GAAR empowers the Government to deny tax benefits to foreign investors on their investments in India.

Companies which attempt to avoid tax by carrying out structured transactions will face new challenges in future with the government empowering the Income Tax Authorities to deny tax benefits to companies if they are convinced that such transactions were aimed at dodging tax in India.

GAAR: Adverse Impacts on Foreign Equity Investors

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Anti Avoidance rules can be broadly classified into following 3 stages:

1. Measures based on general principles in the law:
   - Refers to principles which are not codified in legislation (non-statutory).
   - Includes a range of philosophies and approaches including "substance over form", "abuse of law", etc.
2. General Anti Avoidance Rules:
   - Has same meaning as "anti avoidance rules based on general principles in law" except that it is codified and included in the legislation.
3. Specific Anti Avoidance Rules:
   - Definite anti avoidance rules which apply to specific situations. E.g. Exit Tax, etc.

'General Anti-Avoidance Rules' also known as GAAR was unveiled by the Finance Minister during the Union Budget 2012-13 and is now deferred to be applicable from April 1, 2013. By introducing GAAR, India has moved from first stage to second stage. GAAR primarily deal with avoidance as well as evasion of tax liability.

- Avoidance – An attempt to reduce tax liability through legal means, i.e. to carry out business affairs in such a way that minimum tax would be imposed by the Act as opposed to the maximum. Example:– Mr X forms a company to sell his products. The company pays 15% tax by taking benefit of tax-holidays, but if Mr X himself sells the products, he would pay 30% tax.

- Evasion – Use of illegal means to reduce tax liabilities, i.e. falsification of books, under-statement of income, over-statement of deductions, etc. Example:– Mr Y sells his products for cash. However, Mr Y neither accounts for it nor deposits the proceeds in bank account.

Expected Provisions of GAAR

By introduction of GAAR, Income Tax Authorities would be empowered to declare an arrangement as an Impermissible Avoidance Arrangement 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.

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"Lacking commercial substance" can 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 canceling each other
  - A transaction which is conducted through one or more persons and disguises the nature, location, source, ownership or control of funds

The presumption applies even if the main / overall purpose of the arrangement is not to obtain a tax benefit and only if a part of the arrangement is to obtain a benefit. The onus of proving that the purpose of a transaction is not to avoid taxes is likely to be on the assessee. The GAAR can be invoked as an alternative to or in addition to any other basis of making an assessment.

New Hurdles for Foreign Equity Investors

The proposals in the Finance Bill 2012 related to taxation of indirect transfers of assets and GAAR have created serious concerns among the foreign investors. GAAR empowers the Government to deny tax benefits to foreign investors on their investments in India. For instance, if local investors form entities in Mauritius with the sole intention of claiming exemption from capital gains tax, Indian Tax Authorities have the right to deny their claim for exemption provided under the India-Mauritius Treaty. Similar treatment will also be applicable for entities in Cayman Islands, Panama, etc.

Recently, the Asia Securities Industry & Financial Markets Association (ASIFMA) along with Securities Industry and Financial Markets Association (SIFMA) had written to the Finance Ministry contending that "such onerous taxation or even the risk of such taxation could threaten this important source of capital for India's businesses". Noting that FIIs are carefully evaluating these new tax risks, the communication also said that the proposals are too broadly worded. Further, there is also ambiguity in respect of tax structure for investments made under Participatory Notes (P-Notes) mechanism by the Foreign Institutional Investors (FIIs).

Finance Ministry recently announced that persons investing in stock markets through P-Notes will not have to pay taxes in India. It also clarified that Indian Tax Authority would not go beyond FIIs to check details about the P-Note holders. Accordingly, a question of liability for tax in India of the P-Note holder would not arise.

FIIs have assets under custody of more than Rs 10 lakh crore or 17 per cent of the capitalisation of India's equity markets. Further, many of these entities also regularly invest in Indian Government and corporate debt instruments. Moreover, several private equity and venture capital funds have significant exposure to India.

The Government needs to be very cautious while introducing and implementing measures like GAAR in order to protect interests of foreign investors or else it can have catastrophic impact on the future foreign equity investments in the economy. Needless to mention, other emerging countries will not miss such a golden opportunity to present themselves as an alternative to India for preferred investment destination by foreign investors.

In fact,

The Dutch East India Company undertook the world's first IPO in the year 1602 and therefore, became the first public company to issue stock. The Dutch East India Company was formed in 1602 by a royal charter granting a 20-year monopoly on trade with the East Indies and sovereign rights in any newly discovered territories. The Company existed for almost 200 years.

Source: http://www.investopedia.com/ask/answers/08/first-company-issue-stock-dutch-east-india.asp#ixzz1uYfmKGsz