Tax Policy and Economic Growth within the BRICS: A Case-Study of Tax Structuring in the face of India’s General Anti-Avoidance Rules

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The rates of economic growth across the BRICS countries have slowed significantly over the course of the last few years and the Indian growth story has been no exception. There are multiple reasons for India’s slowing down but one of the significant factors has been controversy surrounding Indian tax policy. This article examines the story surrounding India’s proposed general anti-avoidance rules and how this episode has damaged investor confidence in the Indian system.

I. INTRODUCTION

Similar to the other BRICS countries, beginning in 1991, India too, began the process of liberalising its markets and opening its doors to the global economy. Economic liberalisation has led to a period of impressive growth and, although not entirely immune to the effects of the global financial crisis, India had been able to successfully weather the recent global economic storm.1

In last few years, however, the Indian growth story has started to come into question. From an average GDP growth of 8.3% from 2004 to 2011 the Indian GDP growth has slipped to 6.4% in 2011-12 and an estimated 5.4% for 2012-13.2 These figures are far below the 8% growth envisioned for in India’s twelfth five year plan.3

The recent drop in GDP growth has raised some questions regarding the validity of the Indian growth story. FDI has dropped and domestic Indian firms have also been reducing their domestic exposure by increasingly seeking investment opportunities elsewhere. There are

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undoubtedly multiple factors that have contributed to this drop, including a perception of widespread corruption and political indecisiveness regarding the FDI policy. But the controversy surrounding India’s tax policy has played an important role in souring India’s image within the foreign investment community.4

At the heart of this tax controversy has been a debate surrounding the use of foreign tax havens in the structuring of in-bound foreign investment. The single largest foreign direct investor in India over the course of the last ten years has been the island nation of Mauritius.5 This small nation, with a 2009 GDP of $16.9 Billion (USD),6 was responsible for $49.6 billion (USD) worth of Indian Foreign Direct Investment (FDI) equity inflows from April 2009 to March 2010.7 Over the last ten years, investments from Mauritius have constituted 42% of India’s total FDI inflows.8 Singapore occupies the second position, with 9.55% of total FDI, and the United States and the United Kingdom are third and fourth with 7.4% and 5.15% respectively.9

Given these figures, it is hard to avoid the conclusion that Mauritius is primarily acting as a conduit for investment from other parts of the world. India’s Double Taxation Avoidance Convention (DTAC) with Mauritius has created significant tax advantages to structuring an investment through Mauritius.10 The Indian authorities have not been entirely comfortable with the tax benefits provided by the Mauritian DTAC but in Union of India v. Azadi Bachao Andolan,11 the Indian Supreme Court found that a Mauritian tax certificate was sufficient evidence of residency for a company to receive the benefits of the DTAC.

Azadi Bachao, however, has not been the final word in this controversy. In 2010, the Mumbai High Court ignited a firestorm when it attempted to impose tax liability on Vodafone for the acquisition of Hutch India through a complicated arrangement involving a variety of international tax shelters.12 This decision was later overruled by the Supreme Court.

7 Supra note 6.
8 Id.
9 Id. (Canada is 24th, constituting 24% of India’s FDI inflows).
which, in turn, the legislature attempted to over-rule through the 2012-13, Union Budget.

All of this has occurred against the backdrop of parliamentary wrangling over the fate of the Direct Tax Code Bill (DTC) which since 2009 has contained provisions that could have given the Indian tax authorities the statutory power to set aside tax haven arrangement of the type used by Vodafone when acquiring Hutch. In the face of pressure from the investment community, however, the government has backed off from its hard-line position and a high level committee, the Home Committee, was formed to re-evaluate the government’s policy.

Keeping this brief overview in mind, this paper examines the evolution of the government’s position regarding tax structuring of in-bound foreign investment and what it means going forward. The first section is a descriptive analysis of the legal framework governing the regulation and taxation of foreign investment in India prior to the High Court’s ruling in the 2011 Vodafone case. Building on this conversation, the paper then looks at how the relevant provisions of the proposed DTC would have differed from the pre-2011 position in relation to tax structures taking advantage of double taxation treaties. Included in this discussion is a brief examination of these provisions within a comparative legal context. After providing this background, the paper then examines Vodafone and the government’s reaction to it in the form of the 2012-13 Union Budget. These developments, which will be highly crucial for the future of tax regime in India, can be equally insightful for the other BRICS partners, as they share a similar nature of economic growth trajectory and governance institutions. Before, delving into the case-study of tax regime in India, we shall discuss the synergies amongst BRICS countries with respect to tax policies.

II. BRICS AND TAXATION REGIME - FACING SIMILAR CHALLENGES AND EVOLVING CONCERTED PRACTICES

Over the recent times, BRICS have co-operated to evolve best practices and build capacity in various areas of taxation, especially in the domain of international taxation. During January, 2013, BRICS reiterated their concerted efforts in the field of anti-avoidance and exchange of information. The treaty partners evolved a mechanism for an elaborate procedure for sharing specific information thereby facilitating joint audits, if related persons are engaged in cross-border

activities. The BRICS forum traces its co-operation to pre-existing platforms such as India, Brazil, South-Africa (IBSA) revenue administration working group, UN-World Customs Organization, OECD (Organization for Economic Co-operation and Development), Task Force on Tax and Development etc. Further, BRICS countries have synergies and common practices existing in their tax regimes, e.g. Both China and India’s expectations on similar returns on contract R&D services etc. Therefore, the co-operation aims at more efficient tax systems which would connote improved revenue and society, thereby maintaining BRICS as attractive investment locations in the world.

While this paper discusses the implementation of General Anti-Avoidance Rule (GAAR) policy in India, the on-going and future efforts of BRICS become highly relevant. Amongst the BRICS, China and South-Africa have already implemented GAAR in their legal tax regime. Therefore the concerted efforts at the BRICS platform will help all BRICS countries learn the nuances of international taxation on sophisticated issues such as tax avoidance, Double Taxation Avoidance Agreements (DTAAs) and policy tools including GAAR. Since most of the authoritative texts on these issues have emanated predominantly from the West, BRICS provide a great learning platform from wherein, new rules for taxation, specific to the BRICS countries may evolve.

Keeping this crucial issue in mind, this paper traces the saga of GAAR provision in India and provides reference to China and South Africa, wherever necessary. The overall trend in India could be a great learning and a word of caution for its BRICS partners.

III. CURRENT REGULATORY FRAMEWORK GOVERNING FOREIGN INVESTMENT AND ITS TAXATION IN INDIA

A. Bringing the Money In

Although the liberalising reforms of the 1990s helped to open the Indian economy to foreign investment, there are still significant controls on inbound investment. Indian currency is still not fully convertible and there remain significant sectoral restrictions and equity caps on foreign investment.

The central pieces of legislation governing investment in the Indian economy are the Foreign Exchange Management Act, 1999 (FEMA) and the Securities and Exchange Board of India Act, 1992. These Acts are administered and interpreted by a variety of organisations ranging from the Ministry of Commerce and Industry and the Ministry of
Finance to the Securities and Exchange Board of India (SEBI). It should also be mentioned that the Companies Act, 1956 and the Industries (Development and Regulation) Act, 1951 both play a more general role in the regulation of foreign investment. Furthermore, there still exist vestigial remnants of the so called license raj which governed the Indian economy prior to the economic liberalization in 1991. As such, sector specific legislation will have an important impact of any given project.

On a practical level, one of the most critical pieces of regulation for foreign investors is the Consolidated FDI Policy, which is issued on a biannual basis by the Department of Industrial Policy and Promotion within the Ministry of Commerce and Industry. This document draws its authority from FEMA and it describes everything from which sectors a foreign entity can invest in, to how those investments can be made.

Once an investment is made, it is subject to taxation according to the Income Tax Act, 1961 (IT Act) which is administered by the Indian Revenue Service. The specific tax rates are set by the Parliament every year in the annual Finance Bill, which is also known as the annual Union Budget. As will be discussed later, the Union Budget can have a tremendous impact on the legal and regulatory climate governing the taxation of foreign investments in India.

Generally speaking, foreign investment in India falls into three categories: Foreign Direct Investment (FDI), Foreign Institutional Investment (FII), and Foreign Venture Capital Investment (FVCI). FDI generally involves the active establishment of operations in India while FII and FVCI generally involve a more passive financial investment. There is an overlap between these different types of investment but for something that could fall into multiple categories, it is often up to the investor to decide how the investment should be treated.

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16 §§ 1.1-3, 2.1-12, Consolidated FDI Policy, Department of Industrial Policy and Promotion (October 2010), available at: dipp.nic.in/English/Publications/Manuals/FDI_Circular_02022010.pdf.

17 William Sharp, supra note 16.
B. Double Taxation Treaties: Structuring FDI into India through an Intermediary Jurisdiction

Over the last ten years, around 52% percent of India’s FDI inflows came in through Mauritius and Singapore.\(^\text{18}\) As has been mentioned, Mauritius alone accounted for 42% of these inflows.\(^\text{19}\) It seems highly likely that a significant portion of this money has been routed through Mauritius, in order to take advantage of the favourable Double Taxation Avoidance Conventions (DTACs) which these countries have with India.

1. Mauritius

Under the India-Mauritius DTAC, if a company can show that it is a tax resident of Mauritius and it does not have a permanent establishment in India, the company will not have to pay capital gains tax when selling shares in an Indian company.\(^\text{20}\) Furthermore, when the Mauritian entity owns more than 5% of an Indian entity, the Mauritian government will not impose a dividend tax.\(^\text{21}\) As mentioned above in the context of FVCIs, using a Mauritius based investment vehicle can also help insulate a foreign investor from the danger of unfavourable changes in the Indian tax code.

In order to receive a Mauritian tax residency certificate, two of the company’s Directors must be residents of Mauritius; the company must maintain a Mauritian bank account; and it must have a Mauritian auditor.\(^\text{22}\) According to the law laid down by Indian Supreme Court in \textit{Union of India v. Azadi Bachao Andolan}\(^\text{23}\), a tax residency certificate is sufficient to establish residency and beneficial ownership in Mauritius for the purposes of the DTAC.\(^\text{24}\)

It is interesting to note that the India-Mauritius DTAC does not contain what is termed as a Limitation of Benefits clause. This type of clause essentially allows for the removal of the treaty benefits if a party is shown to have established residency ‘primarily’ for the purpose of taking advantage of the benefits of the treaty.

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\(^\text{18}\) \textit{India FDI Fact Sheet}, supra note 6 (Cyprus and Sweden are also popular routes through which to structure investments into India).

\(^\text{19}\) \textit{Id.}

\(^\text{20}\) Anjali Agarwal, supra note 11.

\(^\text{21}\) \textit{Id.} It should be noted that, the Indian tax authorities usually levy a dividend distribution tax on the company declaring the dividend as such dividends are not taxed in the hands of the recipient.

\(^\text{22}\) \textit{Id.}


\(^\text{24}\) See Anjali Agarwal, supra note 11.
2. Singapore

Another popular place through which investment is structured into India is Singapore. Under the India-Singapore Double Taxation Avoidance Agreement (DTAA), a Singaporean company is not liable for Indian capital gains tax arising from the sale of shares in an Indian company. The Singaporean tax authority generally only levies capital gains tax on trading activities.

Unlike the India-Mauritius DTAC, the India-Singapore DTAA does contain a Limitation of Benefits clause. The clause can be found in a protocol which was signed between India and Singapore amending the original DTAA on 25th January, 1994. The relevant clause for our purposes is Article 3 of the protocol, which states that a resident of a contracting state is not entitled for benefits if the primary reason is to take advantage of the tax benefits associated with the DTAA. Further, a shell/conduit company is not entitled to benefits. A company will be deemed to be a shell company if its total annual expenditure on operations in that contracting state is less than $200,000 (SD).

IV. The Direct Tax Code Bill, 2010

As discussed, corporate taxation in India is currently governed by the Income Tax Act, 1961 (IT Act) and circulars issued from time to time by the Central Board of Direct Taxes. The Direct Tax Code Bill, 2010 (DTC) represents a significant shift in tax policy. It was submitted to Parliament on August 30, 2010 where it will be referred to the Standing/Select Committee. It was originally slated to come into effect from April 1, 2012.

The DTC makes a number of significant modifications that would, arguably, simplify the tax treatment of foreign investors. In particular, the DTC significantly changes the tax treatment for foreign companies operating in India through the introduction of a branch profits tax and modification to the capital gains tax structure so as to treat foreign investors on par with domestic companies. Controversially, the DTC, in contrast to the IT Act before 2012, contained both a treaty override provision as well as General Anti Avoidance Rules (GAAR). These were new concepts in Indian law and could potentially have made very difficult for foreign investors to continue to make use of the Mauritius DTAA.

25 Id.
26 Id.
28 Id.
By their very nature, GAAR provisions inject a certain amount of uncertainty into any tax regime. GAARs are designed to help ensure that in the absence of specific or judicial anti-avoidance rules the spirit of the law is followed. In other words, a transaction may technically be in compliance with the letter of the law but still is violating its underlying purpose and intent. Under these circumstances a GAAR gives the authorities the power to bring the party into compliance.29

A. Treaty Override Law

Generally, in India a treaty requires the endorsement of an Act of Parliament. Given the need for numerous Double Taxation Treaties, Section 90 of the IT Act, 1961 was enacted as a fast-track provision for the establishment of DTAC’s.30 In Azadi Bachao, the Supreme Court held that pursuant to Section 90, in the case of a conflict between a provision of the Mauritius DTAC and a provision of the IT Act, the DTAC would control unless the conflicting provision of the IT Act were more beneficial to the taxpayer.31

The DTC contains a similar provision, however, §291(9) of the DTC describes three exceptions: GAAR violations under §123, the levy of Branch Profit Tax in §111, and the Control Foreign Company Rules contained in the Twentieth Schedule. In other words, a beneficial DTAC will control unless one of these three provisions is triggered.

B. General Anti Avoidance Rules (GAAR)

Until recently, the IT Act contained no general anti-avoidance rules and the Indian courts have traditionally, at least in dicta, upheld the idea that an individual has a right to structure a transaction so as to minimise tax liability.32 The DTC, however specifically grants the income tax authorities the power to disregard “impermissible avoidance arrangements.”33

This provision has been designed to promote the collection of revenue “in an efficient, equitable and efficient manner.”34 The Ministry of Finance in the original Discussion Paper on the DTC describes the purpose of the GAAR provision as follows:

30 Supra note 24.
31 Id.
32 Vodafone, supra note 13.
Tax avoidance, like tax evasion, seriously undermines the achievements of the public finance objective of collecting revenues in an efficient, equitable and effective manner. Sectors that provide a greater opportunity for tax avoidance tend to cause distortions in the allocation of resources. Since the better-off sections are more endowed to resort to such practices, tax avoidance also leads to cross-subsidization of the rich. Therefore, there is a strong general presumption in the literature on tax policy that all tax avoidance, like tax evasion, is economically undesirable and inequitable. On considerations of economic efficiency and fiscal justice, a taxpayer should not be allowed to use legal constructions or transactions to violate horizontal equity.

The burden in the case of an alleged violation under §125 of the DTC would be on the defendant to show that the main purpose of the arrangement was not to obtain tax benefits. This section reads as follows:

(1) An arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit unless the person obtaining the tax benefit proves that obtaining the tax benefit was not the main purpose of the arrangement.

(2) An arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit.

The Revised Discussion Paper on the DTC\textsuperscript{35} attempts to clarify that the GAAR provisions will only be invoked when a transaction confers a tax benefit and is “not at arms length,... represents a misuse or abuse of the provisions of the code,... lacks commercial substance,... or is carried on in a manner not normally employed for bona-fide business purposes.”\textsuperscript{36} Once the DTC becomes law it has been proposed that the Central Board of Taxes will be responsible for issuing guideline detailing the circumstances under which the GAAR provisions will be invoked.\textsuperscript{37} It has also been suggested that a Dispute Resolution Panel be formed to hear appeals on GAAR decision and threshold limits be introduced to act as safeguards.\textsuperscript{38}

\textsuperscript{35} See Id. §24.2.
\textsuperscript{36} Id. Ch. XI §3.1.
\textsuperscript{37} Id. Ch. XI §3.2.
\textsuperscript{38} Id.
C. India’s Proposed GAAR within an International Context

The idea of anti-avoidance rules is certainly not a new phenomenon; however, it is a relatively new concept in India. India has used specific anti-avoidance rules, such as the Limitation of Benefits clause contained in the India-Singapore Double Taxation Avoidance Agreement but that is only applicable to the context of that treaty. As mentioned, the India-Mauritius Double Taxation Avoidance Convention does not carry a similar provision.

There appears to be a global movement towards fighting the “abuse” of tax treaties; consequently, India’s decision to put GAAR provisions along with the treaty override rule into the new DTC is not particularly surprising. GAAR provisions are an important part of the tax law in a number of jurisdictions ranging from South Africa and China in the developing world to Canada and the United Kingdom in the developed world.

D. Treaty Shopping and GAAR — Canada

The Canadian Parliament, in 2005, amended the country’s General Anti-Avoidance Rule, contained in §245 of the Canadian Income Tax Act, so that tax treaties would explicitly come within the scope of the provision. The amended rule was to have retroactive effect going back to September 13, 1988. The relevant provisions of the IT Act read as follows:

39 See Zoe Prebble & John Prebble, The Morality of Tax Avoidance, 43 CREIGHTON L. REV. 603, 703 (2010). (The world’s oldest GAAR is thought to be that of New Zealand, which traces its history from § 62 of the Land Tax Act 1878, and which was modified and retained as Section 40 of New Zealand’s first income tax legislation, the Land and Income Assessment Act 1891.)
40 ARTICLES OF THE MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL, July 17, 2008, available at: www.oecd.orgctp/treaties/42219418.pdf/ (OECD’s Model Tax Convention (2008) does not define treaty “abuse” but it does state that a treaty should be set aside when “1) the main purpose of entering into the transaction was to secure a more favorable tax position; and, 2) obtaining that more favorable treatment in given facts would be contrary to the object and purpose of the relevant provisions of the tax treaty.”)
44 Id.
Section 245(2):

Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

Section 245(3):

(a) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or

(b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

Section 245(4):

[GAAR] applies to a transaction only if it may reasonably be considered that the transaction

(a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of this Income Tax Act or other tax statutes; or

(b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.45

The first attempt to use this rule in the context of alleged treaty shopping came in July of 2006 in the case of MIL (Investments) S.A. v. Queen.46 In addition to the MIL case, in 2006, the Supreme Court of Canada came out with two concurrent decisions, Canada Trustco v. Canada47 and Mathew v. Canada,48 which described the rules to be used when applying the GAAR provisions of the Income Tax Act. In Canada Trustco, the Court described a two part analysis which should be used when applying the Canadian GAAR provisions: first, the court should determine the "object, spirit and purpose" of the provisions creating the tax benefit; second, it needs to determine whether the transaction in question frustrates that purpose.49 This type of analytical process seems

49 Canada Trustco, supra note 47, at ¶66.
to be in line with the interpretive principles contained in the Vienna Convention on the Law of Treaties. 50

Without domestic statutory guidance, determining the spirit and purpose of the treaty may be somewhat complicated. It may be a little simplistic to say that, without statutory language to the contrary, the purpose and spirit of a treaty is violated when the primary motivation for the transaction was to receive more favorable tax treatment. 51 For example, an argument can be made that a country entering into a tax treaty with a known tax haven foresees that the treaty will be utilised by those seeking to avoid taxation. 52

The second part of this analysis requires a high degree of case specific analysis and a somewhat sophisticated understanding of the nature of the underlying transaction. This is particularly true when, without a specific anti-avoidance provision such as a Limitation of Benefits clause, the court must determine whether a particular transaction frustrates the purpose of a given treaty. 53 In MIL, the court found in favour of the taxpayer but, although the holding is not controversial, the Court’s reasoning when applying the second part of this analysis has been criticised. 54

V. VODAFONE AND THE 2012-13 UNION BUDGET

A. Vodafone – The Acquisition of an Indian Company through Shell Companies

Although the Direct Tax Code Bill has been circulating for some time, it was really the Bombay High Court’s decision in Vodafone that brought this issue into focus. In Vodafone, Vodafone acquired an ownership interest in a Cayman Islands company, which in turn controlled a company in Mauritius, which in turn controlled the telecom company Hutch India. Finding that the purpose of the transaction was to acquire a controlling interest in Hutch India, the High Court held that Vodafone was liable for the withholding tax associated with the transfer of an Indian capital asset. In Vodafone, the Bombay High Court held that a party indirectly acquiring a controlling interest in an India entity would be liable for withholding tax under Section 195 of the IT Act. 55

50. See Kimberly Brown, supra note 44, at 88.
51. Id. at 51.
52. supra note 46.
53. Id.
54. Id. at 41.
55. See Vodafone, supra note 13.
In addressing the structuring of the deal, the High Court said the following:

In assessing the true nature and character of a transaction, the label which parties may ascribe to the transaction is not determinative of its character. The nature of the transaction has to be ascertained from the covenants of the contract and from the surrounding circumstance.\textsuperscript{56}

This lower court decision is reflective of language contained in the DTC which, in Section V, 4(g), states:

Income from transfer, outside India, of any share or interest in a foreign company unless at any time in twelve months preceding the transfer, the fair market value of the assets in India, owned, directly or indirectly, by the company represent at least 50% of the fair market value of all assets owned by the company.

Furthermore, according to Section V, 6 of the DTC, capital gains on a transaction involving a company owning underlying assets, more than 50% of which are Indian assets, would be liable to pay a capital gains tax on a proportionate basis.\textsuperscript{57}

\textbf{B. Vodafone at the Supreme Court}

The Indian Supreme Court, however, did not agree with the findings of the High Court. A critical part of the Supreme Court’s ruling turned on the fact that the language of the IT Act was expressly different from the language in the DTC Bill. The IT Act, unlike the DTC Bill, did not contain any express GAAR provision, or treaty override rule. Without that express legislative language, the Supreme Court held that those powers can’t be read into the existing law.\textsuperscript{58}

From, the legal justifications for overruling the High Court aside, it is clear that the Supreme Court was very sensitive to the fact that the High Court’s decision in Vodafone was causing significant controversy within the foreign investment community. Acknowledging the importance of predictability of tax outcome when structuring an investment, the Court stated the following in the conclusion to Chief Justice Kapadia’s opinion:

FDI flows towards location with a strong governance infrastructure which includes enactment of laws and how well the legal system works.

Certainty is integral to rule of law. Certainty and stability form the basic foundation of any fiscal system. Tax policy certainty is crucial.

\textsuperscript{56} \textit{Id. at ¶140.}
\textsuperscript{58} Vodafone v. UOI, Supreme Court Civil Appeal No. 733 of 2012 (India) ¶ 71.
for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner.\textsuperscript{59}

It appears that the Court was of the opinion that the imposition of a judicial GAAR, absent explicit statutory guidance, would undermine the certainty and stability of the Indian tax system as it relates to foreign investors. However, the Indian Ministry of Finance, which had been pushing the prosecution of the Vodafone case, did not share this point of view.

VI. The 2012-13 Union Budget

Unhappy with the Supreme Court's ruling in the Vodafone case, the Indian government, and in particular the Finance Ministry lead by Pranab Mukherjee, proposed a Union Budget for 2012-13 that would have effectively over-ruled the Court's decision. Not only did the Union Budget propose accelerating the time-table for the implementation of GAAR, it also contained retroactive provisions that could have exposed a variety of companies to potentially enormous tax liability.\textsuperscript{60} This budget arguably called into question both the Supreme Court's authority and the long-term stability of Indian tax law and policy.

A. Moving Forward GAAR

Instead of waiting for the passage of the Direct Tax Code Bill, the Union Budget of 2012-13, through Section 40 of the Finance Act 2012, inserted GAAR provisions directly into the Income Tax Act. Furthermore, under the Budget proposed by Pranab Mukherjee, the new provisions were to come into force from April 1, 2013 (the beginning of fiscal year 2013-14).\textsuperscript{61} Interestingly, although this was viewed as acceleration by the investment community, it was in fact a delay relative to the original time table envisioned in the DTC Bill.

B. Overruling Vodafone

As mentioned, beyond the implementation of GAAR, the Budget also proposed other amendments to the IT Act that directly undermined the Supreme Court's ruling in Vodafone. In particular, Section 4 of the Finance Bill amended the explanations for Section 9 of the IT Act in

\textsuperscript{59} Id. at ¶91.


such a way as to directly undermine the Supreme Court’s interpretation in Vodafone. Furthermore, according to Section 4 of the Finance Bill, these clarifications were “deemed to have been inserted with effect from the 1st day of April, 1962.” Interestingly, although the government has argued that retroactive tax amendments are permissible under Indian law, the government chose to couch these amendments as clarifications of the existing language contained in the existing IT Act.

Directly addressing the power of the court, Section 113 of the Finance Bill, asserts the power of the government to impose tax liability “notwithstanding anything contained in any judgment, decree or order of any Court or Tribunal or any authority.” This provision has caused some commentators to suggest that it might “mean government could have the last word in any tax dispute in cross-border deals.”

C. Addressing the Mauritius DTAC

In addition to attacking Vodafone, the Finance Act also contained amendments to the IT Act that directly undermined the validity of the India Mauritius DTAC and the Court’s earlier ruling in Azadi Bachao. In particular, in Sections 31 and 32, it called for the amendment of Sections 90 and 90A of the IT Act so that they now read: “(2A) Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee, even if such provisions are not beneficial to him.”

This amendment appeared to create a situation in which, despite that language of the India Mauritius DTAC, the IRS would have the power to override a treaty.

VII. THE SHOME COMMITTEE REPORT — PUTTING ON THE BREAKS

As mentioned above, the 2012-13 budget controversy fell right in the middle, and arguably contributed to, a significant slowdown in the Indian economy. Proponents of the plan cited other jurisdictions, such as China, to support their argument that GAAR would not threaten economic growth but with economic growth slowing, this position became difficult to support. FDI inflows had reduced, economic growth slowed and many commentators were pointing at GAAR: that something needed to be done. The first step was to move Pranab Mukherjee out of

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the Ministry of Finance and replace him with Palaniappan Chidambaram, a Harvard-educated lawyer and technocrat.

Closely following this change in leadership, an expert committee was established to re-evaluate the government's position with regards to GAAR. The committee, headed by Dr. Parthasarathi Shome, engaged in a thorough analysis of the rules established in the 2012-13 Budget and put forward a series of suggestions designed to rationalise India's GAAR provision and, hopefully, assuage the concerns of the international investment community.

A central recommendation of the report was to delay the implementation of the GAAR Amendment to the IT Act for three years pending the establishment of more detailed regulations. Although the Committee noted that the concept of GAAR has been around since 2009 as a component of the DTC, its immediate implementation through the Finance Act of 2012 was a significant shock to the investment community. Noting that:

GAAR is an extremely advanced instrument of tax administration – one of deterrence, rather than for revenue generation – for which intensive training of tax officers, who would specialize in the finer aspects of international taxation is needed,” the Committee proposed that these provisions not be implemented until FY 2016-17.

In examining the retroactive nature of the amendments contained in the Finance Act, 2012, the Committee recommended that investments made prior to the implementation of GAAR should be grandfathered. This exemption, however, would apply only to specific investments and not to more general business arrangements.

As noted, beyond simply accelerating the implementation of GAAR, the Finance Act, 2012, sought to weaken the level of protection provided by the India Mauritius DTAC and undermine the Supreme Court’s ruling in Azadi Bachao. The Committee has recommended that GAAR not be used as vehicle to second guess a Mauritian tax residency certificate “as needed, the Mauritius treaty itself should be revisited if policy so dictates, rather than challenged indirectly through the use of the GAAR instrument”. The Committee’s more general recommendation regarding treaty override was “that where the treaty itself has anti-avoidance provisions, such provisions should not be substituted by GAAR provisions under the treaty override provisions.”

63 Shri Pranab Mukherjee was promoted to President of India.
65 Id. §3.14.
66 Id. §3.15.
67 Id. §3.16.
A. Implementation

To the great relief of the international investment community, the Indian government has moved forward with the adoption of most of the recommendations put forward by the Shome Committee. There is still debate surrounding how exactly GAAR will be implemented (for example the role specific anti-avoidance rules will play) but for the most part, the three-year delay has successfully allowed for a serious and thoughtful dialogue between the stakeholders. Furthermore, India's economic downturn and the appointment of Minister Chidambaram has helped foster a climate in which the Indian government is much more sensitive to the concerns of the international community.

B. Discussion

Both the Supreme Court and the Shome Committee acknowledge that predictability and stability of tax are a central element in any investment decision. The global trend appears to be moving towards the establishment of provisions that seek to ensure that tax payers comply with both the spirit as well as the letter of the law. Many countries are becoming increasingly uncomfortable with the widespread use of international tax structures designed simply to limit exposure to domestic taxation. India's experience with GAAR is an example of this trend.

Unfortunately, given its very nature, a GAAR provision can create tremendous uncertainty. Focusing on the amorphous spirit, rather than strict letter, of the law can create tremendous room for abuse. For a GAAR's implementation to go smoothly, the investment community must have significant confidence in the implementing authorities.

India's economic rise is not predestined and in spite of interest in the India growth story, the international investment community can be very fickle. In his recent book, *Breakout Nations*, Ruchir Sharma, the Head of Emerging Market Equities and Global Macro and Morgan Stanley Investment Management, suggests that "the probability of India's continuing on its journey as a breakout nation this decade [is close to]... 50 percent." The story of India's rise is not assured and it is very important that initiatives like GAAR be handled very sensitively.

C. Lessons from Canada

Although the analytical framework developed by Canada may well help inform Indian courts at some later date, it is unlikely that India's

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experience with GAAR and treaty shopping will be similar to the Canadian experience. The reason for this is not the text of the two Acts, which are substantially similar, but the realities of the Indian context. First, it appears that the underlying motivations behind the Indian GAAR are quite different from the Canadian motivations. Second, although India and Canada are both common law countries, their tax enforcement mechanisms do not function the same way.

1. Policy Motivations for GAAR

India's GAAR provision appears to be in large part designed to help expand the tax base by allowing the Indian authorities to "tax avoidance arrangements spanning across several tax jurisdictions." In other words, this policy is being driven by a desire to bring an end to the use of multinational tax structure by foreign investors. In a way, this could be seen as a legislative attempt to overrule the Indian Supreme Court's holding in *Azadi Bachao*. Similarly, China too has not defined the 'main purpose' of GAAR, stating merely that the provisions would be applicable, "where the main purpose is the reduction, exemption or deferral of tax payments."

As we have seen, the Canadian rule has been used against treaty shopping but it should also be noted that treaty shopping was not necessarily the motivating factor behind the development of the rule. The Canadian GAAR was enacted in response to the case of *Stubart Investments Ltd. v. The Queen*, which was essentially about the use of domestic structure for tax avoidance.

2. Application of GAAR

On its face, India's common law legal system should function in a manner similar to its former colonial sibling, Canada. Unfortunately, India's legal system is massively overburdened and judicial delays can stretch out for decades. Things are improving but getting timely judicial review of a regulatory decision can often be a significant challenge; as such, the balance of power often shifts in favour of the regulator. Furthermore, although there are some excellent Indian judges, the quality of Indian judicial decisions is not consistent. Rulings can often be outcome driven and, at times, it can be quite difficult to determine the precedential value of a given decision.

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69 *See supra* note 34, at §24.2.
71 *Supra* note 43.
The interplay between the judiciary and the legislature is critical for the proper functioning of the Canadian GAAR. The ambiguous nature of this rule makes timely and consistent judicial interpretation essential. Without a highly effective judiciary, there is a great danger that it could become extremely difficult for the purposes of tax planning to ascertain the difference between a permissible and an impermissible tax avoidance arrangement.

3. Corruption

India ranks 87th and Canada ranks 6th in the world for corruption according to Transparency International.\(^\text{72}\) It is widely acknowledged that corruption amongst government officials is endemic in India and between the 2G spectrum scandal, the Commonwealth Games scandal, and the hunger strike by the Activist Anna Hazare, it has become a prominent issue.\(^\text{73}\) This is a real concern for foreign investors,\(^\text{74}\) particularly when they have to be concerned with domestic legislation such as the U.S. Foreign Corrupt Practices Act.

As has been discussed, a GAAR is designed to act as a catch-all; it fills in where specific and judicial anti-avoidance rules fail. It is not supposed to act as a blanket ban on all tax avoidance arrangements but, at least at the lower levels, it could give the parties responsible for its enforcement tremendous powers. Absent timely and consistent judicial review, there is real danger that this provision would be ripe for abuse.

D. Lessons from China

Throughout the GAAR controversy, it was noted that China has enacted its own GAAR policy and has still been maintaining high rates of foreign investment. China's GAAR, however, differs significantly from India's provisions. For example, in India, the investments made by non-resident Indians in FIIIs have been spared from the GAAR purview whereas China makes it obligatory for Non-China Tax Residents to report share transfers in offshore special purpose vehicles in some specified jurisdictions which in turn hold equity in Chinese companies. Based on the information supplied by non-residents,

\(^{73}\) See Manoj Mitta, Rahul Says He Too Worries About Graft, TIMES OF INDIA, April 17, 2011.
\(^{74}\) See Simon Denyer, The Indian Wild Card: Although the allure of this emerging market is clear, the nation's unpredictable tax policies and uneven regulation have left potential foreign investors wary, WASHINGTON POST, April 2, 2011, available at: http://www.washingtonpost.com/todays_paper/Business/2011-04-03/G/t/14.0.1802988273_epaper.html.
China decides how the GAAR provisions would be applicable.\textsuperscript{75}

Similarly, with respect to the applicability of the GAAR policy, the onus is on the companies to prove that the arrangement entered into has reasonable commercial interest within 60 days of receiving a notice from the tax authorities.\textsuperscript{76} If the enterprise fails to provide the information within 60 days or can't prove reasonableness, then tax authorities may make tax adjustments based on the information already obtained, and issue a "Special Tax Investigation Adjustment Notice" to the company.\textsuperscript{77} Further, post the invocation of GAAR, the tax authorities in China, follow a very stringent approach and re-characterise the tax-avoidance arrangement apart from cancelling off the tax benefits obtained from the arrangement.\textsuperscript{78}

CONCLUSION: A WORD OF CAUTION FOR OTHER BRICS PARTNERS TOO!

India is by no means a zero tax jurisdiction and the vast majority of foreign investors do not expect it to be so. However, investors do expect to have a meaningful understanding of their potential future tax liability prior to making their investment decisions. The government's reactionary approach to the Supreme Court's ruling in Vodafone, and in particular its use of retroactive amendments, badly shook the international investment community's faith in the predictability of the India tax law.

The Sone Committee was essentially tasked with finding a face saving way for India to reassure the international community. As things stand today, the pre-2012 budget position has essentially been reinstated. GAAR will eventually come into place but, hopefully, its final form will be more acceptable to investors. However, despite the best efforts of the Committee, significant damage had already been done. The story of India rising has come under increasing scrutiny and India's reputation as an investment destination has been damaged. The GAAR controversy is not solely responsible for this, there have been other controversies running from FDI policy reform to corruption scandals that have caused significant damage, but it does represent an episode of significant self-inflicted damage.

\textsuperscript{76} Id.
\textsuperscript{77} Id.