INTERNATIONAL RESEARCHERS

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Volume No 1 Issue No.4 December 2012

www.iresearcher.org

ISSN 227-7471

THE INTERNATIONAL RESEARCH JOURNAL "INTERNATIONAL RESEACHERS"

www.iresearcher.org

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THE CONTROVERSY WITH TAX: IS IT PLANNING, AVOIDANCE OR EVASION?

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ABSTRACT

The recent verdict by Supreme Court on Vodafone case generates fresh debates on whether India needs to review her existing legal provisions particularly with respect to offshore tax laws. In this context, formal treatment and clear demarcations between tax evasion, tax avoidance and tax planning practices are imperative. The Standing Committee on Finance in its 49th Report on Direct Taxes Code bill, 2010(submitted to Parliament on 9th march, 2012) recommended Controlled Foreign Corporations (CFC) rules, Advance Pricing Agreement (APA) along with General Anti Avoidance Rule(GAAR) provision to replace the Income Tax Act, 1961. The Committee also acknowledges the need for an appropriate Dispute Resolution Panel (DRP) as GAAR might result in a disproportionate discretionary power for the Income tax authority. The appropriate application of GAAR provision assumes a crucial role, in particular with countries lacking any Limitations of Benefit (LOB) clause (e.g. Mauritius) with India. Before entering into litigation, an attempt could be made to settle tax disputes through a bilateral negotiation in the form of a Mutual Agreement Procedure (MAP). However, occasionally this is problematic as the parties often unable to reach an agreement. An alternative approach (in case MAP fails or otherwise) might be seeking advice from Supreme Court authorities, before invoking a litigation.

Keywords: tax evasion, tax avoidance, General Anti Avoidance Rule, Limitations of Benefit

JEL Classification: Y5, Y50, Z1

1. INTRODUCTION

The recent verdict by Supreme Court on Vodafone case generates fresh debates on whether India needs a review of her existing legal provisions particularly with respect to offshore tax laws. Regarding this, serious discussions are essential for a clear distinction between tax evasion, tax avoidance and tax planning. Tax evasion is the *illegal* practice where individuals/firms escape paying taxes to the government through deliberate concealment or misrepresentation of their tax liability. However, when a taxpayer escapes his/her tax liability by exploiting legal ambiguities/resort to non-compliance of tax payments being entirely within the framework of the law (i.e. not violating any laws), it amounts to tax avoidance(Sandmo 2004).Another way to make a distinction between tax evasion and avoidance is that while in case of evasion, transactions are mostly unreported due to the natural tendency of avoiding punitive actions, in tax avoidance details are not hidden by tax payer(s) i.e. transactions are usually on record.[i] For instance, the Australian Ralph Review of Business Taxation has described tax avoidance as misuse of the law that is often driven by structural loopholes in the law(Garg and Mukherjee 2012).

However, it is often difficult to distinguish between the two as both practices are harmful to society as they cause a drain on the exchequer through loss of public revenue. Both tax avoidance and evasion are forms of tax noncompliance describing a range of activities that are unfavourable to a nation's tax system. Though tax avoidance is a legal practice, it is often very hostile as companies/individuals seek to pay less than their tax liabilities. Such aggressive tax avoidance causes substantial public revenue loss. Hence, most literature on tax evasion discusses both tax evasion and avoidance as a collective way of escaping taxes (using terms like 'tax noncompliance' or 'tax dodging'). For instance, according to Wenzel:

Tax evasion refers to such deliberate criminal non-fulfillment of tax liabilities. In contrast, tax avoidance refers to deliberate acts of reducing one's taxes by legal means. However, the distinction is not always clear because tax laws

are not always precise. Moreover, when taxpayers try to find loopholes with the intention to pay less tax, even if technically legal, their actions may be against the spirit of the law and in this sense considered noncompliant. The present research will deal with both evasion and avoidance and, based on the premise that either is unfavorable to the tax-system and uncooperative towards the collective, subsume both under the concept of tax noncompliance. Its primary form is of course tax evasion(Wenzel 2002).

Conversely, 'tax planning' may be justified where individuals/institutions or firms plan to minimise their tax payments through financial planning.[ii]

A disturbing fact is that while tax evasion is an outright illegal way of non-payment of taxes (breaching the law) and from legal point of view is quite unambiguous, the distinction between tax avoidance and tax planning is often difficult to make. The ambiguity arises since both the tax planning and tax avoidance is related with the activity of non-payment of tax liability being within the framework of the law. For instance, a person may adopt different accounting methods for different sources of income/ invest in tax saving securities/other tax-planning schemes — all these may reduce/negate tax liability and do not violate laws. However, some strategies for tax avoidance (for instance transfer mis-pricing) are often intended for the sole purpose of non-payment of taxes and hence controversial. Therefore, tax avoidance is controversial and often treated as bizarre whereas tax planning is not. But the distinction between the two in practice is extremely difficult since both are legal. Therefore if a person/company is accused of tax avoidance in its negative sense, that person/company may claim that the intention is only 'tax planning' and not 'tax avoidance'. The debate then ultimately boils down towards identifying what transactions should be treated as legal. Given the proliferation of sophisticated devices used by companies for non-compliance of legitimate tax payments fine-tuning the existing legal provisions has also become essential.

Nobody would like to pay tax since it reduces disposable income. However, the approach towards non-compliance is crucial. For instance, an economic entity in India may engage in a 'tax planning' by investing in a judicious portfolio of tax saving instruments (e.g. National Savings Certificates, Equity Linked Savings Schemes etc.) to minimise her overall annual tax payments. On the other hand, a practice of routing back same amount of money via a number of tax haven countries (or the so called 'round tripping') to the origin country, or parking higher profits in lower tax jurisdictions and lower profits in higher tax jurisdictions via 'transfer mispricing'[iii] may be 'tax avoidance'. Another way of looking into the difference between tax planning and tax avoidance is that while an economic entity tries to minimise the overall tax burden by *utilising the available options* in case of tax planning (and does not try to escape from tax payments), in case of tax avoidance an entity try to escape from tax burden by creating *sophisticated methods for non-compliance of legitimate tax payments*. However, it is difficult to treat the latter practice in a legal manner as it is done within the framework of the law, even in cases where the sole purpose is non-compliance of taxes and nothing else.[iv]

Certain transfer pricing policies have been challenged on legal ground in some countries. For instance, global pharmaceutical company GlaxoSmithKline was accused of charging a transfer price for its marketing services to its US-based subsidiaries at rates much lower than the normal market price, which undermined Glaxo's US income. By understating its income, the company escaped around USD 5.2 billion in US taxes. Glaxo had to pay a penalty of USD 3.4 billion to the Internal Revenue Service (IRS) of the United States after a prolonged litigation. This case is remarkable in the sense that GSK's USD 3.4 billion payment to the IRS is the largest single payment made to the US tax authority to resolve a tax dispute.[v] Again, Russia's biggest privatised energy company, Yukos, has allegedly been engaged in stripping of enormous amount of assets and of transfer mis-pricing.[vi]The Russian government filed a case against Yukos and a number of shell companies[vii] helping the transfer mis-pricing process by acting as legitimate financial institutions. The Russian government claimed that a subsidiary of Yukos sold crude oil at a price much below the market rate to some shell companies to escape its tax liability. The shell companies are unregistered companies and therefore not liable to pay tax to the Russian government. These companies are accused of reselling the crude oil at much higher prices than the transfer prices charged by Yukos to domestic and foreign buyers, and the revenues following the resale has in effect been appropriated by Yukos. Yukos has been able to escape the tax by officially reporting a much lower transfer price (below the taxable limit) while indirectly appropriating the revenue proceeds from the resale at the market price (not declared, as these prices were charged by shell companies not officially registered with the Russian government as being liable to pay tax).[viii]

2. THE SUPREME COURT VERDICT ON VODAFONE

In this context, the recent Supreme Court(SC) verdict regarding the Vodafone case is not only important for the Income Tax Department (I-T Department)of India but for the country as a whole given the aspect of shrinking fiscal policy space with respect to resource mobilisation. It is crucial to understand *the reasons* for which SC gave the

decision against Income tax Department of India, whereas the verdict of Bombay High Court was the opposite. Let us explore the following:

- The background of the case and Issues
- Reasons for rejecting the case in favor of Vodafone
- Some Concerns

2.1. THE BACKGROUND OF THE CASE AND ISSUES

The entire transaction and subsequent acquisition of shares of CGP(a Holding Company incorporated in Cayman Islands) by Vodafone is a complex process. Put simply, the claim by the Indian Tax Department is that Vodafone purchased USD 11.2 billion worth of assets (67 percent stake) of a Hong Kong-based company called Hutchison Whampoa Limited in 2007 indirectly through the purchase of shares(or being entered into a Share Purchase Agreement called SPA) of CGP Holding private Limited. This deal by Vodafone is subject to a capital gains tax of USD 2.5 billion, as most of the assets acquired by it from Hutchison were based in India and under Indian law. These assets had been generated and held initially by Hutchison while doing its mobile business in India. The rule of violation arises since the transaction involves a transfer of Indian assets (initially held by Hutchison, which Vodafone acquired in 2007 without deducting tax at source on them through the purchase of shares of CGP Holdings Limited; a company incorporated in Cayman Islands) which were supposed to generate public revenue in India. The defense argument by Vodafone is that Indian tax laws do not apply in this case since it is a Dutch company registered in the Netherlands, whereas CGP(through which the Hutchison shares had been acquired by Vodafone) is located in the Cayman Islands and the agreements were signed abroad (outside the Indian geographical territory) between two non-Indian entities. On the other hand, the acquisition of shares by Vodafone of Hutchison is on income/revenue generated in India acquired initially by Hutchison via their mobile business in India. Therefore, the revenue is subject to Indian capital gains tax laws. The Income Tax Department of India sought to tax the capital gains arising from the sale of the share capital of CGP on the basis that CGP though not a tax resident in India, holds the underlying Indian assets which acted as an intermediary between Vodafone Group and Hutchison. The crux of the dispute had been whether or not the Indian Income Tax Department has jurisdiction over the transaction. Vodafone had maintained from the outset that it is not liable to pay tax in India, and even if tax were somehow payable, then it should be Hutchison to bear the tax liability which I-T Department is supposed to collect during Hutchison's business in India. The relevant Sections of the Income Tax Act (for instance Section 9), henceforth is not applicable for Vodafone as the contract had taken place in a different (offshore) jurisdiction.

Bombay High Court, in September 2010, dismissing the writ petition filed by Vodafone, held that share transfer had a significant nexus with India and the proceedings which have been initiated by the Income Tax Authorities cannot be held to lack jurisdiction. Accordingly, Bombay High Court has held that the share transfer by Cayman entity (CGP) is liable to tax in India.

2.2. REASONS FOR REJECTING THE CASE IN FAVOUR OF VODAFONE

However, after an appeal by Vodafone to Supreme Court and further proceedings of the case, Supreme Court did not uphold the Bombay High Court ruling and rejected the case in favour of Vodafone. The important reasons[ix] that were cited for the rejection of the case in favour of Vodafone are as follows:

(1) The 'Situs' (the place where a thing/right properly belongs) of CGP shares was outside India and not taxable under Sec 9 of the Income Tax Act of India. Transfer of a capital asset (in Hutch-Vodafone case, CGP share which is based in Cayman Island) situated outside India, falls outside the ambit of Sec 9(1) of the Income Tax Act. Moreover, it has been argued by the Supreme Court that "Acquisition of the CGP share which gave VIH an indirect control over three genres of companies evidences a straightforward *share sale* and not an *asset sale."*[x]

(2) The actual acquisition by Vodafone of CGP shares was 51.96% and not 67%. The Supreme Court verdict stated that :
According to VIH, the price also included a control premium, use of Hutch brand in India, a non-compete agreement, loan obligations and an entitlement to acquire, subject to the Indian FDI rules, a further 15% indirect interest in HEL. According to the said letter, the above elements together equated to 67% of the economic value of HEL. This sentence has been misconstrued by the High Court to say that the above elements equated to 67%

of the equity capital (See para 124). 67% of the economic value of HEL is not 67% of the equity capital. If VIH would have acquired 67% of the equity capital, as held by the High Court, the entire investment would have had breached the FDI norms which had imposed a sectoral cap of 74%.[xi]

(3) The entire structure cannot be looked at as an 'artificial tax avoidance scheme', (a 'sham' transaction is solely for the purpose of non-compliance of legitimate tax payments without having genuine business purposes) in as much as CGP was not situated at the last minute, and existed since 1998 having economic and commercial substance and cannot be treated as 'shell' in its bizarre or pejorative interpretation. Therefore it cannot be said to be a 'pre-ordained' transaction for the sole purpose of avoiding tax only.

(4) The Supreme Court emphasised that a 'look at' (a holistic) approach is required instead of a 'look through' (or dissecting) approach. To quote :
High Court, in the present case, ought to have examined the entire transaction holistically. VIH has rightly contended that the transaction in question should be looked at as an entire package. The items mentioned hereinabove, like, control premium, non-compete agreement, consultancy support, customer base, brand licences, operating licences etc. were all an integral part of the Holding Subsidiary Structure which existed for almost 13 years, generating huge revenues, as indicated above.[xii]

In this context, it may be worth mentioning that before the Ramsay case, the statue of Duke of Westminster was omnipotent which rested upon "Given that a document/transaction is genuine, the court cannot go behind it to some supposed underlying substance." [xiii]However, the relevance of the Ramsay principle had been understood in a later stage stating:

companies that had made substantial capital gains had entered into complex and self-cancelling series of transactions that had generated artificial capital losses, for the purpose of avoiding capital gains tax. The House of Lords decided that where a transaction has pre-arranged artificial steps that serve no commercial purpose other than to save tax, the proper approach is to tax the effect of the transaction as a whole

following litigation with respect to *a farming company W. T. Ramsay Ltd.*[xiv] In this context, McDowell and Azadi Bachao cases were also referred. In the McDowell case, Justice Ranganath Mishra stated that tax planning might be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods.

3. SOME CONCERNS

The Supreme Court verdict regarding the Vodafone issue is extremely important with respect to the current Income tax laws, potential revenue impact of the Government of India (GoI), future approach regarding offshore transactions as well as socio-economic implications for the common people. Among others (if any), the following issues required further discussions:

(1) The suggested 'look at' approach (or a holistic approach) instead of a 'look through' approach (or a dissected approach) provides scope for further debates and discussions. While, the need for a holistic approach can be recognized from the perspective of the distinction between 'genuine' and 'sham' transactions, it appears also that the treatment of taxes might be case sensitive and not a uniform approach. In the present Income Tax Act Section 9(1)(i) it is mentioned that the following incomes shall be deemed to accrue or arise in India " all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situate in India."[xv]

Therefore the income that deemed to accrue in India is income generated through either from (a) a business connection in India; (b) a property in India(c) any asset or source in India; and (d) transfer of a capital asset in India.

It is difficult to believe that no income has generated through any of the four categories in this transaction. Vodafone has a business connection in India through CGP Holding and in turn Hutchison. Even if we consider that there is *only a share sale and not an asset sale,* it is clear there is a share sale which generated an amount of income from India. The important question is whether this is taxable, and if so who should pay the tax? Is it Hutchison or Vodafone?

Since this is an acquisition (the purchase or obtaining of a controlling interest in a firm, usually via a tender offer for the target shares) by Vodafone (the acquirer or bidder) of Hutchison (the target company), it appears that the proceedings from such acquisition or takeover should be included in the asset side of Vodafone in its balance sheet. However, if we accept the definition of capital gains as 'The gain on sale of a capital asset is called capital gain' (Standing Committee on Finance 2012) then capital gains tax can be implemented only on capital assets. Hence, the issue is whether capital gains tax is applicable on income generated through purchase or sale of shares and whether shares can be treated as capital assets. As per the Income Tax Act Department, India

The incidence of tax on Capital Gains depends upon the length for which the capital asset transferred was held before the transfer. Ordinarily a capital asset held for 36 months or less is called a 'short-term capital asset' and the capital asset held for more than 36 months is called 'long-term capital asset'. However, shares of a Company, the units of Unit Trust of India or any specified Mutual Fund or any security listed in any recognised Stock Exchange are to be considered as short term capital assets if held for twelve months or less and long term capital assets if held for more than twelve months.[xvi]

In the 49th Parliamentary Standing Committee report, equity or preference shares, securities like debentures, listed government securities, units of mutual funds and UTI, zero Coupon bonds are defined as long term capital assets (Standing Committee on Finance 2012). Another crucial issue is to determine the benchmark of permissible amount of 'income transfer' (whether in form of assets or shares) or 'upper limit' of such transfer.[xvii]

Occasionally, it is extremely difficult to prove that a company lacks commercial substance. This is difficult because laws are not specific/do not provide any objective criteria regarding this. A fundamental problem with tax avoidance schemes is that making a deal via any tax haven countries is not illegal. For instance, in the Vodafone case it has been pointed that the CGP Holding has not been created at the last moment and existed since 1998. But, there are a number of such tax haven corporations already in place since long time which may be used to avoid paying taxes by a number of companies like Vodafone. This is a fully external factor and beyond the scope of Income Tax Authorities. Unless global pressure is created on 'tax haven' countries to amend their tax laws to impose certain taxes on offshore transactions and broaden tax bases on such transactions, it is difficult to tackle such tax avoidance practices. Though OECD has taken an initiative in this regard[xviii], still the tax rates and tax structure in a number of tax haven countries are highly and unnecessarily beneficial for business purposes. In this regard, the Standing Committee Finance recommendation on Controlled Foreign Corporation (CFC) rule is crucial which would be applicable to Companies located in low tax jurisdictions.

Law should be able to clearly reflect precisely: *Whether Income Tax authorities are entitled to charge capital gains tax where mergers and acquisitions take place outside Indian Territory by foreign companies containing any relation to Indian assets* Or *whether companies (foreign/domestic) have to pay a capital gains tax to Indian tax authority in case of a M&A held outside Indian jurisdictions containing any relation to Indian assets (and under what conditions).*Laws should be clear and mostly inclusive to reflect how to tax *direct and indirect offshore transactions arising from sale of assets*. Moreover, what should be treated as assets for tax purposes and the related classification of such assets is crucial.

It can be mentioned in this context that the proposed Direct Tax Code (DTC) in India suggested that income from transactions in all *investment assets* will be computed under the head 'Capital gains.' However, more clarity is required whether capital gains tax would be generated on both assets and income since a major controversial area is whether the income generated from capital market transactions should be treated as business income or as capital gains. There is also a need of clear separation of different corporations/companies (for instance, 'offshore companies') to specifically categorise *which types of taxes* would be applicable on *which types of companies* and *under what circumstances*. For instance, in the revised discussion paper of DTC an explicit mention is provided whether capital gains tax would be applicable for Foreign Institutional Investors(FIIs) as "The capital gains arising to FIIs shall not be subjected to TDS and they will be required to pay tax by way of advance tax on such gains"(CBDT 2010).

(2) The General-Anti Avoidance Rules (GAAR) in the proposed Direct tax Code in India has the potential to empower the Income Tax Department of India regarding taxing offshore transactions. Countries like UK, US, Mexico and Denmark have specific anti-abuse rules pertain to taxation instead of a statutory GAAR,[xix] for instance, Controlled Foreign Corporation (CFC) regime[xx] to tax income parked in low tax jurisdictions, thin capitalisation rules[xxi] to rule out tax rebates for inflated and unjustified interest deduction etc. The positive side of such anti-abuse rules is that these are very clear-cut laws reducing possibilities for litigations. Again countries like Australia, Canada, Germany, France, New Zealand and South Africa have the provision of

GAAR(Garg and Mukherjee).The Standing Committee on Finance has recommended GAAR should not override the Limitations of Benefit (LOB) Clauses already made with contracting countries (Standing Committee on Finance 2012). While this is important to avoid disputes, appropriate application of GAAR is crucial in case any tax disputes arises with countries lacking LOB clauses (e.g. Mauritius). India has included LOB with some countries, for instance with Singapore. The norm of 'residential status' is stricter in Double Tax Avoidance Agreement (DTAA) treaty with some other countries compared to Mauritius. For instance, there is a 'conduit/shell' test of Singapore- based companies selling Indian shares, whereas the company should either be a listed company on a recognised Singapore stock exchange or it must expend more than Singapore USD 200,000(Indian Rs.5 million) on its operations in Singapore. Again, the Double Tax Avoidance Agreements or DTAA with United Arab Emirates (UAE) provides the definition of a resident company as:

A company is deemed to be a UAE resident if it is incorporated, managed and controlled wholly in the UAE. A strict interpretation of the word "wholly" by the Indian tax authorities might result in a UAE entity being denied the benefits of the treaty if even a small degree of control of the entity is exercised outside the UAE. By contrast, a Mauritius entity carrying out the same activities would not be liable to any tax on capital gains under the Mauritius-India DTAA, nor would it be subject to any 'primary purpose' test or such rigid controls regarding the management of its affairs (Xavier 2009).

It is not understood, why such Limitation of Benefit (LOB) clause cannot be included between India and Mauritius whereas such clause can be included in the DTAA treaty between India and Singapore.[xxii] While GAAR may obviate the need for such fresh LOB clauses, appropriate application of GAAR is crucial.Moreover, It may be noted that the applicability of GAAR would be most useful in case of abusive 'tax avoidance', i.e. in cases where it is difficult to draw clear legal lines between genuine tax planning and abusive tax planning (or 'tax avoidance' in its bizarre interpretation).

(3) Before entering into litigation, an attempt could be made to settle tax disputes through a bilateral negotiation in the form of a Mutual Agreement Procedure (MAP), where tax authorities of the respective countries negotiate to settle disputes in a cordial manner. However, occasionally this is problematic as the parties often unable to reach an agreement. An alternative approach (in case MAP fails or otherwise) might be seeking advice from Supreme Court authorities, before invoking a litigation.xxiii

(4) There is a need for a formal treatment of tax evasion and tax avoidance. There should be clear legal guidelines distinguishing tax evasion, tax avoidance and tax planning and what type of strategies under what circumstances would be taxable or subject to penalty. In the Vodafone case it has been pointed that "Tax avoidance and tax evasion are two expressions which find no definition in the Indian Companies Act, 1956 or the Income Tax Act, 1961."xxiv

4. Conclusions

In the era of globalisation and liberalisation competition among multinational corporations has increased tremendously. It would be a natural tendency for such companies seeking reduction of their 'tax costs' by any affordable means. The challenge lies in framing appropriate legal provisions to tackle such practices in an unambiguous manner. A problem with tax avoidance is that the determination of the extent of 'avoidance by abusive means' is largely a subjective issue depending upon court(s) view about such transactions. Unless certain fundamental problems are addressed, it would be difficult to prove that such transaction(s) are 'abusive avoidance' even if actually this is so. For instance, so long there are 'tax haven' countries; any cases related to such *tax free* jurisdictions would make Income Tax authority impotent, since transactions via such tax haven jurisdictions are not illegal. The General Anti Avoidance Rule(GAAR) is crucial in this regard, and a policy option for India is to follow other countries(those who have adopted and practicing GAAR) guidelines. When countries like Australia, Canada, Germany, France, South Africa have GAAR provisions(and China has introduced recently in 2008), India should also introduce such provisions to tackle tax avoidance practices following Ramsay rule('substance over form' should be allowed, i.e. the allowance in lifting the corporate veil in contrast to the Duke of Westminister, if we think some tax practices, are, in fact abusive and should be stopped).The essence of rule(s) like GAAR is that such rule is supposed to set certain *objective criteria* to address tax avoidance practices. From the point of view of companies, certainty in tax laws is essential. Whereas a well-defined tax laws like GAAR is expected to provide such certainty in tax laws, implementation and practicing of GAAR is not an easy task and requires considerable time to study cases of other

countries. More in-depth and serious thoughts are required in distinguishing between *acceptable tax avoidance* /*strategic tax planning practices* in one hand, and *abusive tax avoidance practices* on the other hand. However, all such considerations should not undermine the importance of GAAR, instead the essence of these considerations lies in the careful application of GAAR. Moreover, objectives of different provisions in tax law should be clear and non-overlapping. For instance, the essence of Double Tax Avoidance Agreement(DTAA) is not to tax doubly a company both in resident and in the investing country. But that does not imply that laws like Limitations of Benefit or primary purpose test should be non-existent in such treaties. These are necessary to prevent misuses of such DTAA provisions.

5. Acknowledgements:

I want to acknowledge my Organisation Centre for Budget and Governance Accountability(CBGA), Praveen Jha(Associate Professor. JNU and member, advisory board, CBGA), Subrat Das(Executive Director of CBGA), Pooja Parvati, Pooja Rangaprasad and Prashant Prakash for their suggestions and comments.

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[i] An example of tax evasion may be cited by referring the practice of money laundering. The major purpose of money laundering is to hide illegally generated money from official records to escape from investigations and punitive actions. Initially, the amount is kept in offshore banks (where secrecy/non-disclosure of the account holder is guaranteed) and then the account holder/launderer brings back the money by mixing that money into the 'white component'.

[ii] Ideally, tax planning refers to the minimisation of total tax liability/burden by firms/individuals through an appropriate 'planning' by consulting tax advisors/consultants. It is a cost minimisation strategy. However, occasionally this strategy is being criticised (for instance, the transfer pricing strategy of Multinational Companies) as a tendency towards non-compliance of legitimate tax payments and referred to as 'aggressive tax planning'. For details see the OECD report published in August 2011, titled as "Corporate Loss Utilisation through Aggressive Tax Planning", ISBN 978-92-64-11921-5.

[iii] Transfer price is the price at which goods and services between related companies are transacted. The main branch of a company is called the parent company and a number of associated units spread in different jurisdictions/ countries are called its subsidiaries. Often, associated companies and main company manipulate prices at which goods & services are transacted among them to reduce overall tax liabilities. Hence, higher profits are shown at countries/region where tax rates are low, and lower profits are shown at countries/regions where tax rates are high by adopting suitable transfer prices (transaction prices).Though this is not an illegal practice, and a cost minimisation strategy of multinational companies, often transfer prices are manipulated(manipulated transfer pricing practices are sometimes referred to as 'transfer mispricing' to indicate the abusive nature of such transactions) to avoid substantial tax payments. The OECD published general guidelines for dealing with transfer pricing for Multinational Enterprises and Tax Administrations that form the basis for the transfer pricing legislation in the UK, which was put in place in 1999.

[iv] This aspect is however, noted by the OECD project report on "Harmful Tax Practices". For details see OECD's project on *Harmful Tax Practices: Update on Progress In Member Countries, 2006*,URL: http://www.oecd.org/dataoecd/1/17/37446434.pdf.

[v] See "IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute"(September 11, 2006), URL: http://www.irs.gov/newsroom/article/0,,id=162359,00.html

[vi] See "Yukos tax case coming full circle"(February 6, 2007), *The New York Times,* URL: http://www.nytimes.com/2007/02/06/business/worldbusiness/06iht-yukos.html

[vii] "Shell" companies are often susceptible as fake companies operating just as a mediator/conduit in tax haven countries for abusive tax practices and other illegal activities like money laundering, market manipulation, bankruptcy fraud etc. Though a shell company may act as perfectly legal entity, however in a number of instances certain companies are alleged to engage in tax abusive practices, particularly in States like Delaware, Wyoming, and Nevada based in United States. On the other hand, States like Alaska and Arizona have strict regulations for company formations. For details see, the URL: http://www.fraudauditing.net/ShellCompanies.pdf.

[viii] Some abusive tax avoidance practices are treated under the provision of General Anti Avoidance Rule (GAAR) or Specific Anti Avoidance Rule (SAAR) in some countries. However, treating such practices under GAAR is sometimes highly controversial and entails prolonged litigation.

[ix] In the present context, the most fundamental reasons are only discussed relevant for the discussion.

[x] See p. 84 of the "Vodafone International Holdings BV V. UOI(CIVIL APPEAL NO.733 OF 2012(arising out of S.L.P. (C) No. 26529 of 2010)" dated 20th January 2012.
[xi] ibid, p. 85.
[xii] ibid, p. 86-88.
[xiii] See the House of Lord, URL: http://www.publications.parliament.uk/pa/ld199798/ldjudgmt/jd970612/mcguc02.htm
[xiv] The Ramsay Principle is the shorthand name given to the decision of the House of Lords in two important cases in the field of UK tax, reported in 1982. In the Ramsay case, a company (W. T. Ramsay Ltd) which had made a substantial capital gain had entered into a complex series of transactions which had generated an artificial capital loss. The House of Lords decided that where a transaction has pre-arranged artificial steps which serve no commercial purpose other than to save tax, then the proper approach is to tax the effect of the transaction as a whole.

[xv] See the Section No. 9: "Income deemed to accrue or arise in India" in the URL: http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx
[xvi] See "How to Compute Your Capital Gains? "Taxpayers Information Series-3, Income Tax Department, URL: http://incometaxindia.gov.in/Archive/How_to_compute_capital_gains_2008-09.pdf P.15
[xvii] This discussion is however, has taken place in the Standing Committee of Finance in its 49th report and the proposed Direct Taxes Code Bill, 2010.See p.70.
[xviii] The initial objectives were three-fold: (1) Identifying and eliminating harmful features of preferential tax regimes in OECD member countries (2) Identifying "tax havens" and seeking their commitments to the principles of transparency and effective exchange of information and (3) Encouraging other non-OECD economies to associate themselves with this work. Currently, the OECD maintains three lists: (a) A white list of countries implementing an agreed-upon standard (b) A gray list of countries that have committed to such a standard (c) A black list of countries that have not committed. See OECD's project on *Harmful Tax Practices: Update on Progress In Member Countries, 2006*,URL: http://www.oecd.org/dataoecd/1/17/37446434.pdf

[xix] See "Ready for GAAR?" by Ajay Kumar and Dheeraj Chaurasia, Business Line (December 5, 2009), URL: http://www.thehindubusinessline.com/todays-paper/tp-opinion/article1070925.ece.
[xx] When a person/company invests in a foreign company, the tax base of the investing person/company apparently declines in his/her domestic country as the invested amount that could be taxed in the investor's residence state is transferred to a foreign company. In order to prevent erosion of the tax base due to residents investing in foreign companies in tax havens or low tax regimes many countries impose Controlled Foreign Company (CFC) rules. Several countries(US, UK, Japan, China and most OECD countries) have formulated CFC regulations to prevent residents from escaping their tax liabilities by diverting profits/incomes(e.g. in form of royalty, interest, rent and dividend) to foreign companies they control that are located in low-tax jurisdictions.

[xxi] A company is thinly capitalized when the proportion of debt is higher than equity in its capital structure. A potential problem arises when such companies claim higher tax rebates/deductions from tax authorities on interest payments on such debts since there is no deduction of tax on the interest that is paid on the debt, whereas certain amount of income tax is deducted on the dividend that is paid on equity. Interest payments on debt may be inflated artificially or can be manipulated to substantially lessen tax liability. In most countries, such practice is regulated (Prescribed upper limits of debt-equity ratio are laid down in countries like US, Hungary, Poland, Germany beyond which a penalty is imposed).
[xxii] As per the DTAA treaty between India and Mauritius, capital gains realised from sale of shares are taxable only in the country of residence of the shareholder (the company/entity selling shares). Hence, an offshore company taking a residential status in Mauritius and making capital gains tax by selling Indian shares in India or elsewhere needs to pay capital gains tax only according to the tax laws of Mauritius. However, there is no capital gains tax in Mauritius. Therefore, any company having a residential status of Mauritius effectively need not pay any capital gains tax on transactions of Indian shares as per the DTAA treaty with India and Mauritius.

[xxiii] After the verdict of the Vodafone case, there is a plan of tax authorities seeking advice from Supreme Court regarding taxation of offshore transactions. See, "Vodafone effect: Taxmen to seek Supreme Court advice on foreign bank accounts of Indians" (January 30, 2012) *Economic Times*, URL: http://articles.economictimes.indiatimes.com/2012-01-30/news/31005843_1_lgt-bank-bank-accounts-tax-havens
[xxiv] "Vodafone International Holdings BV V. UOI(CIVIL APPEAL NO.733 OF 2012(arising out of S.L.P. (C) No. 26529 of 2010)" dated 20th January 2012,p.162.

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APPENDIX

A. TRANSFER PRICING

Transfer price is the price at which goods and services between related companies are transacted. The main branch of a company is called the parent company and a number of associated units spread in different countries/locations are called its subsidiaries. For instance, let us assume that a television company (say Wisco) based in the US provides teleservices to India. Owing to an increasing demand from people in India for this teleservice, the US company decides to set up a subsidiary in India that will provide teleservices and movies in the country. The parent company then floats a film production company in India for better facilitation. Now, Wisco has to make a strategic decision regarding at what price the teleservices would be provided to its subsidiary in India. This is the transfer price of Wisco.

Since the film production company has to operate in a new country, tie up with new partners and create brand loyalty where it had no presence before, the parent company might decide to support the efforts to build a market share by arranging a suitable transfer price for the India based company. Given the fragile condition of the start-up company, Wisco might provide a "preferably suitable price" to it compared to its other already established subsidiaries. This preferably suitable price might be below, above or equal to the existing market price depending on profit and other considerations.

But *what should the preferably suitable price be?* As per the Transfer Pricing laws followed by various countries, it should be a fair one, that is, a price that would be charged between the parent and subsidiary companies, as if they are "unrelated companies". (The normal transaction price that prevails between two separate companies is called "Arm's Length Price"). However, companies often manipulate the transfer price to escape taxes. For instance, Wisco might charge the India-based subsidiary a price much below the market rate which falls short of the taxable income. In this manner, MNCs might pay less tax than it should pay under normal circumstances by charging lower prices (and projecting lesser profits) where tax rates are high, and higher prices and higher profits where tax rates are low.

Theoretically, the concept and practice of transfer price is not illegal. The idea underlying transfer pricing is optimal allocation of a firm's resources by minimising costs. The practice can be accepted if transactions between the parent company and its subsidiaries or between subsidiary firms can be done at the market price. Smaller manipulations might be tolerated but over the years, transfer prices have been severely manipulated in order to shift profits to low tax countries from high tax countries. Consequently, there are substantial losses of legitimate tax revenues of governments of different countries.

An Illustration:

Suppose Wisco faces 20 percent tax in the US, produces 100 television sets for sale, and has a subsidiary in Canada with the market price per at USD 50,000 per TV set in Canada. Let us further assume Wisco has zero production costs. (The assumption of 'zero production costs' is made to keep the illustration simple.In reality, firms definitely has production costs. However, if firms have identical costs or if the production cost does not vary much between the subsidiary and parent company, then including it would not alter the results, and therefore, the cost of production would not matter. Firms can continue to evade taxes by suitably determining transfer prices even if production costs are taken care of.)

let us consider the following:

Q=100 units (output)

The tax rate t=20 %

Market price in Canada of television set P_m=50 dollars per TV set

If Wisco decides to charge a transfer price of USD 10 to its subsidiary in Canada (Let us denote the transfer price by P^T) for the sale of a television set to its subsidiary in Canada, its revenue would be $R= P^T \times Q=10\times100=1000$ dollars. Since production costs of Wisco are assumed to be zero (C=0), the profit of Wisco would be Profit (Π) =Revenue(R) - Cost(C) =1000 dollar

At t=20% tax rate, the total tax payable by Wisco in the US is =tax rate (t) ×Profit (Π) = (20%) ×1000=200 dollar

On the other hand, the subsidiary resells the television sets at Canada at the market price (P_m) =50 dollars. Assuming zero cost of production, the profit of the subsidiary would be $\Pi = P_m \times Q = 50 \times 100 = 5000$ dollars.

It can be noted that this profit is also the profit of Wisco. At t=20%, total taxable amount would be T=t× Π=20%×5000=1000 dollars. But instead of paying USD 1000 as tax, Wisco pays 200 dollars as tax, thus saving 800 dollars ($ 1000 - $200) as tax.[Note: Wisco should pay tax on the *fair price/market price/arm's length price* of 50 dollars that prevails in Canada. Instead, Wisco pays tax on 10 dollars, which is the 'transfer price' set by Wisco to sell at its subsidiary in Canada. Wisco thus avoids taxes by showing a lower "officially reported price" to US tax officials/tax authority]

If the tax rate in Canada were t^c =5% (much lower than the tax rate in the US, which is 20%), the taxable amount at Canada would be $T^c = t^c \times \Pi^c = 5\% \times 5000 = 250$ dollars (t^c=Tax rate at Canada and Π^c=profit in Canada). On the other hand, taxes paid in the US would be $T^{US} = t^{US} \times \Pi^{US} = 20\% \times 1000 = 200$ dollars.

Therefore, in effect, Wisco pays a total tax of $T = T^c + T^{US} = 200 + 250 = 450$ dollars. If Wisco were paid tax in only the US at a uniform tax rate of t^{US} =20%, it would have had to pay an amount of 6000×20%=1200 dollar as tax (i.e., t^{US} =20% on total combined profit in Canada and US which equals $\Pi^{US} + \Pi^c = 1000 + 5000 = 6000$ dollars). By adopting a suitable transfer price, Wisco reduces its tax rate substantially.

From the above illustration, the following points emerge:

- Higher profits are shown in lower tax jurisdictions (profit in Canada is USD 5000 higher than profit in the US, USD 1000 and tax in Canada is 5% compared to the US 20%)
- Low transfer price is charged in high tax jurisdictions (Wisco sells TV sets at USD 10 to its subsidiary in Canada, i.e., it charges a transfer price of 10 dollars only in the US where the tax rate is much higher at 20%

In the United States, the Internal Revenue Service (IRS) uses a "best method rule" to determine a range of prices. If it finds that a particular inter-company transfer price is less than 50 percent or more than 200 percent of the arm's length price, then it may penalise the taxpayers involved. The "arm's length principle" has become an international benchmark among all OECD countries and also a number of non-OECD countries (e.g. Argentina, Russia, China). A number of methods [Comparable Uncontrolled price or CUP, Resale Price Method(RPM), Cost Plus Method(CPM), Profit Split Method(PSM) and Transactional Net Margin Method(TNMM)] are used to determine the arm's length price in different market conditions.

Given the increasing disputes and litigations with respect to transfer pricing issue in different countries, the Organisation for Economic Co-operation and Development (OECD) released guidelines on transfer pricing in 1995 (OECD 1995). The report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, published by the OECD, was the foundation for the OECD Guidelines. To incorporate changes in international trade, the OECD published the revised OECD Guidelines in 1995, with subsequent chapters added in 1996 (intangible property and intercompany services) and 1997 (cost contribution arrangements). There is also "OECD Guidelines for Multinational Enterprises" published in 2008.

In 1995, only three countries in the world had regulations regarding cross-border transfer pricing – South Africa, the US, and Australia. Over the years, a number of countries started to implement and follow transfer pricing laws, given the increasing cases of abusive transfer pricing practices.

Since the liberalisation of the Indian economy and its integration with world markets, the number of cross-border transactions between Indian enterprises and their group entities has increased significantly. Therefore, it became imperative to put in place a comprehensive code for transfer pricing as a part of the Indian income-tax legislation. The Finance Act 2001 introduced with effect from assessment year 2002-2003, detailed Transfer Pricing regulations vide section 92 to 92F of the Income Tax Act, 1961.

B. SELECTED COUNTRY EXPERIENCES AND PROVISIONS OF GAAR: OVERVIEW OF SOME CASES AND NOTABLE FEATURES

AUSTRALIA

In Australia, Part IVA of the Income Tax Assessment Act 1936 (ITAA) acts as Australia's primary tax anti-avoidance rule started in 1981. This anti-avoidance rule applies to schemes that took place after 27 May 1981. It applies to schemes both in Australia and abroad. The applicability of Part IVA to a scheme depends upon the following:
1. Whether an entity obtained a tax benefit.
2. Was that tax benefit resulted from a scheme?
3. Whether this tax benefit was available without the scheme. Or, whether the tax benefit was realized *only exclusively* because of entering this particular scheme.
3. Was the scheme used for the sole or dominant purpose of obtaining the tax benefit?
The terms 'tax benefit', 'scheme' etc. has been explained in detail in the anti-avoidance rule. The implication of the above-mentioned criteria is to ensure whether a scheme is used specifically for the purpose of availing a tax benefit, lacking appropriate commercial substance. Before the application of GAAR to any particular scheme, the matter has to be referred to the Tax Counsel Area(TCA)[comprising of senior tax officers specialising in Part IVA] of the Australian Tax Office (ATO) for consideration. Once there is a consensus of TCA regarding the applicability of GAAR, the matter is referred to the GAAR Panel made up of business, professional experts and senior tax officers. There is scope of argument for the relevant taxpayer before the Panel.

Cases: *Commissioner of Taxation v. Hart[2004] 219 CLR 216:* In case of Commissioner of Taxation v. Hart[2004] 219 CLR 216, the High Court of Australia upheld that a home loan product was under the domain of GAAR(Part IVA of the ITAA). The purpose of the loan was to(a) Finance the purchase of a personal residence and (b)Re-finance an investment property held by the taxpayers. The need of invoking a GAAR arose as the home loan product was structured to avail considerable tax deductions on account of refinancing the investment property. According to the GAAR application to this case, a comparison has been made between this transaction and *all other alternative options to the taxpayers*(called 'Counterfactual'). A comparison between the 'counterfactual' and the actual transaction/scheme led to conclude by the High Court that the foremost purpose of the scheme was to avail *only* the tax benefit. Another case of *News Australia Holdings*[Commissioner of Taxation v. News Australia Holdings Pty Ltd(2010)FCAFC78] was in contrast to the earlier case, i.e. that of *Hart*, where a buy-back of shares resulting in a capital loss of almost 1.5 billion Australian dollar was found beyond the ambit of Part IVA.

CANADA

The Canadian GAAR[Section 245 of the Income tax Act (Act)], became operative since 13 September, 1988. A novel feature of the provision is that transactions beginning before 13 September 1988 as well as transactions completed before 1989, would not be subject to the GAAR. Moreover, transactions entered into before April 13, 1988; where concerned taxpayer(s) had received a confirmation in writing with respect to the tax consequences from the tax authorities would also not subject to the Canadian GAAR. According to the Supreme Court of Canada, the GAAR should be viewed as a last resort to combat abusive transactions, and should not be viewed as an instrument generating uncertainty in tax planning. Following are the major objectives of the Canadian GAAR:

(a) Distinguishing between legitimate tax planning and abusive tax avoidance
(b) Creating a judicious balance between the protection of the tax base and the need for certainty for taxpayers in planning their businesses.

The application of the GAAR involves the following three steps:
• Step-1: To decide whether there is a "tax benefit" arising from a "transaction"
• Step-2: To determine whether the transaction is an *avoidance transaction* (Whether the transaction is arranged predominantly for bona fide purposes other than to obtain the tax benefit. If not, then the transaction is susceptible to an avoidance transaction)
• Step-3: To determine whether the avoidance transaction is *abusive*.

GAAR can be applied only after the fulfillment of the above criteria.

Cases: *The Queen v. Canada Trustco Mortgage Company 2005 SCC 54*: In the *Canada Trustco Mortgage Co. v. Canada/The Queen v. Canada Trustco Mortgage Company* case, the taxpayer(i.e. the Canada Trustco Mortgage Company or CTMC) bought a number of trailers and then leased back to the initial vendor via a series of transactions. This arrangement allowed CTMC to reduce its taxable amount substantially by enabling the company in

claiming considerable amount of capital cost allowance(CCA) deductions on depreciation of machines/assets. The Minister of National Revenue (Canada) disallowed the CCA claim of CTMC on the ground that the purpose of the series of transactions is to obtain only the 'tax benefit', without any substantive business purposes. However, the Tax Court of Canada found that the transaction fell within the spirit and purpose of the CCA provisions of the Income Tax Act, and concluded that the general anti‑avoidance rule ("GAAR") did not apply in this case[i.e. though there is a 'tax benefit' it is not a preordained/abusive transactions].*

*For a critical analysis of the Canada Supreme Court judgment of this case, see Arnold J. Brian "Confusion Worse Confounded—The Supreme Court's GAAR Decisions"(2006), Canadian Tax Journal, Volume 54.

UNITED KINGDOM

The UK approach to tax avoidance practices is 'judges to decide' to interpret tax laws, according to the *nature* of different tax avoidance cases. Instead of a wide-ranging GAAR provisions, the approach is to rely upon Targeted Anti-Avoidance Rule(TAAR) or Specific Anti-Avoidance Rule(SAAR) to combat unacceptable tax planning.

Cases: (a) *Barclays Mercantile Bussiness Finance Limited v Mawson[2004] UKHL 51*: Barclays Mercantile Bussiness Finance Limited(BMBF), a member of the Barclays Bank Group, purchased a pipeline from Bord Gais Eireann (BGE) at the cost of 91 million GBP with a borrowed amount from the Barclays Bank for supply, transmission and distribution of natural gas in the Republic of Ireland. After the purchase, BMBF leased it back to the BGE. Taking advantage of the leasing transactions, BMBF reduced her costs by claiming capital cost allowances (writing- down allowances on the pipeline). The sale proceeds of BGE was deposited with another company Deepstream, acting as a guarantor of the rental obligations of BGE. With this arrangement, the initial purchase amount of GBP 91 million remained with BMBF(not held by the BGE, acted as a lessee) and moreover, BMBF was entitled to the capital allowances under section 24(1) of the Capital Allowances Act 1990.The Inland Revenue(UK) denied the claim of capital cost allowances by BMBF, arguing that the transaction between BMBF and BGE does not serve any commercial purpose. The allegation against this transaction by the Inland Revenue was based on the 'Ramsay principle' (after the House of Lords decision in WT Ramsay Ltd v IRC 1981), where the company WT Ramsay Ltd made substantial capital gains via a series of pre-ordained transactions. The Inland Revenue argued that the entire transaction by the BMBF is made in a manner to obtain *exclusively* a 'tax benefit' via higher capital cost allowances. However, the House of Lords disregarded the claim of the Inland Revenue in favour of the BMBF, stating that the BMBF satisfied all the requirements of Section 24(1) of the Act and accordingly BMBF is entitled to capital allowances. According to the House of Lords, the transactions did not affect the necessary elements of a tax statute, i.e. the claim by BMBF for the capital cost allowances is perfectly consistent with the relevant tax Act provided in the Section 24(1) of the Act, irrespective of the nature of the transactions. The House of Lords emphasized that the Ramsay rule should not be treated as a 'blind norm' in such cases in the sense that whenever in the application of any taxing statute, transactions or elements of transactions which had no commercial purpose were to be disregarded. To quote:

"The Ramsay Case did not introduce a new doctrine operating within the special field of revenue statutes. On the contrary….it rescued tax law from being 'some island of literal interpretation' and brought it within generally applicable principles... Cases such as [IRC v Burmah Oil, Furniss v Dawson and Carreras Group Ltd v Stamp Commissioner] gave rise to a view that, in the application of any taxing statute, transactions or elements of transactions which had no commercial purpose were to be disregarded. But that is going too far." [Judgments - Barclays Mercantile Business Finance Limited (Respondents) v. Mawson (Her Majesty's Inspector of Taxes (Appellant), *Publications & Records*, available at <http://www.parliament.uk> and International Law Office, Newletters]

(b) *HMRC v. Tower MCashback LLP1 and Another[2011] UKSC 19*:The case was regarding tax implications of a financing scheme by MCashback Limited("MCashback") to roll-out *M Rewards;* a software package developed by MCashback. The funds were sought to be raised by selling rights to the software via software licence agreements (SLAs) to four Limited Liability Partnerships(LLPs). A representative of the four LLPs, LLP 2 entered a software licence agreement or SLA according to which it was to pay GBP 27.5 million for a licence (part of the M Rewards; i.e.the software) and it was entitled to 2.5 percent of the fees received from exploitation of the software. LLP 2 obtained the funds from investors(who became investor members of LLP 2).Such investor members of LLP 2 contributed 25 percent from their own funds and the remaining 75 percent was borrowed from banks. LLP then claimed GBP 27.5 million first year capital allowances for the 2004/05 tax year, on account of SLA. The HM Revenue & Customs(HMRC) rejected the claim of capital allowances on account of the borrowed amount (i.e. 75 percent), as this was not the real expenditure(i.e. the money which the investors members borrowed was not used in any meaningful sense as expenditure in the acquisition of software rights).The court upheld the HMRC view.

UNITED STATES OF AMERICA

The tax statute of US is relatively richer compared to other countries in the sense that it comprises of a number of legal provisions. The tax statute, however, is a SAAR or TAAR type instead of GAAR. Apart from this, most of the US DTAA treaties with other countries have LOB clauses, reflecting clear guidelines regarding the provision of treaty benefits. Following are the judicial anti-avoidance provisions which can be used by the Internal Revenue Service(IRS) to challenge transactions seeking to avail only tax benefits:
(a)*Substance over form*: The substance of the transaction, rather than its form, determines the tax consequences. The "form" of a transaction is only the *tag* the interested parties assign to their arrangement/transactions. For instance, despite the fact that documents support the apparent transaction(s), judiciary might inquire into the underlying substance by going beyond the mere formal steps through which a transaction was undertaken.
(b)*Sham transactions doctrine*: A tax benefit can be denied by the IRS in case the transaction is a sham, i.e. either the transaction actually did not take place, or it fails the substance over form test, i.e. it lacks actual substance. An example of the former is that a claim where a taxpayer implying to purchase treasury notes as well as undertaken a financing activity via treasury notes(say, entering into a loan agreement via a collateral backed by such treasury notes) to avail tax benefits, but neither the purchase nor the loan actually took place, the sham transactions test would be applicable to deny the tax benefit. An example of the latter case is a transaction violating arm's length principle or circular trading in its bizarre interpretation.
(c) *Business Purpose doctrine:* A transaction lacking any genuine business/corporate purpose, but serves merely for dodging taxes would not be recognized as a valid transaction.
(d) *Economic Substance doctrine:* A transaction must have a genuine economic purpose for claiming a tax benefit. If a transaction is found without any substantive economic purpose, the related tax benefit arising from such transaction would be denied.

Cases: (a) *Gregory v. Helveing, 293 U.S. 465(1935):* The benchmark case of *Gregory v. Helvering* [Gregory v. Helvering, 293 U.S. 465(1935)] marked the watershed in US tax avoidance cases, which was the basis of the economic substance doctrine. In this case, Mrs. Evelyn Gregory(the taxpayer) wished to transfer stock from a company(United Mortgage Company or 'United'), wholly owned by herself. In case, she was directly transferring the stock, the transaction would have substantial tax implications. However, she created a new company (Averill Corporation or 'Averill') and transferred the stock in the newly formed company. Immediately after the transfer, she liquidated the newly formed company. i.e. the Averill, and claimed its assets. The claim of Gregory was that this transaction should not have any tax implications, as this is done as a plan of corporate reorganization. However, the Commissioner of Internal Revenue (Mr. Guy Helvering) argued that in terms of economic substance there really was no "business reorganization" — that Gregory, who controlled all three corporations, followed a legal form to make it appear to be a reorganization, so that she could dispose of the stock/shares without having to pay a substantial income tax. According to the Commissioner, Gregory had understated her 1928 income tax by USD 10,000. The Supreme Court agreed with the Commissioner's view that Gregory did follow the "letter of the law"; and she did not follow the intent or spirit of the law. The manner, in which the 'business reorganization' is done did not have any economic substance and aimed at to avail the tax benefit only.

(b) *Del Commercial Properties Inc. v. Commissioner, 251 F.3d 210(DC Cir. 2001)*: On July 18, 1990, Delcom Financial Ltd; a Canadian company took a USD 18 million loan from the Royal Bank of Canada. The Delcom, then started to transfer the entire loan amount between its various subsidiaries through a series of transactions (involving five subsidiaries).The series of transactions was as follows:
(i)Delcom Financial Ltd(DFL) made a loan of USD 14 million out of the entire loan to its wholly owned Canadian subsidiary.
(ii)The same amount (USD 14 million) was transferred by the Canadian subsidiary of DFL to another subsidiary of Canadian based at Cayman Islands.
(iii) The same amount was transferred by the Cayman subsidiary to the Antilles subsidiary.
(iv)The same amount was transferred by the Antilles to its Netherlands subsidiary (BV).
(v) Finally, the Netherlands (BV) transferred the loan to Del Commercial (America based company of Del).

The Del Commercial continued interest payments to the Netherlands BV on the loan amount(which in turn appropriated by the DFL through its wholly owned subsidiary Netherlands BV).However, the Commissioner of the Internal Revenue Service(IRS) informed Del Commercial that it failed to deduct withholding taxes on its interest payments to the Netherlands BV during 1990-1993.The Del Commercial petitioned the IRS, by claiming that the

interest payments were not subject to withholding tax under the USA-Netherlands tax treaty. The IRS argued that the loan was actually from DFL(a Canadian Corporation) to Del Commercial(USA based subsidiary) and hence, the interest payments is subject to withholding tax under the USA-Canada tax treaty. The IRS claimed that the series of transactions was subject to the 'step transaction doctrine' where such series of transactions were not necessary from the point of view of the economic substance, and motivated from the 'tax benefit' aspect only. The Court (US) upheld the Commissioner(IRS) for paying the withholding taxes on the interest payments made by the Del Commercial.

CHINA

China Corporate Income Tax (CIT) law introduced GAAR in 2008 and a series of circulars in early 2009 to address tax avoidance, provide guidance on implementation of provisions of double tax treaties and plug loopholes for cross-border transactions involving non- residents. The GAAR provision states that tax authorities can adjust arrangements undertaken 'without reasonable business purposes' that result in tax benefits. The implementation rules clarify that 'without reasonable business purposes' means any arrangement whose primary purpose is reducing, avoiding or deferring of tax payment (Gu et al, 2011). The State Administration of Taxation (SAT), under the circular Guo Shui Fa (2209) No. 2 (Circular 2), further clarified that GAAR will be directed to transactions intended to abuse tax incentives under the CIT Law, double tax treaties or corporate organisation structures, or to avoid tax by using tax havens (ibid). Interestingly, the burden of proof is on the taxpayers to prove that GAAR should not apply to the arrangement[xxiv]. The initial proposal in India also had a similar feature, but was changed under pressure from investors and the burden of proof is now on the revenue authority[xxiv].

Circular 601 issued in October 2009, the Beneficial Ownership circular, clarifies that agent or conduit companies do not qualify as beneficial owners for DTA purposes (Chan, 2011). This Circular is supported by Circular 12 which laid out detailed requirements for applications to be made to Chinese tax authorities to obtain clearance for the treaty benefits (Gu et al, 2011). Circular 698, also introduced in 2009, emphasised the 'substance over form' principle which ensures that GAAR will be invoked if an intermediate holding company is found to have no commercial purpose except the avoidance of tax and gives guidance related to non-residents' equity sales (Chan, 2011). Chan notes that China, in terms of some elements of taxation, is "rapidly making the transition from a developing to a more mature approach" (Chan 2011; 9).

Table 1: Details of the major circulars issued in China in 2009-2010

Circular No.	Key focal point and description	Issue date
Guoshuifa [2010] No. 75	**Comprehensive document with regards to general application of treaty articles:** The comprehensive and detailed implementation guidance for DTA articles applied the provisions of the China-Singapore DTA to DTAs in general. Circular 75 covered all important concepts, including the definition of "person" and "resident," the determination of permanent establishment (PE), as well as guidance on the application of the dividends, interest, royalties, and capital gains articles	Jul 2010
Guoshuihan [2009] No. 698	**Capital gains:** Provided guidance related to non-residents' equity sales, aiming to strengthen tax collection and administration on capital gains derived by non-residents. Circular 698 emphasized the doctrine of "substance over form" and stressed the SAT's power to disregard structures if they were established for tax avoidance purposes and possessed a lack of business substance. Circular 698 imposed a PRC documentation filing requirement on non-resident sellers who have sold PRC equities indirectly when such gains are not subject to an effective tax of 12.5% or above.	Dec 2009
Guoshuihan [2009] No. 601	**Beneficial owner:** Clarified the principles of determination of beneficial ownership for intended tax treaty benefits by the tax authorities.	Oct 2009

Guoshuihan [2009] No. 507	**Royalties:** Specified the scope of royalties, provided the SAT's current views on differentiation between service fee receipts and royalties and listed certain non-royalty payments. It also specified DTA royalty clauses applying to resident beneficiaries only.	Sep 2009
Guoshuifa [2009] No. 124	**Documentation requirements on treaty benefit claims:** Circular 124 clarified the procedures and documentation requirements for non-residents seeking to enjoy tax benefits provided by treaties on their PRC-sourced income ("Treaty Benefits").	Aug 2009
Guoshuihan [2009] No. 395	**Residency:** Requirement to provide samples of official tax resident certificates of 42 contract jurisdictions in order to facilitate the implementation of tax treaties and identification of tax resident status by local tax authorities	Jul 2009
Guoshuihan [2009] No. 81	**Dividends:** Provided criteria for compliance requirements, as well as necessary supporting documents, for claiming tax treaty benefits on dividends.	Feb 2009

Source: Chan (2011)

Impact on FDI

As per UNCTAD World Investment Report 2012[xxiv], FDI flows to China reached a "record level" of $124 billion in 2011. The report also notes that transnational corporations rated China as the top investment destination for 2012-14, above USA.

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