

Differentiating tax avoidance and evasion

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OVER several decades, legal sophistry and judicial exposition have endeavoured to discover the spectre of the unique dividing line between tax evasion and tax avoidance. OECD broadly defines tax avoidance as arrangement of the taxpayer's affairs to reduce his tax liability which could be strictly legal, but is usually against the intent of tax laws.

In India, the law is settled that tax avoidance is legal and evasion is not. A taxpayer may create a device to arrange his commercial affairs to minimise his tax liability and its acceptance is based on operation of law. While revenue authorities are entitled to decipher the true meaning of a transaction, they cannot substitute its legal effect by a perceived 'substance of the transaction' without concomitant provisions under the tax legislation for Anti-avoidance rules.

The Direct Tax Code, 2009, proposes to introduce General Anti-Avoidance Rule (GAAR), which would erase the thin line between tax avoidance and tax evasion. Section 112 of the code empowers revenue authorities to declare any arrangement as 'impermissible avoidance arrangement' if it results in certain tax benefits or it creates rights or obligations which would not normally be created between persons dealing at arm's length or it results in abuse of the provisions of the code, lacks commercial substance or lacks bonafide business purpose. It allows revenue authorities to disregard, combine or re-characterise any step in any such arrangement, or re-characterise equity in to debt and vice versa.

The code allows revenue authorities to label a transaction as lacking commercial substance if it results in significant tax benefit to a contracting party without concomitant business risks or cash flows or if the legal substance is inconsistent with the legal form or it involves round trip financing. The code also makes a presumption in favour of the Revenue that an arrangement is entered into for the tax benefit alone, unless it is rebutted by the taxpayer. The tax benefit is defined, amongst other things, to mean a reduction, avoidance or deferral of tax arising as a result of a tax treaty. It is questionable if the attempt to override the tax treaties by invoking GAAR will stand the scrutiny of Indian judiciary.

India is not isolated in enacting GAAR in its taxing legislation. It is an established trend among countries to legislate on GAAR to deny tax benefits for any arrangement structured with the sole objective of tax avoidance. The South African Revenue Service released a 'Discussion Paper On Tax Avoidance' in November 2005 wherein it outlined the typical features of such arrangements as those lacking in economic substance or those accommodating tax avoidance with special purpose offshore entities or those where complex hybrids and synthetic instruments are used or those where tax havens are effectively used.

Canada introduced GAAR in 1987. The Canadian Supreme Court examined GAAR provisions in the case of 'Canadian Trustco Mortgage Co Vs Canada (2005) SCC 54' and held that the GAAR

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can be invoked only where there is a tax benefit arising from an avoidance transaction, which defeats or frustrates the object, spirit and purpose of the tax law and where the transaction is abusive. It may be noteworthy that the Federal Court of Appeal in Canada, in the case of 'Queen Vs MIL (Investments) SA,' denied invoking GAAR in a treaty shopping situation and allowed the benefit of the capital gain exemption under the tax treaty between Canada and Luxemburg even though it resulted in double non-taxation of the gains.

While in general, introducing GAAR is a step in line with many of the mature economies, in India, it is apprehended that wide discretionary power provided to the tax officers may be used without a matured guiding principle. Trepidation lurks that GAAR could be used against even genuine transactions, thereby affecting the investment climate in the country. The introduction of GAAR must be coupled with suitable administrative and judicial reforms. The backlog of cases must be cleared to gear up for the new bout of litigation that may arise post-implementation of GAAR. Unless it is implemented judiciously along with a fast track 'Alternative Dispute Resolution' mechanism, the new regime will elevate India's position on the taxpayers' hardship index.

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