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GAAR – a policy shift calling for conservative enforcement

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(View expressed are personal and not necessarily those of the Firm)

General Anti-Avoidance Rules ('GAAR') is one of the most hotly debated legislation in India keeping corporates on tenterhooks and guessing nervously on its reach and fold. Expected to come into force on April 1, 2012 under the umbrella of Direct Tax Code ('DTC'), there is understandable anxiety surrounding its application given the radical policy shift envisaged under these rules.

In the absence of detailed guidance on the proposed GAAR, each clause appears laden with meaning and ramifications as wide as the policy administrators may choose to apply and enforce. This article briefly examines certain implications of GAAR with a particular focus on Revenue's power to enquire into the motives of business arrangements.

The Policy Shift

At any point of time, Tax Policy is determined by the inter-play of legislative, executive and judicial actions undertaken in their constitutionally defined realms of activity. Historically, antiavoidance policy in India has been the amalgam of select statutory measures existing in the tax code supplemented by common law doctrines like 'substance over form' and 'lifting of corporate veil'. *Mcdowell*[1] and the subsequently pronounced *Azadi Bachao Andolan*[2] are certain landmark decisions that have supplemented statutory law to shape the existing anti-avoidance landscape. While tax policy is continuously evolving, taking Azadi Bachao Andolan as the last checkpoint, one can broadly spell out the contours of existing anti-avoidance policy as follows:

- Starting point - a presumption that every business structuring/ arrangement is legal
- Burden of proof - the onus of rebutting the presumption is on Revenue – Revenue must demonstrate

1 1985 3 SCC 230
2 263 ITR 706 – Azadi Bachao Andolan overruled Justice Chinnappa Reddy's concurring opinion in Mcdowell though it did not express any disagreement with the majority opinion (expressed by Justice Ranganath Misra) in Mcdowell.

convincingly that the arrangement is contrived merely for tax benefit and lacks 'commercial substance'

- Scope of scrutiny - So long as an arrangement/ re-structuring is backed by 'commercial substance', it should be permissible.

GAAR Policy on Anti-Avoidance

The contours of the anti-avoidance policy under proposed GAAR are as follows[3]:

- Starting point - Technically, the presumption that every business re-structuring is legal is maintained. However, now it appears far more easily susceptible to challenge.

- Burden of proof - Again, technically, the onus is on Revenue but the same is extremely diluted – the Revenue merely has to prove that the main purpose of a step or part of the arrangement is to obtain tax benefit. Thereafter, the entire burden shifts to the taxpayer who must demonstrate that the main purpose of the arrangement as a whole is not to obtain tax benefit.

- Scope of scrutiny - 'Impermissible arrangement' (under GAAR) covers any arrangement with the main purpose of obtaining a tax benefit and which is;

(i) Not in conformity with arm's length principle; or

(ii) Results in misuse or abuse of the provisions of the Code; or

(iii) Lacks 'commercial substance'; or

(iv) Not normally employed for 'bonafide' purposes

While each one of the above provisions is worthy of a separate discussion, we shall focus only on the last condition that implies a ground-breaking policy shift enabling Revenue Authorities to question 'motives' or 'bonafides' of a business arrangement.

'Commercial Substance' versus 'Motive'

The distinction is a thin but fine one. 'Commercial substance' can be viewed as the 'alibi' for any business arrangement certifying that the affairs are indeed being carried out in the manner stated. It is the factual corroboration of a business arrangement through the actual conduct of parties. Are people meeting at the official meeting place, are decisions indeed being taken by those in-charge, is there actually any business activity at the professed 'place of business'

3 For sake of brevity GAAR provisions (sections 123 and 124 of DTC) have not been re-produced but it is advised that the same be referred to facilitate comprehension.

and so on – these are the relevant questions seeking to bridge the gap between 'theory' and 'reality'. To the extent GAAR requires 'commercial substance' there is no significant policy shift since this requirement already exists albeit under un-codified common law.

Commercial rationale/ motive on the other hand entails an enquiry into the 'wills' or 'motives' for decision making aiming to unearth the prime-mover behind a business arrangement or structuring exercise - was the arrangement motivated solely for tax reasons, was it the outcome of business imperatives or was it (as it happens in most cases) a joint outcome of both.

Implications of Policy Shift under GAAR

There is no exhaustive (or even inclusive) definition of the term 'bonafide purpose' under the proposed legislation that may clearly delineate the circumstances in which GAAR may be invoked. The DTC merely provides for an exclusive definition of 'bonafide purpose' which excludes arrangements that:

(a) create rights or obligations that are normally not created at arm's length; or

(b) result, directly or indirectly, in the misuse or abuse of the DTC provisions.

We may now consider two examples that assess the impact of GAAR on business arrangements. The implications under the existing law are also referred to.

Case I – Tax Motive is Sole Consideration

The first case is of a business arrangement motivated solely by tax considerations but comprehensively meeting the 'commercial substance' test – so for a moment let us assume that a multinational company with full fledged distribution operations in India realigns its business with a view to reduce the intensity of its functions, assets and risks in India, re-locating the more value add functions to a low tax jurisdiction. A limiting assumption is that the re-structuring exercise has been undertaken mainly for tax considerations[4]. The re-structuring comprehensively complies with the 'commercial substance' requirement – the shifting of functions and risks is reflected in the actual re-location of the staff and critical decision making ('significant people functions') responsible for distribution operations in India.

In the above example, even though the test of 'commercial substance' is satisfied it is not entirely clear whether the re-structuring (motivated solely for tax reasons) would meet the standard of a 'bonafide purpose'.

4 Practically, business re-structuring is usually driven by tax and non-tax considerations with latter taking the lead

'. Rather, it is quite possible that GAAR could be triggered in absence of any strong commercial reasons supporting the re-structuring.

On the other hand, as briefly discussed above, under the existing anti-avoidance policy regime, such re-structuring which meets the test of 'commercial substance' does not appear to be problematic per se.

Case II – Tax and Non Tax Motives Co-exist

Case II is merely an extension of the above example with a dilution of the limiting assumption of tax consideration being the sole motive for re-structuring. In Case II, re-structuring is partly driven by tax and partly by non tax considerations ie ease of sourcing, geographical advantage etc. Even though a commercial rationale for re-structuring may co-exist, depending upon the relative strength of different motives, a challenge under GAAR may not be ruled out. In other words, if it is demonstrated that amongst the multiple motives, tax avoidance remains the dominant motive and commercial benefit is only incidental, it remains an open question whether GAAR challenge could still be triggered.

Conclusion

The above are just some illustrations of the variety of situations that could crop up for adjudication under the GAAR regime. Quite clearly, application of GAAR and in particular, 'bonafide purpose' is an area calling for well timed (ideally before GAAR becomes effective) and more pin-pointed clarity. There can be several commercially expedient ways of doing business - each with different tax implications. Ideally, the prerogative of commercial decision making should be left to 'businesses' and no matter how strong the temptation is, 'bonafide purpose' should not become a garb for 'witch-hunting'. Adherence to common law principles advocating freedom of business and non interference in commercial decision making shall be the key for success of the new anti-tax avoidance policy.