of clause (d) of sub-rule (1), the provisions of Chapter X-A shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the 1st day of April, 2017.

Interestingly, a combined reading of clause 1 and 2 seems to suggest that there is no effective grandfathering that is available in respect of investments made upto the cut-off date. While on one hand, clause 1(d) provides grandfathering in respect of income on transfer of investments made upto the cut-off date, clause 2, an overriding provision, denies any benefit in respect of

incomes (from any arrangement) arising after the cut-off date. Consider a case where an investment made in January 2014 is sold in September 2017 resulting into tax benefit of INR 5 Cr which is exempt under a particular tax treaty. In such a scenario, can it be argued by the tax-payer that the tax benefit after the cut-off date should be grandfathered since it squarely falls under the purview of clause 1(d)? On the other hand, would the revenue authorities also be justified in denying this claim based on the blanket restriction under clause 2?

Investments made pursuant to circular 789 dated April 13, 2000 from Mauritius is a classic example. In a scenario where the investment was made based on TRC produced by the Mauritian Holding Co, can the tax benefit arising to the tax payer after the cut-off date be denied in accordance with clause 2 of rule 10U?

Given that the true intent of grandfathering is to provide effective shelter to gains arising from legitimate investments that were made upto the cut-off date, a clarification is necessary for the two provisions to operate harmoniously, failing which, the existing 'diluted' grandfathering provisions would operate only in respect of tax benefit recorded upto the cut-off date.

CBDT Clarifications

The clarification offered in respect of grandfathering provisions addresses specific issues put forth by the stakeholders in respect of convertible instruments such as compulsory convertible debentures, convertible preference shares and Global Depository Receipts issued before the cut-off date. The Circular has stated that these convertible instruments will be regarded as Investments made prior to the cut-off date provided the terms of such instruments are finalised at the time of issuance of such convertible instruments.

Similarly, bonuses, share split and consolidation of shares in respect of shares acquired by the same investor (who subsequently receives bonus/ consolidated shares) prior to the cut-off date will also be grandfathered.

It is clearly stated that lease contracts and loan arrangements will not be grandfathered.

Grandfathering Under GAAR and Tax Treaties

It is noteworthy that while GAAR provides relief in respect of an 'investment' made before the cut-off date, the recently modified treaties with both Singapore and Mauritius extends treaty benefits to capital gains earned in respect of any shares 'acquired' before that date. Since the intent under both GAAR and the amended tax treaties is to eventually grandfather investments made by the cut-off date, the use of different expressions, although not deliberate, is likely to cause interpretation issues. A line of clarification will allay concerns.

Another issue that is relevant here is in respect of a potential conflict that may arise on the issue of grandfathering under the amended tax treaties with Mauritius and Singapore when compared with the GAAR provisions under domestic law which have an overriding impact on the tax treaties. Under such scenario, would the tax benefit, accruing after the cut-off date, be denied per rule 10U(2) to a tax payer who has otherwise adequately met the LOB clause per the amended tax treaties? In other words, would the grandfathering apply here in its true sense? Well, the CBDT has addressed this scenario and clarified that if a case of tax avoidance is sufficiently addressed by LOB in the tax treaty, there shall not be an occasion to invoke GAAR. Although this provides some clarity, the expression 'sufficiently addressed' leaves room for ambiguity which the revenue authorities may use to their advantage in invoking GAAR citing misuse of LOB under the tax treaties.

Other Issues Examined

Transactions Under SAAR – Whether Exempt from GAAR?

In light of specific concerns and taking cue from global practices, the Expert Committee had suggested that GAAR should not be applied in situations where Specific Anti Avoidance Rules ('SAAR') operate under the domestic legislation. However, the CBDT has taken a different position and instead stated that GAAR and SAAR can both co-exist based on the facts and circumstances of each case. This provides room for ambiguity and potential misuse of GAAR even in genuine cases where the tax payers have met the test of SAAR conditions to the satisfaction of the revenue officer.

Decision by Courts and AAR – Whether Exempt from GAAR?

This issue is squarely covered under the CBDT Circular. It is stated that GAAR will not apply to arrangements that have been held permissible by the Authority of Advance Ruling ('AAR') or other similar authorities (such as judicial courts). This is a welcome step which should typically help the mergers and amalgamations schemes that are examined by the courts (now National Company Law tribunal 'NCLT'). However, the actual test of this clarification would be a situation where the courts / NCLT, approves a scheme without adequately looking into the tax aspects of a business scheme. Will the revenue authorities be justified in invoking GAAR provisions in such a situation?

4. Concluding Remarks

It is evident from this discussion that the existing provisions under the Indian GAAR are generically worded, leaving ample scope for subjective interpretation. Therefore, despite various clarifications and intense public consultations, the taxpayers are getting nervous and wary of the manner in which the GAAR legislation will be implemented. Also if the legislator expects this regulation to operate successfully, the revenue officers would need to be trained on both the technical as well as soft aspects.

The Circular issued by the CBDT has made an honest attempt to clear air on some critical issues but there is enormous scope for exhaustive and more precise clarification. Take for example, the Guidelines on GAAR Exemptions by the UK HMRC where GAAR is carefully constructed to include a number of safeguards that ensure that any reasonable choice of a course of action is kept outside the target area of the GAAR. Specific examples have been provided in the legislation to ensure that the tax payers right to select a business method is adequately protected from application of GAAR. There are similar instances in the Australian Tax Office's Guidelines on GAAR.

The Indian GAAR has made no such concentrated effort besides issuing clarifications through a Circular in January 2017. This has left much to desire. The legislature ought to have acted wisely in accepting the recommendations of the Expert Committee to introduce a 'negative list' (arrangements not subjected to GAAR) and additionally, prescribe genuine cases where the tax payer's right to select method of implementing a transaction is safeguarded. These could have acted as an effective ready reckoner for both the tax officers as well as the tax payers and the selection of cases would then become more of an exception with a higher probability of sailing through the approving panel.

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