

The General Anti-Avoidance Rules

Direct Taxes Code Bill, 2009

Background

Avoidance – An attempt to reduce tax liability through legal means, i.e. to regulate your affairs in such a way that you pay the minimum tax imposed by the Act as opposed to the maximum

Example – Mr. A forms a company to sell his products. The company pays 25% tax, but if he himself sold the products he would pay 30%

Evasion – Use of illegal means to reduce tax liabilities, i.e. falsification of books, suppression of income, overstatement of deductions, etc.

Example – Mr. B sells his products for cash and does not bank the cash.

“Every man is entitled to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be”

– Lord Tomlin (IRC v. Duke of Westminster)

Anti-avoidance

Anti Avoidance rules can be classified into following:

– Measures based on general principles in the law

- This refers to principles which are not codified in the legislation (non-statutory)
- They include a range of philosophies and approaches including “substance over form” “abuse of law”

– General Anti Avoidance rules

- It has same meaning as “anti avoidance rules based on general principles in law” except that it is codified and included in the legislation

– Specific Anti Avoidance rules

- These are the specific anti-avoidance rules which applies to the specific situations- CFC, Thin Capitalization rules, Exit Tax etc.

India moved from the first stage to the second stage by introducing GAAR under Domestic Tax Laws.

General anti-avoidance provisions introduced

The Commissioner empowered to declare an arrangement as an impermissible avoidance arrangement (IAA) if:

- The whole, a step or a part of the arrangement has been entered with the objective of obtaining tax benefit, and
- The arrangement:
 - Creates rights and obligations not normally created in arm's length transactions, or
 - Results in direct or indirect misuse or abuse of the provisions of the code, or
 - Lacks commercial substance in whole or part, or
 - Is not bonafide

Impact of IAA

Once treated as an IAA, look through permitted by:

- Disregarding the whole or part of the impermissible avoidance arrangement
- Treating related or accommodating or connected parties as one and the same person
- Reallocating amongst parties or re-characterizing any accrual, receipt, expense, deduction, rebate, etc. whether revenue or capital
- Re-characterizing debt to equity or vice versa

Domestic transfer pricing rule ?

Thin – capitalization ? Impact of currency law ?

Do we need FAQ's, safe harbors ?

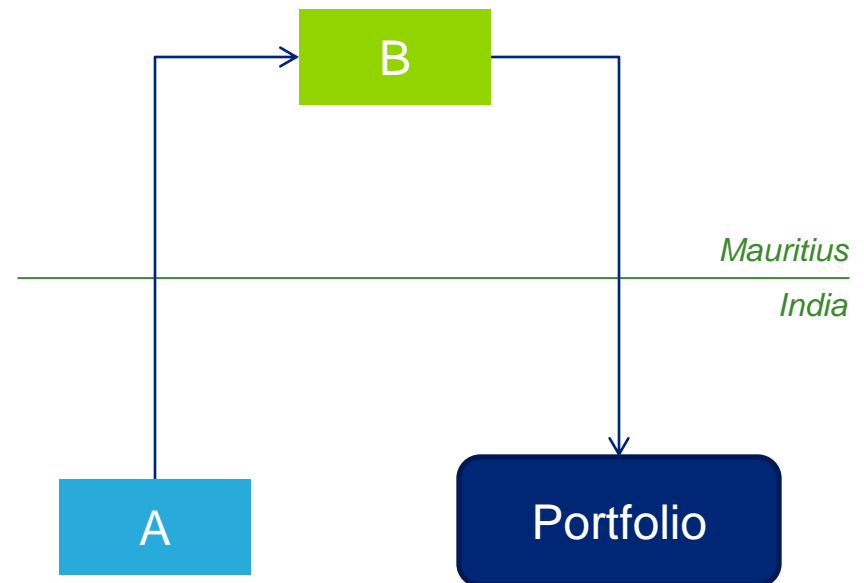
Lacking commercial substance

Lacking commercial substance defined to include situations where there is a:

- Significant tax benefits without a significant effect upon business risk or net cash flows
- Legal substance or effect differs from legal form
- It involves or includes:
 - Round trip financing
 - An accommodating or tax indifferent party
 - Any element that has the effect of offsetting or cancelling each other
 - A transaction which is conducted through one or more persons and disguises the nature, location, source, ownership or control of funds

Round trip financing

- The ordinary meaning of the word 'round-tripping' is 'a journey to a place and back again'
- Differential rates of tax for foreign and Indian investors have been the primary driver for this route
- Reserve Bank of India averse to any such proposals
- FIPB refers these arrangements to tax authorities



Other aspects

The GAAR can be invoked as an alternative to or in addition to any other basis of making an assessment

Presumption of Purpose

- The onus of proving that the purpose of a transaction is not to avoid taxes is on the assessee
- The presumption applies even if the main / overall purpose of the arrangement is not to obtain a tax benefit and only if a step / part of the arrangement is to obtain a benefit

Appealable order / dispute resolution ?

Advance Ruling ?

Penalties ?

Other countries

South Africa – 2006 GAAR introduced appears to have been the inspiration behind Indian provisions

Netherlands and Canada – Burden of proof on the tax authorities

Australia – Application determined on the basis of 8 test or factors

Australia and Canada will issue advance rulings

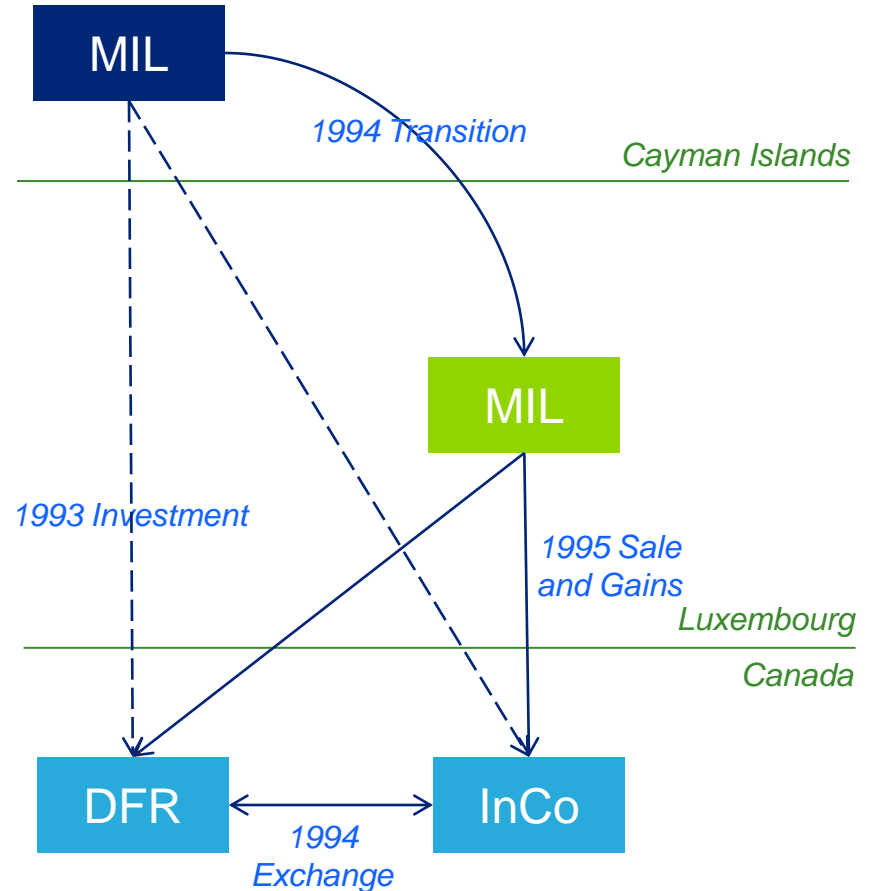
Is the Mauritius investment route compromised ?

The GAAR, applies if it can be established that there was an avoidance transaction that was a misuse or abuse of the provisions of the Canadian ITA or a tax treaty

A commercial transaction can be structured in a tax-efficient manner – i.e., once the "why" of a transaction is established to be for a nontax purpose, the "how" of implementing it may be tax-driven

No inherent anti-abuse or limitation of benefits rule in the treaty led to the conclusion

Does the AAR in DLJMB still prevail ?



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