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# 'GAAR' AND CORPORATE GOVERNANCE: WILL THE STICK DO THE TRICK?

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*With the objective of tax-minimization towards increasing shareholder return, tax-avoidance strategies are being frequently employed by corporations especially multinationals. In the wake of increasing evidence of corporate collapses linked with tax-avoidance maneuvers, both economic and legal experts have revisited the role of anti-avoidance rules as a measure to promote corporate tax-compliance. While few countries are satiated with the judicially enforced doctrines countering tax-avoidance, the recent trend is to legislate the anti-avoidance rules for empowering tax-administrations to challenge abusive and tax-motivated transactions. The case of India is no different which has introduced general anti-avoidance rules or 'GAAR' in the direct tax law permitting the tax-administration to counter 'impermissible avoidance arrangements'.*

*In the backdrop of these changes the paper makes a survey of economic and legal literature on the positioning of GAAR in tax legislations and its impact on the corporate governance standards. The idea is to present a holistic understanding of the numerous variables to explore the intertwined relationship between tax-avoidance and corporate governance and thus examine the impact of GAAR upon the prevailing corporate culture of adopting aggressive tax-positions. The success of GAAR in other jurisdictions which have fair bit of experience of their application has also been*

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*examined so as to draw lessons for corporate managers.*

*The paper examines the economic factors applicable to measure the relationship between GAAR and corporate governance but the appraisal of this relationship is undertaken predominantly in a legalistic backdrop where the idea is to draw lessons from a theoretical as well as pragmatic perspective on how GAAR abet changes in corporate decision-making styles vis-à-vis the tax considerations at play. Upon an assessment of the competing considerations and drawing lessons from Australia, Canada, New Zealand and United Kingdom in particular, the paper concludes that while GAAR will indeed act as a deterrent against opportunist tax-behaviour but may not serve as a statutory corporate governance rule as many would expect it to be.*

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## I. Introduction: Setting the 'Context'

> "Paying taxes is perhaps the most fundamental way in which private and corporate citizens engage with broader society. Tax revenues are the lifeblood of the social contract, vital to the development and maintenance of physical infrastructure and to the sustenance of the infrastructure of justice that underpins liberty and the market economy. It is therefore curious that tax minimization through elaborate and frequently aggressive tax-avoidance strategies is regarded as one of the prime duties that directors are required to perform on behalf of their shareholders. It is more curious still that the debate about Corporate Social Responsibility (CSR), which has touched on virtually every other area of corporate engagement with broader society has scarcely begun to question companies in the area where their corporate citizenship is most tangible and most important – the payment of tax."[1]

With taxes being costs of business, tax-minimization is as old as tax itself. The availability of advice for maneuvering complex corporate structures to dodge the consequences of a literal reading of tax-laws pose interesting choices to the corporate managers against the backdrop of fierce competition in the industry. Some adopt a conservative outlook and rather err in paying the tax than taking the tax-administration head-on; some succumb to the attractive option of avoiding to pay taxes by adopting creative means; some take calculated risks considering the strength of the advice received and stakes involved; so forth and so on. There is no gain-saying that these vagaries arise owing to the fiscal law either being ambiguous or failing to achieve what it purports to achieve. Nonetheless the difference in choices adopted by corporate managers cannot be ignored.

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[1] John Christensen & Richard Murphy, *The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the bottom line*, 47(3) Development 37 (2004). *See*, Prem Sikka, *Smoke and Mirrors: Corporate Social Responsibility and Tax Avoidance*, 34(3&4) Accounting Forum 153 (2010); for a disillusioning discussion on the relationship between 'corporate social responsibility' and tax-avoidance.

Instilled with an avowed premise that corporations should concentrate on doing business and leave the interpretation of taxation laws to it, the tax-administrations choose to condemn the non-conformists. Dubbing the creative schemes as tax avoidance mechanisms – or tax-evasion device in case of overtly evident illegality – the supposedly tax-efficient corporate structures are challenged before judicial forums with none being able to predict with certainty the view the courts will adopt. Precedents are varied and diverse but with no discernable unanimous principle. Thus each of the action adopted by the so-called tax-avoiders, given the monetary thresholds the tax-administration would like to ignore, is subjected to test under intensive motivated legal scrutiny.

The tax-administration possesses unlimited resources to handle the disputes compared to the lone corporation and thus the dispute is often dragged on up to the highest court. The tax-administration, being only a concomitant of the ruling Government, also carries the might to get the laws retrospectively amended in case of an adverse verdict and thus possesses the might to change the rules of the game from a back-date. Thus victory for the corporation, which itself is rare, is often short-lived. The resultant outcome, in a long-term perspective, offers a bleak picture for those corporate managers who consider the consequences of taking the battle to the tax-administration. Surprisingly however, the obvious is not the choice. Tax-mitigating devices are continually explored and tested, probably because the stakes are higher on each occasion. With the persistence of the greed to maximize returns by employment of tax-motivated corporate structures, the outcome notwithstanding, it is corporate governance which suffers the most.

The tussle between the corporation and tax-administration, over the correct view of the tax law, continues until the introduction of the rules which tilt the tide in favour of the latter. Christened as 'anti-avoidance rules', these rules vest with the tax-administration the power to challenge tax-motivated arrangements which may well be compliant of the tax-laws strictly read but fail to answer the test of commercial substance or justify their purpose other than to avoid taxes. These rules may be targeted i.e. specific to a particular avoidance transaction which the legislature seeks to address; or may be general, conferring power upon the tax-administration to legally challenge the structures which apparently toe the line of the taxation laws literally read but fail to provide commercial justification other than reduction of cost by way of tax-mitigation.

Hitherto only legal justifications could be the basis for tax-administration to impose liabilities upon corporations. The empowerment of tax-administration by these rules, however, requires compliance with taxation laws in a multi-dimensional perspective in as much as economic justifications; commercial substance; etc. become relevant considerations. In as much as they permit the tax-administration to re-appreciate corporate decisions and pass judgments even on issues purely governed by commercial expediency, for this one simple reason alone these rules are of concern for the corporations and viewed in a wider picture a necessary impetus to revisit corporate governance standards in vogue. With this perspective let us proceed with the inquiry of the interplay of anti-avoidance rules and corporate governance.

## II. Tax Avoidance and Corporate Governance: An intertwined relationship

Before one ventures into exploring the relationship between tax-avoidance and corporate governance it is expedient for the benefit of the explorer to add a caveat – to establish the contours of the relationship a multidisciplinary analysis is essential. This arises purely on account of taxation being a unique area with an interplay of economic considerations and legal theory. Fiscal laws have a well-demarcated enunciation in jurisprudence and have their own set of interpretative principles. On the other hand, in as much as it effects corporate performance and is a cost of operating in a jurisdiction, economic of taxation also plays considerable role in defining the corporate outlook towards tax-positions adopted by the corporation. These legal and economic realities have, however, evolved different reasons for tax-minimization/tax-avoidance stances adopted by the corporations, as we shall appraise.

### A. *The Legal approach*

Legal realists attribute the issue of tax-avoidance to the principle of strict construction accorded to fiscal statutes[2] and 'certainty' as an important consideration of fiscal policy.[3] Moral and equitable considerations are foreign to fiscal enactments[4] and "every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be."[5] These principles have been, though inconsistently, followed both in the United Kingdom as well as in India[6] and serve as the core premise for judicial appreciation of fiscal cases in most civilized countries.[7] This

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[2] Mathuram Agrawal v. State of M.P., (1999) 8 SCC 667. (Constitutional Bench) Which following Russell (Inspector of Taxes) v. Scott, (1948) 2 All ER 1, holds that "the subject is not to be taxed unless the words of the taxing statute unambiguously impose the tax on him".

[3] Commissioner of Customs v. Tullow India Operations Ltd., (2005) 13 SCC 789, holding that "it is no doubt true that the fiscal liability has to be certain". Adam Smith in his treatise *The Wealth of Nations* attributes 'certainty' as a canon of taxation. He notes, "the tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. Where it is otherwise, every person subject to the tax is put more or less in the power of the tax-gathered, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty." [Volume 5-2.26].

[4] To restate the often-quoted phrase of Rowlatt, J. in Cape Brandy Syndicate v. Inland Revenue Commissioner, (1921)1 KB 64 at 71, "in a taxing Act, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language".

[5] Duke of Westminster v. Commissioners of Inland Revenue, (1936) AC 1 (HL), per Lord Tomlin.

[6] *See*, Tarun Jain, *How Vodafone has overruled Azadi Bachao Andolan decision*, (2012) 250 CTR (Articles) 8-22 for a detailed enunciation of the legal position.

[7] *See*, for illustration the decision of the Supreme Court of Canada in Queen v. Canada Trustco Mortgage Company, (2005) 2 SCR 601, where despite anti-avoidance rules under the statute the Court held (¶ 54) that "the statutory language

judicial bent legally permits the tax-payer to plan his affairs to reduce the tax liability in the absence of any tax-avoidance provision.[8] Thus the citizens (which include corporations liable to pay taxes) are free to structure their transactions in a manner which would lead to reduction of their tax liability i.e. legal permission to indulge in tax-minimization.[9]

This interpretative premise of fiscal statutes forms the reason for discord and is attributed in theory as the principle factor for indulgence by those-with-means into aggressive tax-strategies. Their concern is aptly reflected by the contentions of the Advocate General Poiares Maduro raised before the Grand Chamber of the European Court of Justice[10] where he expressed the antagonistic view in the following terms;

> "77. … It is true that tax law is frequently dominated by legitimate concerns about legal certainty, deriving, in particular, from the need to guarantee the predictability of the financial burden imposed on taxpayers and the principle of no taxation without representation. However, a comparative analysis of the Member States' legal rules is sufficient to make it clear that such concerns do not exclude the use of certain general provisions and indeterminate concepts in the realm of tax law to prevent illegitimate tax avoidance. Legal certainty must be balanced against other values of the legal system. Tax law should not become a sort of legal 'wild-west' in which virtually every sort of opportunistic behaviour has to be tolerated so long as it conforms with a strict formalistic interpretation of the relevant tax provisions and the legislature has not expressly taken measures to prevent such behaviour."[11] (emphasis supplied)

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must be respected and should be interpreted according to its well-established legal meaning".

[8] Commissioner of Income Tax v. Walfort Share & Stock Brokers Pvt. Ltd. (2010) 8 SCC 137.

[9] Vodafone International Holdings v. Union of India (2012) 6 SCC 613.

[10] Halifax Plc v. Commissioners of Customs & Excise (2006) ECR I-1613.

[11] *Id*. at I-1642.

The iteration of these compelling legal considerations has caused a topsy-turvy development of the jurisprudence with precedents on both sides[12] and thus anti-avoidance rules are advocated to compel the change in judicial standards of adjudication in such matters. Since corporations are at play, the legal debate also recedes into the dimension of corporate governance as it is now firmly held that corporate decisions merely represent the state of mind of their directors and managers.[13] It is further found that "the interactions between corporate governance and taxation are bilateral and biunique: in fact, on one side, the manner in which corporate governance rules are structured affects the way a corporation fulfills its tax obligations; on the other side, the way tax designs (from the government perspective) and related tax strategies (from the corporation perspective) are planned influences corporate governance dynamics."[14] Thus we establish the relevance of legal dimension exploring how debate on tax-avoidance floods the corporate governance paradigm.

### B. *The Economic approach*

Apart from the legal luminaries who contest the permissibility of tax-avoidance structures on legal theory and precedents, we have the economists who view the entire minimization exercise in an agency-conflict perspective where the haste to maximize shareholder returns[15] and increase managerial incentives lies at the core of opportune behaviour adopted by corporations. In an economic analysis it is found that "tax shelter benefits accrue to shareholders in well-governed firms".[16] Tax-avoidance activities appear to be increasingly central to

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[12] *See*, *infra 'Success of GAAR in taming Tax-Avoidance: An Appraisal'*.

[13] Aneeta Hada v. Godfather Travels & Tours Pvt. Ltd., AIR 2012 SC 2795, quoting Lord Denning in H.L. Bolton (Engineering) Co. Ltd. v. T.J. Graham & Sons Ltd., (1956) 3 All ER 624.

[14] Nicola Sartori, *Effects of Strategic Tax Behaviour on Corporate Governance*, *available at* http://ssrn.com/abstract=1358930.

[15] "In recent years, many companies have come to view their tax liability in any given tax year as a manageable cost that they can reduce like any other ordinary operational cost". *See*, Y.Keinan, *Corporate Governance and Professional Responsibility in Tax Law*, 17 JOURNAL OF TAXATION AND REGULATION OF FINANCIAL INSTITUTIONS 10 (2003).

[16] Ryan J. Wilson, *An Examination of Corporate Tax Shelter Participants*, 84(3) THE ACCOUNTING REVIEW 969 (2009).

corporate financial decision-making where financial innovations, the integration of capital markets, and an increasingly complicated corporate tax code provide opportunities for firms to capitalize on differences in tax rates, tax preferences, and tax status in more and more elaborate ways.[17] Thus there is a reason for the corporate managers to engage in structuring their actions with intent to avail tax-shelters wherever possible.

Other than the intent to maximize shareholder-return as being the impetus to engage in aggressive tax-strategies, there is an alternative view on the justification for such action by corporate managers. It is suggested that "tax avoidance demands obfuscatory actions that can be bundled with diversionary activities, including earnings manipulation, to advance the interests of managers rather than shareholders".[18] Upon an empirical analysis it has also been established that "individual executives play a significant role in determining the level of tax avoidance that firms undertake incremental to characteristics of the firm"[19]. Therefore even if shareholders provide general guidance with regard to the corporation's tax attitude toward risk, managers make the practical tax choices.

Further economic analysis also confirms that (a) "higher the level of corporate social responsibility activities of the corporation, the lower is the level of corporate tax aggressiveness, therefore, more socially responsible corporations appear to deter tax aggressive activities";[20] and (b) "outside director membership has a positive impact on debt policy, and further, that it strengthens the negative association between tax aggressiveness and debt by reducing the agency costs between controlling shareholders and bondholders, and decreasing opportunities for managerial rent diversion related to tax

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[17] Mihir A. Desai & Dhammika Dharmapala, *Corporate Tax Avoidance and High Powered Incentives*, NBER Working Paper No. 10471 (2004).

[18] Mihir A. Desai & Dhammika Dharmapala, *Earnings Management and Corporate Tax Shelters*, HBS Finance Working Paper No. 884812 (2009).

[19] Scott D. Dyreng, Michelle Hanlon & Edward L. Maydew, *The Effects of Executives on Corporate Tax Avoidance*, *available at* http://ssrn.com/abstract=1158060.

[20] Roman Lanis & Grant Richardson, *Corporate Social Responsibility and Tax Aggressiveness: An empirical analysis*, 31 JOURNAL OF ACCOUNTING AND PUBLIC POLICY 86 (2012), analyzing publicly-listed Australian corporations.

aggressiveness."[21] This aspect is further accentuated by empirical evidence suggesting that "individuals' political beliefs influence their decisions on tax avoidance behaviors."[22] Thus political preferences and affiliations of the corporate managers are also critical to determine the tax approach adopted by them.

These random yet pin-pointed studies appraising the role of executives provide overwhelming evidence of corporate governance having a bearing on tax-aggressiveness of corporation. A number of factors, such as (a) direct Costs; (b) exposure to risk of sanctions; (c) implicit taxes; (d) compliance costs; etc. are some of the factors which influence corporate decision-making in respect of aggressiveness of tax-strategy to be adopted and these studies clearly affirm by economic analysis the hypothesis that "tax laws can influence corporate governance dynamics directly (i.e. as a direct consequence of specific tax policy choices) or indirectly (i.e. as an indirect consequence of the way the tax system operates)."[23]

### C. *Tax-administration perspective*

The exploratory exercise will be incomplete unless once sees the perspectives of the tax-administration as well, which is at the receiving end in as much as avoidance of tax directly affects the budget and planning of the public exchequer. While the tax-administration is concerned with collection of taxes plain-and-simple, in enforcing the fiscal statutes to their logical end however, tax-administration's actions carry significant implications on how corporations are governed.

In any interesting analysis[24] three economists have undertaken the task of interposing the Government as performing the role of

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[21] Sidney Leung, Roman Lanis & Grant Richardson, *Corporate Tax Aggressiveness, Outside Directors and Debt Policy: An Empirical Analysis*, Paper presented at the Annual Meeting of American Taxation Association (2012).

[22] Bill B. Francis, Iftekhar Hasan & Xian Sun, *CEO Political Affiliation and Firms' Tax Avoidance*, (2012), *available at* http://ssrn.com/abstract=2013248.

[23] SARTORI, *supra* note 14.

[24] Mihir A. Desai, Alexander Dyck & Luigi Zingales, *Corporate Governance and Taxation*, NBER Research Paper (2003).

shareholders so as to ascertain the impact of taxation laws upon corporate governance. They envision that "the state, thanks to its tax claim on cash flows, is *de facto* the largest minority shareholder in almost all corporations". They bolster their premise by extending practical reasons. One of these reasons is that while a controlling shareholder interested in ensuring rigour standards of compliance by the managers "has to pay the full cost for monitoring, but reaps only a small fraction (equal to their proportional stake in the company) of the benefits", the same is not true for the Government as its interest to verify the correctness of the picture posed by corporate managers "is sustained by its ability to collect revenues on the income it verifies". Thus they extend the rationale of effective implementation of taxation laws as strengthening corporate governance in the following terms;

> "Why can the tax authority succeed where shareholders fail? In contrast to other shareholders, the tax authority does not face a free rider problem in monitoring and enforcing its rights. In fact, by aggressively prosecuting a company the government sets an example that induces other firms to behave. Thus, because of the spillover effect it has on the behavior of all the other companies, the tax authority has an incentive to certify income and enforce its rights even when the cost of doing so is higher than the payoff it can derive. Furthermore, the tax authority has the benefit of disciplinary powers – including criminal penalties – that are unavailable to other parties."

It is not surprising therefore that tax authorities are continually concerned with the ever-declining ebb of corporate governance[25] and look forward to "encouraging top management and audit committees of large enterprises (e.g. CEOs and boards of directors) to take greater interest in, and responsibility for, their tax strategies"[26] where it is

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[25] Seoul Declaration of 2006 signed by the members of the OECD at the Third Meeting of the OECD Forum on Tax Administration acknowledges that the discussion of its members "revealed continued concerns about corporate governance and the role of tax advisors and financial and other institutions in relation to non-compliance and the promotion of unacceptable tax minimization arrangements."

[26] *Id*. The Declaration also notes the acknowledgement of the members that "it is our duty as heads of our respective countries' revenue bodies to ensure compliance

internationally accepted[27] that Board's responsibility includes overseeing systems designed to ensure that the corporation obeys applicable taxation laws.

Top-corporate executives acknowledge "concerns with reputation, both within the organization and as perceived by the public, as regards risk management by tax executives is clearly very important and is evidence of the different audiences to whom companies are accountable."[28] Thus the ability to publicly make castigating remarks upon non-tax paying corporations is used as a tool by tax-administrations to deter tax-minimization strategies. In as much as such disclosures lead to public outcries[29] and consequent decline in the reputation such corporations command, they influence the manner in which corporations make tax-related decisions.

## III. General Anti-Avoidance Rules (GAAR)

The constitutional and administrative limitations controlling the working of these rules carry an important bearing for corporations as availability of remedies permitting them to successfully dodge the invocation of these rules influence the perspectives of corporate managers on adoption of aggressive tax-strategies. Thus, having appraised the intertwined relationship between tax-avoidance and

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with our national tax laws by all taxpayers, including activities beyond our borders, through effective enforcement and by taking preventive measures that deter non-compliance."

[27] OECD, *Principles of Corporate Governance* (2004) at pg. 60.

[28] Emer Mulligan & Lynne Oats, *Tax Risk Management: Evidence from the United States*, 2009 BRITISH TAX REVIEW 680; *See also*, Judith Freedman, Geoffrey Loomer & John Vella, *Corporate Tax Risk and Tax Avoidance: New Approaches*, 2009 BRITISH TAX REVIEW 74.

[29] *See*, *Vodafone faces tax payment row*, The Guardian, June 26, 2012 noting that "careful planning has helped Vodafone to make savings worth £961m in the form of reduced taxes and tax credits that could be offset against future profits. Vodafone paid zero corporation tax in the UK this year, despite handing more than £2.3bn to other countries around the world." *See*, *G.E.'s strategies let it avoid Taxes altogether*, The New York Times, March 24, 2011 which reports that the "extraordinary success" GE achieves in not paying taxes in the US "is based on an aggressive strategy that mixes fierce lobbying for tax breaks and innovative accounting that enables it to concentrate its profits offshore."

corporate governance, it is apt to appraise the anti-avoidance rules independently and the legal context in which they are set in their respective jurisdictions.

### A. *What are GAAR?*

As the name suggest, GAAR or 'General Anti-Avoidance Rules' are rules directed towards countering attempts of tax-avoidance. However the obvious question arises; why GAAR when taxations laws already provide the consequences in the form of penalties and prosecutions for non-payment of taxes? The answer to this lies in the policy premise that tax-avoidance is economically undesirable and inequitable coupled with the pragmatic realties of tax-avoidance being employed as a maneuvering tool to reduce the biggest cost to business – taxes. Ambiguity in letter of the law is held against the tax-administration, the spirit of law notwithstanding. The tax-administration is further constrained to discharge the burden of proof that the tax-payer indulged in avoidance strategies even though all the facts are within the knowledge and control of the tax-payer. The availability of professional expertise to the tax-payer to route flow of funds though various jurisdictions, including tax-havens, also tilts the tide against the tax administration in meeting the challenge of collecting tax revenue as equitably due.

To mend the balancing scale in its favour and also to dissuade the tax-payer to employ artificial devices meant towards avoiding payment of taxes, tax-administrations tend to equip themselves with these omnipotent rules with the underlying intent of bridging the gap between letter and spirit of the law. Sophisticated corporate structures can thus be warded-off by tax-administration by exposing lack of commercial substance therein and empowering itself by providing consequences for impermissible avoidance arrangements.

Countering purely avoidance mechanisms, even the judiciary has developed anti-avoidance rules such as the substance-over-form test, but the application of these rules are subjective and contingent upon the position which the judiciary will adopt on a case-to-case basis. Thus GAARs vest statutory authority upon the tax-administration to persecute tax-avoidance by countering transactions which apparently pass the letter of the law but have no bounded purpose except to reduce or eliminate tax liabilities. These considerations are shared across the board by tax-administrations world-wide and act as the impetus to legislate GAAR. The case of India, United Kingdom and South Africa clearly bring this aspect to fore, as we shall examine in the later part of this paper.

### B. *Need for GAAR: Tax-administration perspective*

A survey of reported incidents of tax-avoidance vis-à-vis failure of corporate governance generally amongst large and professionally managed corporations provides vital insight into the pressing need to adopt strong anti-avoidance rules. The quintessential reflection in the last decade of the vigourous working for tax-minimization towards increasing returns for shareholder is the case of Enron. "Enron's management began to view the role of its tax department as more than managing its Federal income tax liabilities. Rather, Enron's tax department became a source for financial statement earnings, thereby making it a profit center for the company. … Most of the transactions relied on differences between the tax treatment and financial accounting treatment of various items so that the tax benefits could be used to generate financial statement income."[30]

It was further noticed that "Enron's structured transactions reveal a pattern of behavior showing that Enron deliberately and aggressively engaged in transactions that had little or no business purpose in order to obtain favorable tax and accounting treatment. … In effect, the tax department was converted into an Enron business unit, complete with annual revenue targets. The tax department, in consultation with outside experts, then designed transactions to meet or approximate the technical requirements of tax provisions with the primary purpose of manufacturing financial statement income."[31]

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[30] *Written testimony of the staff of the Joint Committee on Taxation on the report of investigation of Enron Corporation and related entities regarding federal tax and compensation issues, and policy recommendations* (2003), *available at* https://www.jct.gov/publications.html?func=startdown&id=1790.

[31] *Id.*

The United States was quick in its reaction and enacted the Sarbanes Oxley Act, 2002 meant to ensure attainments of higher standards of auditor independence, internal controls, enhanced financial disclosures etc. and stringent punishments for violations. However did it result into correcting the inclination towards lucrative tax-minimization structures? On the contrary, "Enron's strategy of minimizing its asset base and avoiding taxes on a global basis made it popular with international investors; indeed, many of the practices used by Enron remain in use, particularly for tax-avoidance purposes. Studies conducted in the United States show that a large number of top companies, including famous brands such as Accenture, ExxonMobil, Hewlett-Packard, Deutsche Bank, Halliburton, Lufthansa, and Deutsche Telekom, have paid legions of accounting, banking and legal practitioners to concoct schemes devised solely to launder profits to tax havens in order to avoid paying their share of taxes in the jurisdictions where they make and market their goods and services."[32]

The findings of this survey of 2004 have been reiterated as lately as in September 2012 where the United States' Senate Permanent Sub-Committee on Investigations woefully noted that "U.S. multinational corporations benefit from the security and stability of the U.S. economy, the productivity and expertise of U.S. workers and the strength of U.S. infrastructure to develop enormously profitable products here in the United States. But, too often, too many of these corporations use complex structures, dubious transactions and legal fictions to shift the profits from those products overseas, avoiding the taxes that help support our security, stability and productivity."[33]

It is therefore firmly documented that the temptation to avoid taxes finds a strong-hold in large corporations which are able to organize their affairs as tax-avoidance enables companies to become economic free-riders, enjoying the benefits of corporate citizenship without accepting the costs. This aspect is significant as this trend causes harmful market distortions and transferring a larger share of the

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[32] Christensen & Murphy, *supra* note 2.

[33] Opening Statement of Carl Levin, Chairman United States' Senate Permanent Sub-Committee on Investigations, 20.09.2012 on the investigations entitled "*Offshore Profit Shifting and the U.S. Tax Code*".

tax burden onto individual tax payers and consumers for no-fault of theirs'. Thus arises the need to position anti-avoidance rules as the harbinger of corporate reform. It is after all the corporations that are liable for the tax stands they take and not the tax-advisors as "tax intermediaries do not work independently from their clients but supply the services that clients demand."[34]

It is also important to address the interaction of GAAR and corporate governance from a policy perspective.[35] These rules, being directed against avoidance, are meant to apply to a limited set. From a tax regulation perspective these rules are not meant for those either at the "tip of the pyramid … who are engaged in tax evasion and they must be dealt with by way of deterrence and penalties" or the taxpayers who voluntarily comply with the tax system and "form the majority, at the base of the pyramid". On the contrary these rules are directed towards who fill the "middle space" which comprise of those who (a) "consider themselves entitled to take advantage of 'grey' areas in the law and believe themselves to be compliant already, within their own definition of the law, even though they may be aware that their view is contentious"; and (b) are "willing to utilize, and even insisting on their right to utilize, schemes to minimize taxation". The problem which persists in the lack of such anti-avoidance rules is that "taxpayers in the grey area move into the bottom of the pyramid if the behaviour they have undertaken is held by the courts to be in accordance with a proper interpretation of the law" and unless "the issue has come to court, however, different views may be taken on the proper interpretation of legislation".

This aspect has negative fall outs for both the sides. On one side it accentuates the problem of the tax administration to counter such and similar devices on a larger scale but also locks up funds in litigation for a considerable period till the issues are ultimately settled. On the other side the corporation reels under uncertainty and has cash-flow issues, other than the glaring interest and penal liabilities in the event the

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[34] OECD, *Study into the role of Tax Intermediaries*, (2008).

[35] References in this paragraph are from Judith Freedman, *Responsive Regulation, Risk, and Rules: Applying the theory to tax practice*, 44(3) UBC LAW REVIEW 627 (2011).

courts rule its position as untenable. This dimension of the issue poses difficult choices for the corporations when faced with issues relating to interpretation of taxation laws. The choice is confined either to meekly comply with the tax-administration's view point on the law or to obtain legal advice on the interpretation of tax rules and defend its contrary stand before the various tiers of taxation and constitutional courts as legal recourse would permit. While in the first option the danger lies in being more loyal than the king and having to pay tax even when the law does not require so, the second option often turns out to be costly affair in hindsight even if the final outcome may be favourable. This dimension of interaction with tax administration has a critical bearing upon the mindset of corporate managers leading to and the competing views being characterized as conservative and aggressive. It is at this juncture that GAAR comes into play and hits out those adopting aggressive stands, tilting the balance in favour of tax-administration's view-point.

### C. *GAAR under the Direct Taxes Code Bill*

"Targeted Anti Avoidance Rules" (TAAR) or "Specific Anti Avoidance Rules" (SAAR) have already been in vogue from long and therefore the idea of giving place to anti-avoidance rules in tax legislation is not new to India at all. Chapter – X of the Income Tax Act, 1961 christened as 'special provisions relating to avoidance of tax' already provides anti-avoidance rules relating to transfer-pricing,[36] securities transactions,[37] transactions with Non-Residents,[38] etc. These statutory rules have further been supplemented by judicially developed anti-avoidance rules.[39] However the Direct Taxes Code Bill ignited the debate, hitherto foreign, in India on the impact and contours of

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[36] § 92 to 92F.

[37] § 94.

[38] § 93.

[39] The Supreme Court in its recent decision in *Vodafone International* (*supra*) notes that "the concept of GAAR is not new to India since India already has a judicial anti-avoidance rule, like some other jurisdictions." This decision also notes that the Direct Taxes Code Bill, 2010 "envisages creation of an economically efficient, effective direct tax system, proposing GAAR. GAAR intends to prevent tax avoidance, what is inequitable and undesirable."

"General Anti-Avoidance Rules" (GAAR) in the direct tax laws of the country.

The Government of India realized the pressing need for adopting statutory rules against tax-avoidance when it unveiled the first draft of the Bill[40] for public discussion in 2009. The accompanying Discussion Paper expressed the rationale for the introduction of the GAAR in the following terms;[41]

> 24.1 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.
>
> 24.2 In the past, the response to tax avoidance has been the introduction of legislative amendments to deal with specific instances of tax avoidance. Since the liberalization of the Indian economy, increasingly sophisticated forms of tax avoidance are being adopted by the taxpayers and their advisers. The problem has been further compounded by tax avoidance arrangements spanning across several tax jurisdictions. This has led to severe erosion of the tax base. Further, appellate authorities and courts have been placing a heavy onus on the Revenue when dealing with matters of tax avoidance even though the relevant facts are in the exclusive knowledge of the taxpayer and he chooses not to reveal them.
>
> 24.3 In view of the above, it is necessary and desirable to introduce a general anti-avoidance rule which will serve as a

[40] *Available at* http://india.gov.in/allimpfrms/alldocs/12779.pdf.
[41] *Available at* http://www.itatonline.org/info/?dl_id=98.

deterrent against such practices. This is also consistent with the international trend.

This understanding was reiterated in the Second Discussion Paper[42] issued by the Government wherein it was stated that "a statutory GAAR can act as an effective deterrent and compliance tool against tax avoidance in an environment of moderate tax rates." This backdrop has a clear reflection upon the corporate governance standards in vogue in India as it has been specifically noted that "increasingly sophisticated forms of tax avoidance are being adopted by the taxpayers and their advisers" and judicial decisions[43] acknowledge growing public resentment against such tax-avoidance tactics in the country. Thus clearly the GAAR is intended to serve as a panacea against tax-avoidance strategies prevalent in India.

### D. *GAAR under the Income Tax Act, 1961*

The Direct Taxes Code Bill, 2010, after its introduction in the Parliament, was referred to the Standing Committee on Finance of the Parliament. In its Report evaluating the nuances of the Bill[44] the Committee noted various fallouts of GAAR being invoked, both on equitable as also pragmatic considerations. These were; (a) the "provisions to deter tax avoidance should not end up penalizing tax-payers, who have genuine reasons for entering into a bonafide transaction"; (b) the "proposals should not lead to any fiscal uncertainty or ambiguity"; and (c) "it should be ensured that any of the proposals does not pave the way for avoidable litigation, which is already at a very high level in tax matters."[45]

Despite the request for ensuring inbuilt safeguards in the draft GAAR proposed in the Direct Taxes Code Bill, the Government of India went ahead to introduce GAAR in the unamended and rather

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[42] *Available at* http://www.simpletaxindia.net/2010/06/revised-direct-tax-code-2010-discussion.html.

[43] *See*, Ram Jethmalani v. Union of India (2011) 8 SCC 1; Union of India v. Azadi Bachao Andolan, (2004) 10 SCC 1; Shiva Kant Jha v. Union of India [2009] 185 TAXMAN 424 (Delhi).

[44] (2012) 342 ITR (St.) 305.

[45] *Id.* at ¶ 98.

expanded form in the Income Tax Act, 1961. The impetus for the same was the then-recent decision of the Supreme Court in *Vodafone International*[46] wherein the Court revisited the entire debate of substance-versus-form of transactions in context of tax-avoidance transactions to reaffirm its earlier view in favour of the tax-payers following the *Duke of Westminster* principle.[47] The Memorandum to the Finance Bill, 2012[48] seeking to amend the provisions of the Income Tax Act, 1961 clearly noted the divergence of judicial views on tax-avoidance and thus the impelling need to introduce GAAR in India in the following terms;

> "The question of substance over form has consistently arisen in the implementation of taxation laws. In the Indian context, judicial decisions have varied. While some courts in certain circumstances had held that legal form of transactions can be dispensed with and the real substance of transaction can be considered while applying the taxation laws, others have held that the form is to be given sanctity. The existence of anti-avoidance principles is based on various judicial pronouncements. There are some specific anti-avoidance provisions but general anti-avoidance has been dealt only through judicial decisions in specific cases.
>
> In an environment of moderate rates of tax, it is necessary that the correct tax base be subject to tax in the face of aggressive tax planning and use of opaque low tax jurisdictions for residence as well as for sourcing capital. Most countries have codified the 'substance over form' doctrine in the form of General Anti Avoidance Rule (GAAR).
>
> In the above background and keeping in view the aggressive tax planning with the use of sophisticated structures, there is a need for statutory provisions so as to codify the doctrine of "substance over form" where the real intention of the parties and effect of transactions and purpose of an arrangement is taken into account for determining the tax consequences, irrespective of the legal structure that has been superimposed to

[46] *Supra* note 9.
[47] *Supra* note 5.
[48] (2012) 342 ITR (St.) 234.

> camouflage the real intent and purpose. Internationally several countries have introduced, and are administering statutory General Anti Avoidance Provisions. It is, therefore, important that Indian taxation law also incorporate a statutory General Anti Avoidance Provisions to deal with aggressive tax planning."[49]

On this premise the Government introduced GAAR in the Indian income tax law being the Income Tax Act, 1961. The newly inserted rules provide[50] that an arrangement whose main purpose or one of the main purposes is to obtain a tax benefit and which also satisfies at least one of the four tests, can be declared as an 'impermissible avoidance arrangements', where the four tests are that the arrangement (a) creates rights and obligations, which are not normally created between parties dealing at arm's length; (b) results in misuse or abuse of provisions of tax laws; (c) lacks commercial substance or is deemed to lack commercial substance; (d) is carried out in a manner, which is normally not employed for *bonafide* purpose.

To serve as a guideline both for tax-administration in identifying and for the judiciary in sustaining the objection of the tax-administration, the substance-over-form test has been enacted by a general rule[51] that "an arrangement shall be deemed to lack commercial substance if the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part". Supplementing this general rule, specific instances have been identified where the arrangements will be deemed to be lacking commercial substance. These are where the transactions "involve or include (i) round trip financing; (ii) an accommodating party; (iii) elements that have effect of offsetting or cancelling each other; or (iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction".[52]

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[49] *Id*. at 282.
[50] § 95 providing for 'applicability of General Anti-Avoidance Rule'.
[51] § (1)(a).
[52] § 97(1)(b).

Providing detailed illustration of what instances / structures do not constitute 'commercial substance'[53] it is further provided that in the event of finding of an 'impermissible avoidance arrangement' the tax-administration is empowered[54] not just in "treating the impermissible avoidance arrangement as if it had not been entered into or carried out"[55] but also in "disregarding, combining or re-characterising any step in, or a part or whole of, the impermissible avoidance arrangement."[56] The underlying idea of invoking GAAR is to undo the form and structure of the transaction intended to avoid tax by reconstructing it in a manner in which it normally would have been. To this effect it is provided that "if an arrangement is declared to be an impermissible avoidance arrangement, then the consequences, in relation to tax, of the arrangement, including denial of tax benefit or a benefit under a tax treaty, shall be determined, in such manner as is deemed appropriate, in the circumstances of the case."[57]

The tax-administration has been further empowered[58] to deal with instances of creative accounting by providing that in such instances of impermissible avoidance arrangement "(i) any equity may be treated as debt or vice versa; (ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or (iii) any expenditure, deduction, relief or rebate may be re-characterised." To deal with instances involving multiple parties it has been provided that the transaction may be re-determined by the tax-administration by "disregarding any accommodating party or treating any accommodating party and any other party as one and the same person"[59], or "deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount"[60] or by "reallocating amongst the parties to the arrangement (i) any accrual, or receipt, of a capital or revenue nature;

[53] § 97 defining 'arrangement to lack commercial substance'.
[54] § 98, providing 'Consequences of impermissible avoidance agreement'.
[55] § 98(1)(b).
[56] § 98(1)(a).
[57] § 98(1).
[58] § 98(2).
[59] § 98(1)(c).
[60] §98(1)(d).

or (ii) any expenditure, deduction, relief or rebate."[61] In fact the tax-administration has now been given statutory power to lift the corporate veil as it is now permitted to determine the correct effect of an impermissible avoidance arrangement by "considering or looking through any arrangement by disregarding any corporate structure."[62] Thus the declaration of the law by the Supreme Court[63] that the tax-administration cannot "look through" the transactions but can only determine taxability by "looking at" them has been statutorily done away with; a quintessential instance of legislative overruling of judicial decisions.

The ‘tax benefit’, entitlement or availment of which may trigger these rules, has also be defined[64] very widely to cover "(a) a reduction or avoidance or deferral of tax or other amount payable under the Income Tax Act; (b) an increase in a refund of tax or other amount under the Act; (c) a reduction or avoidance or deferral of tax or other amount that would be payable under the Act, as a result of a tax treaty; (d) an increase in a refund of tax or other amount under the Act as a result of a tax treaty; or (e) a reduction in total income including increase in loss". In as much as even tax deferment in a year is availment of tax-benefit in that year, non-payment of taxes in a particular year (even with the obligation to pay subsequently) alone can be the reason to invoke GAAR.

Further, in an act which actually amounts to unilaterally repudiating a bilateral treaty, it has been provided[65] that treaty benefit (i.e. the beneficial taxation regime under the Double Taxation Avoidance Agreements) will not be available to transactions where GAAR is invoked. Thus by a minor amendment the entire debate on renegotiating the tax treaty with Mauritius has been set to naught. The need to introduce ‘limitation of benefits’[66] provision in the tax treaty is

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[61] § 98(1)(e).
[62] § 98(1)(g).
[63] *Vodafone International* (*supra*).
[64] § 102(11).
[65] § 90(2A).
[66] *See*, OECD, *Commentary on Model Tax Convention on Income and Capital*, Commentary on Article 1 – paragraph 20 (2010) for relevance of ‘limitation of benefits’ clause in countering treaty-shopping.

also undone as in view of the amended provisions of the Income Tax Act the transactions covered under GAAR will in any case not be entitled to favourable outcome under these treaties.

In short, therefore, Chapter – X of the Income Tax Act, 1961 providing for the 'General Anti-Avoidance Rule' will act as the stick to deal with anti-avoidance behaviour by displacing the cloaked structured put in place by the tax-payer and redefining the arrangement to its correct economic coefficient i.e. one which leads to payment of taxes as legitimately due. Arguably the conferment of such wide powers upon tax-administration may create apprehension of exploitation and vindictiveness though the law conceives guidelines[67] to curb opportunistic behaviour by the members of tax-administration.

To ensure that the application of these rules is undertaken on a fair and rationale basis, the applicability of these rules has been deferred[68] and the draft guidelines[69] for GAAR have been referred to an Expert Committee mandated "to receive comments from stakeholders and the general public on the draft GAAR guidelines" and "vet and rework the guidelines based on these feedback". The first report of this Expert Committee[70] suggests suitable mechanisms towards ensuring that the invocation of GAAR complies with the standards of fair-play that is expected in a dispassionate exercise[71] of collecting tax.

## IV. Success Of 'GAAR' In Taming Tax-Avoidance: An Appraisal

Whether or not anti-avoidance rules have an impact on improving standards of corporate governance is a subsequent question. The first issue to be addressed is whether these anti-avoidance rules serve their bounded purpose i.e. whether they are able to counter tax avoidance at all. No useful purpose will be served by retaining these

[67] § 101 provides that the GAAR "shall be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed".

[68] Initially applicable with effect from 1st April, 2013, the GAAR have now been deferred to apply from 1st April, 2016.

[69] (2012) 251 CTR (Statutes) 198.

[70] (2012) 252 CTR (Statutes) 32.

[71] *See*, Adam Smith, *Supra* note 2.

rules on the statutes for extraneous considerations unless these rules are able to achieve their stated objective i.e. avoiding tax-avoidance. In as much as these rules already have precedents, albeit in developed countries, an appraisal of their working in other jurisdictions will have significant reflection on how these rules may fare in Indian context.

### A. *Australia*

Australia was only of the first countries to adopt statutory anti-avoidance rules three decades back in 1981. Entitled as 'Schemes to reduce income tax', the anti-avoidance rules are contained in Part IVA of the Income Tax Assessment Act, 1936 of Australia. Other than specific anti-avoidance rules such as rules countering profit-stripping scheme;[72] franking-debits;[73] withholding tax avoidance;[74] etc. this Part IVA provides for cancellation[75] of tax-benefits, which are very widely defined[76] in the context of impermissible schemes[77] entered into by the tax-payer, without any limitation of time-frame[78] for amending even concluded assessments. Thus the Australian law provides for undoing tax-benefits obtained by the tax-payer under these anti-avoidance rules. However the application of these rules has been significantly constrained by the judiciary. The High Court of Australia (which is the highest court of the country) restricted the applicability of these rules only in those instances wherein obtaining tax benefit was the dominant objective of the scheme attacked upon by the tax-administration. The High Court in *Spotless Services Ltd.*[79] declared the principle in the following terms;

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[72] §177E.
[73] §177F.
[74] § 177CA.
[75] § 177F.
[76] § 177C which defines 'tax-benefits' to *inter alia* covers scheme whereby (i) an amount was not included in total income; (ii) a deduction was allowed; (iii) capital loss was incurred; (iv) foreign income tax was offset whereas such would not have been permitted or might reasonably not have been permitted if the scheme had not been entered.
[77] Enumerated in § 177D.
[78] § 177G.
[79] Federal Commissioner of Taxation v. Spotless Services Ltd. (1996) HCA 34.

> “A taxpayer within the meaning of the Act may have a particular objective or requirement which is to be met or pursued by what, in general terms, would be called a transaction. The "shape" of that transaction need not necessarily take only one form. The adoption of one particular form over another may be influenced by revenue considerations and this, as the Supreme Court of the United States pointed out, is only to be expected. A particular course of action may be, to use a phrase found in the Full Court judgments, both "tax driven" and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Pt. IVA, a person entered into or carried out a "scheme" for the "dominant purpose" of enabling the taxpayer to obtain a "tax benefit".
>
> Much turns upon the identification, among various purposes, of that which is "dominant". In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose. In the present case, if the taxpayers took steps which maximised their after-tax return and they did so in a manner indicating the presence of the "dominant purpose" to obtain a "tax benefit", then the criteria which were to be met before the Commissioner might make determinations under s 177F were satisfied. That is, those criteria would be met if the dominant purpose was to achieve a result whereby there was not included in the assessable income an amount that might reasonably be expected to have been included if the scheme was not entered into or carried out.”

In that decision the High Court ruled in the favour of tax-administration and reversed the ruling of the lower court but only after specifically noting the factual position that “a reasonable person would conclude that the taxpayers in entering into and carrying out the particular scheme had, as their most influential and prevailing or ruling purpose, and thus their dominant purpose, the obtaining thereby of a tax benefit, in the statutory sense”. This decision has been subsequently followed by the High Court[80] wherein while applying this test the High Court specifically noted that "even if a particular form of transaction carries a tax benefit, it does not follow that obtaining the tax benefit is the dominant purpose of the taxpayer in entering into the transaction." Clearly therefore transactions where tax-advantage indeed occurs but is not the dominant reason for the transaction cannot be hit by the anti-avoidance rules. It has further been held that even though the statute lists various circumstances where tax-benefit may be involved, "the mere presence or absence of one or more listed circumstances is not of itself determinative of the conclusion"[81] and an appraisal of practical and commercial realities are relevant for testing them for anti-avoidance transactions.[82]

### B. *Canada*

A case-study of anti-avoidance rules in Canadian legislation provides great insights on how the judicial attitude towards such rules is critical for their successful application. Section 245 of the Income Tax Act, 1985 of Canada, which sets out anti-avoidance rules, was introduced subsequently in 1988. On the lines of general anti-avoidance rules, the provision defines 'avoidance transaction' in a wide manner by including any transaction which "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".[83] It is provided that in case of such transactions "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."[84] The expression 'tax benefit', which triggers the

[80] Commissioner of Taxation v. Trudy Amanda Hart (2004) HCA 26.

[81] Mills v. Commissioner of Taxation (2011), FCAFC 158 (Federal Court of Australia).

[82] *Id.* The Court declared that a corporate tax entity introduced as a part of the structure by a banking institution had relevant commercial purpose and therefore even though it led to certain tax-benefit being obtained by the firm, it was not subject to Part-IVA of the Australian law of 1936.

[83] § 245(3).

[84] § 245(2).

application of these rules, has also been expansively defined to mean "a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act".[85] Thus, evidently, the GAAR provision confers wide powers to the tax-administration to counter tax-avoidance transactions. The interpretation of the Courts, however, has been otherwise.

In *Canada Trustco* case[86] the Supreme Court of Canada held that despite the enactment of GAAR within the statute it was imperative for the Court to adopt an interpretation which resulted into "consistent, predictable and fair results." Dealing with the claim of tax authorities to apply GAAR on tax deferral benefits obtained by the tax-payer by adopting a 'sale and lease-back' transaction, the Court extensively examined the principle of literal interpretation of fiscal statutes and also noted the fact that the *Duke of Westminster* principle[87] was still applicable. Noting the setting of enactment of GAAR, explanatory notes to the legislation and despite acknowledging that "the GAAR's purpose is to deny the tax benefits of certain arrangements that comply with a literal interpretation of the provisions of the Act, but amount to an abuse of the provisions of the Act"[88] the Court went on to reject performing the role sought to be project by the tax-administration. The Court *inter alia* observed as under;

> 1. … The Act continues to permit legitimate tax minimization; traditionally, this has involved determining whether the taxpayer brought itself within the wording of the specific provisions relied on for the tax benefit. Onto this scheme, the GAAR has superimposed a prohibition on abusive tax avoidance, with the effect that the literal application of provisions of the Act may be seen as abusive in light of their context and purpose. The task in this appeal is to unite these two approaches in a framework that reflects the intention of Parliament in enacting the GAAR and achieves consistent, predictable and fair results.

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[85] § 245(1).
[86] *Supra* note 7.
[87] See text accompanying *supra* note 5.
[88] ¶ 16.

> 41. … The courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue. First, such a search is incompatible with the roles of reviewing judges. The Income Tax Act is a compendium of highly detailed and often complex provisions. To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the Income Tax Act would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to override the specific provisions of the Act? Notwithstanding the interpretative challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretative norms was Parliament's intent.
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> 42. Second, to search for an overriding policy of the Income Tax Act that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs. Although Parliament's general purpose in enacting the GAAR was to preserve legitimate tax minimization schemes while prohibiting abusive tax avoidance, Parliament must also be taken to seek consistency, predictability and fairness in tax law. These three latter purposes would be frustrated if the Minister and/or the courts overrode the provisions of the Income Tax Act without any basis in a textual, contextual and purposive interpretation of those provisions. (emphasis supplied)

Having held so, the Canadian Supreme Court went on to vindicate the tax-payer's stand by declaring that the "Parliament intends taxpayers to take full advantage of the provisions of the Act that confer tax benefits. Parliament did not intend the GAAR to undermine this basic tenet of tax law."[89] Even though subsequently the Canadian courts have upheld[90] the application of GAAR where the tax-administration has been able to demonstrate that a specific tax policy was frustrated or defeated by the series of transactions in addition to exhibiting abuse of tax-provisions and obtainment of tax-benefit, there is no shortage of judicial precedents[91] in Canada where potentially tax-abusive transactions have been upheld despite GAAR on the ground that GAAR cannot be understood to unsettle settled principles of tax legislation.

Thus the Canadian experience of administering GAAR clearly brings to fore the fact that while tax-administration may passionately persecute even seemingly innocuous schemes carrying potential tax advantage for the tax-payer, the judicial may not be willing to join the bandwagon and instead may develop additional safeguards to err in favour of the tax-payer rather then the tax-administration.

### C. *New Zealand*

While the Canadian Courts have sought to place greater reliance upon the principle of certainty than upon GAAR, the situation in New Zealand is to the converse. The decision of the New Zealand Supreme Court in *Ben Nevis*[92] clearly reflects the conservative judicial outlook

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[89] ¶ 61.

[90] Earl Lipson v. Queen, (2009) 1 SCR 3; Speaking for the majority, LeBel J. observed, "The GAAR is neither a penal provision nor a hammer to pound taxpayers into submission. It is designed, in the complex context of the ITA, to restrain abusive tax avoidance and to make sure that the fairness of the tax system is preserved. A desire to avoid uncertainty cannot justify ignoring a provision of the ITA that is clearly intended to apply to transactions that would otherwise be valid on their face." *Id.* at ¶ 52. *See*, Mathew v. Queen, (2005) 2 SCR 643 and Copthorne Holdings Ltd. v. Queen, (2011) 3 SCR 721.

[91] *See*, Mil Investors S.A. v. Queen, 2006 TCC 460 (Tax Court of Canada) holding that "there is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as being abusive. It is the *use* of the selected treaty that must be examined."

[92] Ben Nevis Forestry Ventures Ltd. v. Commissioner of Inland Revenue, (2008) NZSC 115 where the judges differed upon the issue of precedence of SAAR over

on introducing addition requirements not found in the statute. The Court therein *inter alia* observed as under;

> 113. The appellants also argued that tax avoidance legislation should be interpreted in a way which gives taxpayers reasonable certainty in tax planning. But Parliament has left the general anti-avoidance provision deliberately general. That approach has been retained despite the introduction of a civil penalties regime in relation to taxpayers who take certain types of incorrect tax position. The courts should not strive to create greater certainty than Parliament has chosen to provide. We consider that the approach we have outlined gives as much conceptual clarity as can reasonably be achieved. As in many areas of the law, there are bound to be difficult cases at the margins. But in most cases we consider it will be possible, without undue difficulty, to decide on which side of the line a particular arrangement falls. (emphasis supplied)

Thus the widely worded GAAR provisions[93] in the New Zealand law[94] have been permitted[95] to apply generally on all artificial devices leading to tax-benefit. Reverting to the contention of such unbridled application of GAAR leading to uncertainty, the New Zealand Supreme Court in *Glenharrow Holdings*[96] held as under;

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GAAR but were unanimous to hold that the transaction in question was an instance of tax-avoidance and thus subject to GAAR.

[93] *See*, Craig Elliffe, *The New Zealand GAAR: Some Reflections on the UK Proposals*, Presentation made at Said Business School (University of Oxford) 10th February 2012, who describes New Zealand GAAR as "a blunt instrument" as "it does not define the criteria that distinguishes legitimate tax planning from impermissible tax avoidance".

[94] Introduced in 2007 as Section BG1 of Income Tax Act, 1994 wherein under 'tax avoidance' is defined as including "directly or indirectly altering the incidence of any income tax", "directly or indirectly relieving any person from liability to pay income tax" and "directly or indirectly avoiding, reducing or postponing any liability to income tax".

[95] Ian Harvey Penny & Gary John Hooper v. Commissioner of Inland Revenue, (2011) NZSC 95.

[96] Glenharrow Holdings Ltd. v. Commissioner of Inland Revenue, (2008) NZSC 116. Extending the principle relating to anti-avoidance rules under the Income Tax law to GST legislation.

> "[48] It may be said, and indeed the appellant does say, that to approach the question of the intent and application of the Act in this way is not to respect the bargain struck by the parties and would allow the Commissioner to restructure their bargain for them, with different GST consequences, and would thus be productive of uncertainty. But that uncertainty is inherent where transactions have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the Act. There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificially favourable transactions. It is simply not possible to meet the objectives of a general anti-avoidance provision by the use, for example, of precise definitions, as may be able to be done where an anti-avoidance provision is directed at a specified type of transaction.
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> [49] Transactions which are driven only by commercial imperatives are unlikely to produce tax consequences outside the purpose of the legislation and, in any isolated case in which the commercial drivers do have unusual consequences, the existence of those consequences will surely alert the parties to the possibility that the Commissioner may consider invoking the general anti-avoidance provision and may have to be persuaded that the intent of the legislation is not actually being offended." (emphasis supplied)

Thus evidently New Zealand, which is also a common-law jurisdiction and has followed the *Duke of Westminster* principle for long,[97] has given way to the principle of certainty in favour of

[97] *See*, Zoe Prebble & John Prebble, *Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law*, 2008 BULLETIN FOR INTERNATIONAL TAXATION 151; who survey the statutory and judge-made general anti-avoidance rules in eight jurisdictions; Germany, Croatia, New Zealand, Australia, France, the European Union, the United States and the United Kingdom to conclude that the statutory enactment of these rules is not confined only to common-law jurisdictions but civil-law countries grappling with the issue of tax-avoidance also enact such rules.

permitting the tax-administration to neutralize tax-avoidance strategies by applying GAAR. The judicial approach in New Zealand, even though criticized,[98] is at contrast with that adopted in other common-law countries where the judiciary has limited the application of GAAR rather than promoting its frequent application.

### D. *United Kingdom*

Even though currently the United Kingdom does not have any statutory anti-avoidance rules, it is ripe to consider it because the debate whether or not United Kingdom tax laws need statutory anti-avoidance rules is alive and kicking. The traditional adherence to *Duke of Westminster* principle has not been without exception[99] even in the United Kingdom but off-late the courts have decided[100] against the tax-administration seeking to expose tax-avoidance schemes. In terms of the decision of House of Lords[101] purposive construction of statute is the order of the day and ignorance of purely artificial transactions is an accepted norm even in the European Union tax legislation.[102]

In its first, the Government published a consultation document on GAAR in 1998 where the debate on introduction of GAAR brewed

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[98] Report of Taxation Committee of the New Zealand Law Society, the Corporate Taxpayers Group and the Taxation Committee of the New Zealand Institute of Chartered Accountants (2012), *Improving the operation of New Zealand's Tax Avoidance Laws*.

[99] W.T. Ramsay Ltd. v. Inland Revenue Commissioners, (1981) 1 All ER 865 (HL), which held that a device which was colourable in nature had to be ignored as fiscal nullity; Furniss (Inspector of Taxes) v. Dawson, (1984) 1 All ER 530 (HL); which on the factual foundation held that an inserted step had no business purpose except deferment of tax and thus could be ignored. Although the approach of the tax-administration to question all tax-planning mechanism met with resistance in Craven (Inspector of Taxes) v. White Stephen, (1988) 3 All ER 495 (HL).

[100] Commissioner of Inland Revenue v. Scottish Provident Institution, (2004) UKHL 52 (HL), where even though tax-avoidance schemes were described by the Court as ‘anti-*Ramsay* devices’, it was declared that the effect of transactions could not be “disregarded simply because the parties had deliberately included a commercially irrelevant contingency”. *See*, Macniven (Inspector of Taxes) v. Westmore Investments Ltd. (2001) UKHL 6 (HL) which explained the tests for applying *Ramsay* principle in context of tax-avoidance scheme.

[101] Barclays Mercantile Business Finance Limited v. Mawson (Inspector of Taxes), (2004) UKHL 51 (HL) following *Macniven* (supra).

[102] *Halifax Plc* (*supra*).

for more than a decade. The Government in December 2010 entrusted Graham Aaronson QC with the mandate "to lead a study programme to establish whether a GAAR could be framed so as to be effective in the UK tax system and, if so, how the provisions of the GAAR might be framed". The Aaronson Report[103] "concluded that introducing a broad spectrum general anti-avoidance rule would not be beneficial for the UK tax system. This would carry a real risk of undermining the ability of business and individuals to carry out sensible and responsible tax planning. Such tax planning is an entirely appropriate response to the complexities of a tax system such as the UK's."[104]

Pursuant to the Report, the Government invited the views of the stakeholders on the draft GAAR.[105] The proposed draft provides that 'tax arrangements' would be held as "abusive if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action, having regard to all the circumstances including-(a) the relevant tax provisions, (b) the substantive results of the arrangements, and (c) any other arrangements of which the arrangements form part". As a supplement, it is also clarified that the "the reference to the relevant tax provisions includes-(a) any principles on which they are based (whether express or implied), (b) their policy objectives, and (c) any shortcomings in them that the arrangements are intended to exploit." Thus the draft GAAR acknowledges that there may be 'shortcomings' in the taxation laws but subjects the arrangements directed towards exploiting such shortcomings to GAAR.

Four illustrations of 'abusive' arrangements have also been provided in the draft rules, these being the instances where "(a) the arrangements result in an amount of income, profits or gains for tax

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[103] Released in November 2011, *available at* http://www.hm-treasury.gov.uk /d/gaar_ final_report_111111.pdf

[104] The Report nonetheless suggested that "introducing a moderate rule which does not apply to responsible tax planning, and is instead targeted at abusive arrangements, would be beneficial for the UK tax system."

[105] HMRC, *Consultation Document* (12th June, 2012), *available at* http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm. The United Kingdom Budget for Financial Year 2012-13 states that this consultation was initiated "with a view to bringing forward legislation in Finance Bill 2013".

purposes that is significantly less than the amount for economic purposes, (b) the arrangements result in deductions or losses of an amount for tax purposes that is significantly greater than the amount for economic purposes, (c) the arrangements result in a claim for the repayment or crediting of tax (including foreign tax) that has not been, and is unlikely to be, paid, (d) the arrangements involve a transaction or agreement the consideration for which is an amount or value significantly different from market value or which otherwise contains non-commercial terms." In the event the alleged arrangement meets the criteria for application of GAAR, the tax-administration is permitted to "make, on a just and reasonable basis, such consequential adjustments" whereby "the tax advantages arising from the arrangements are to be counteracted".

Even though the draft GAAR has been praised as "very well drafted, and is both succinct and lucid" embodying "all of the main principles which we consider need to be incorporated in, and to form the framework of, a GAAR that would be appropriate for the United Kingdom,"[106] one cannot predict with affirmation the view that the British Courts will adopt both on the GAAR's legitimacy and applicability. It is anyone's guess as to whether they will confine the application of these rules by imposing additional safeguards to control the monster from running amok or will they refuse to appraise substantive appraisals of tax-administration's action.

In what has an important bearing for corporate governance perspective, it must here be noted that the Government in United Kingdom has proceeded towards implementing GAAR whereas it was formally recommended to its tax-administration that "informal consultation with business" is "step in the right direction in providing greater clarity of HMRC's perspective in relation to good corporate governance in respect of tax."[107] Obviously, therefore, the tax-administration finds that "that the GAAR will be an effective deterrent against artificial and abusive tax avoidance, and will over time

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[106] *Supplementary Report of Graham Aaronson QC* (June 25, 2012), *available at* http://www.hm-treasury.gov.uk/tax_avoidance_gaar.htm.

[107] Sir David Varney, *2006 Review of Links with Large Business*, (November, 2006), *available at* http://www.hmrc.gov.uk/large-business/review-report.pdf

influence the culture of tax planning"[108] and is a better response than persuading the corporations to mend tax-avoidance strategies.

### E. *Constitutional law perspective in India*

Having examined the backdrop in which statutory anti-avoidance rules have been received in other jurisdictions, before we proceed to derive the lessons from application of GAAR for India, it is expedient that one examines the legal dynamics which would influence the success of GAAR in India. More specifically, the issue merits considerations from a constitutional law perspective.

The constitutional ethos preempt 'rule of law' in governance in India[109] and administration of fiscal laws is not an exception to the general rule of fair play.[110] The doctrine of equality under Article 14 of

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[108] *Supra* note 106.

[109] Supreme Court Advocates-on-Record Association v. Union of India, (1993) 4 SCC 441; Onkar Lal Bajaj v. Union of India (2003) 2 SCC 673. *See*, Justice S.H. Kapadia, *Constitutional Ethos*, 54 JILI 153 (2012) for a discussion on a number of allied issues. *See*, Judith Freedman, *Responsive Regulation, Risk, and Rules: Applying the theory to tax practice*, 44(3) UBC Law Review 627 (2011) who discusses in general the interplay of 'rule of law' and constitutional law challenges to tax authorities in framing regulations.

[110] *See*, Dabur India Ltd. v. State of Uttar Pradesh, (1990) 4 SCC 113 wherein the Supreme Court urged the executive to exercise restraint in the following terms; "31. Before we part with this case, two aspects have to be adverted to – one was regarding the allegation of the petitioner that in order to compel the petitioners to pay the duties which the petitioners contended that they were not liable to pay, the licence was not being renewed for a period and the petitioners were constantly kept under threat of closing down their business in order to coerce them to make the payment. This is unfortunate. We would not like to hear from a litigant in this country that the government is coercing citizens of this country to make payment of duties which the litigant is contending not to be leviable. Government, of course, is entitled to enforce payment and for that purpose to take all legal steps but the government, Central or State, cannot be permitted to play dirty games with the citizens of this country to coerce them in making payments which the citizens were not legally obliged to make. If any money is due to the government, the government should take steps but not take extra-legal steps or manoeuvre." *See*, recent decision of the Orissa High Court in Management Committee v. Income Tax Officer [WP(C) No. 27531/2011, decision dated 03.07.2012] wherein the High Court passed strictures upon the conduct of the Income Tax department to observe that "it is expected that the Department shall be careful in future not to

the Constitution has been so expanded by the judiciary that grant of unbridled power by the legislature to the executive has never been tolerated.[111] Prescription of guidelines circumscribing the perimeter for the executive to act within is the general norm[112] and even in the context of fiscal policy every deviation is strenuously addressed.[113]

Thus a GAAR, even if broad-ranged and under mandate to retort to contrived corporate structures, has to find its feet and operate within the narrow permissible gauge of administrative action. The Supreme Court of India has categorically held that fairness and reasonableness must be the pivotal touchstones to check exercise of wide discretion vested with administrative authorities – a test which squarely applies to tax-administration in the wake of wide powers conferred by the statutory GAAR. The law to this effect was declared by the Supreme Court in *Rash Lal Yadav* in the following terms;[114]

> "6. … If the statute confers drastic powers it goes without saying that such powers must be exercised in a proper and fair manner. Drastic substantive laws can be suffered only if they are fairly and reasonably applied. In order to ensure fair and reasonable application of such laws courts have, over a period of time, devised rules of fair procedure to avoid arbitrary exercise of such powers. True it is, the rules of natural justice operate as checks on the freedom of administrative action and

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indulge in any such avoidable circumstances thereby creates an impression that the intention of the Department is not to help the assessee but to harass them."

[111] The decision of a seven-judge Constitutional Bench of the Supreme Court in *Delhi Laws Act, 1912, In re* AIR 1951 SC 332 declared this aspect in the nascent stages of India as an independent nation and the principle has been followed without deviation hence. *See*, Abhinav Chandrachud, *Due Process of Law*, Eastern Book Company (2011) at pg. 200 who laments that "Article 14, couched as an equal protection clause, has become an overreaching 'fairness' provision, under which the constitutional courts test legislative procedure and determine whether it is fair."

[112] Alok Kumar Banerjee v. Union of India, (1984) 3 SCC 127 which declares that "the principle which has been well established is that Legislature must lay down the guidelines, the principles of policy for the authority to whom power to make subordinate legislation is entrusted."

[113] J.K. Industries Ltd. v. Union of India, (2007) 13 SCC 673.

[114] Rash Lal Yadav v. State of Bihar, (1994) 5 SCC 267.

> often prove time-consuming but that is the price one has to pay to ensure fairness in administrative action. And this fairness can be ensured by adherence to the expanded notion of rule of natural justice. Therefore, where a statute confers wide powers on an administrative authority coupled with wide discretion, the possibility of its arbitrary use can be controlled or checked by insisting on their being exercised in a manner which can be said to be procedurally fair."

It is imperative, consequently, for the legislature to provide detailed rules discerning fairness and controlling the discretion of field formations entrusted with the authority to administer GAAR. Failure to provide such restrictions may evince violation of constitutional norms with a high degree of probability of being declared arbitrary and thus unenforceable.[115] In this backdrop, even with the entrustment of wide powers with the tax officers to challenge artificial corporate structures by applying the GAAR, tax-payers may instead seek to test waters by putting the competence of the officers to test rather than coming clean or mending the ways to improve governance standards within the organization. Such challenges are not unheard of in India and have a fair bit of success as well.[116]

## V. 'GAAR': Lessons For Corporate Managers

We have important lessons to learn from previous corporate collapses. On one side we have "Enron's aggressive interpretation of

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[115] Khemka & Co. (Agencies) Pvt. Ltd. v. State of Maharashtra, (1975) 2 SCC 22 (Constitutional Bench). In fact Section 101 of the Income Tax Act provides that the GAAR "shall be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed". It must also be noted that the Calcutta High Court has already issued notice to the Government of India in WP No. 441/2012 (Mcleod Russel India Ltd. v. Assistant Director of Income Tax, order dated 10.06.2012) challenging the amendments made to the Income Tax Act, 1961 by Finance Act, 2012 as arbitrary.

[116] *See*, *Azadi Bachaoo Andolan* (*supra*) *Vodafone International* (*supra*); *Walfort Share & Stock Brokers* (*supra*) wherein the contentions of the tax-payers have been accepted. *See*, conversely McDowell & Co. v. Commercial Tax Officer, (1985) 3 SCC 230 (Constitutional Bench) and Commissioner of Wealth Tax v. Arvind Narottam, (1988) 4 SCC 113 for a discussion on why tax-avoidance schemes should be discouraged.

business purpose, the cooperation of accommodation parties, the protections provided by tax opinions, the complex design of transactions – all were factors that encouraged Enron to engage in tax-motivated transactions"[117] and on the other side we have the case of Satyam where external approval of fictitious financial position adopted by the corporation grossly misled the stakeholders. These cases "demonstrate the need for strong anti-avoidance rules to combat transactions that might satisfy the technical requirements of the tax statutes and administrative rules, but that are conducted for little or no purpose other than to generate income tax or financial statement benefits".[118]

Therefore, in as much as onset of anti-avoidance rules in tax enactments is to a large extent attributable to failure of corporations to maintain qualitatively appreciable standards, GAAR have a bearing on the corporate governance standards in vogue. The persistence with which corporations adopt tax-avoidance strategies challenging the positions adopted by tax-administrations is the key factor for the tax-administrations to retort back with sterner and deterrent anti-avoidance rules. The case of South Africa abandoning GAAR enacted in 1941 to introduce a new GAAR in 2006 serves as a potent illustration to the fact that even with GAAR tax-administration may grapple in successfully countering tax-avoidance[119] but is also a pointer to the fact

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[117] *Written testimony of the staff of the Joint Committee on Taxation on the report of investigation of Enron Corporation and related entities regarding federal tax and compensation issues, and policy recommendations* (2003). *available at* https://www.jct.gov/publications.html?func=startdown&id=1790. The report opines that the Enron case puts a spotlight on the "general ineffectiveness of tax laws" and "until the costs of participating in tax-motivated transactions are substantially increased, corporations such as Enron will continue to engage in transactions that violate the letter or the spirit of the law."

[118] United States Joint Committee of Taxation, *Report of Investigation of Enron Corporation and Related Entities regarding Federal Tax and Compensation issues, and Policy Recommendations*, Volume 1, pg. 39. (February 2003)

[119] *See*, South African Revenue Service, *Discussion Paper on Tax Avoidance* (2005) *available at* http://www.sars.gov.za/home.asp?pid=5981, which acknowledges that the anti-avoidance provision "section 103 has proven to be an inconsistent, and at times, ineffective deterrent to abusive avoidance schemes and other impermissible tax avoidance".

that however ingenious, tax-avoidance is not acceptable to tax-administrations and will be persistently under attack.

In the wake of GAAR, the immediate and first action-point for the corporate decision-makers will be to revisit their tax-positions as these positions will be tested for compatibility with GAAR and therefore require amending action at corporate front. For instance in the absence of anti-avoidance rules the courts have ruled tax-administration lacks competence to challenge various internationally frowned-up corporate structures such as round-trip financing,[120] thin-capitalization structures,[121] dividend-stripping transactions,[122] etc. This position will change as "a GAAR which comprises a number of principles, including, but not limited to, directions about the significance of economic substance and of the manner of carrying out a scheme, may be able to operate, in conjunction with new approaches to legislation, to support the judiciary better in their task of statutory interpretation."[123]

Further, in the light of GAAR, corporations planning to persist in taking changes with seemingly tax-efficient structures will face tight-rope situations as a stringent GAAR envisages higher professional fees changed by tax-advisors and intermediaries to develop models which can withstand the attacks of tax-administrations. The role of tax-intermediaries is already documented[124] as fuelling aggressive tax-planning by tax-payers and the fact that despite statutory GAAR certain decisions are indeed in favour of tax-payers[125] can be sufficient inducement to continue with the policy of aggressive tax-positions.

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[120] *Vodafone International* (supra).
[121] Besix Kier Dabhol, SA v. Deputy Director of Income Tax, (2011) 131 ITD 299 (ITAT).
[122] *Walfort Share and Stock Brokers Pvt. Ltd.* (*supra*).
[123] Judith Freedman, *Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament*, 123 LQR 53 (2007), who considers statutory anti-avoidance rules in various Australia, South Africa, Canada and New Zealand to conclude that a GAAR provision which provides guidelines for the judges to ascertain legislative intention would be effective in taking the statutory provisions to their intended end.
[124] *Supra* note 34.
[125] *See*, text accompanying *supra* note 80 and 90.

Economic and commercial considerations, which have hitherto before not been permitted by the judiciary to be interfered by the tax-administration in India,[126] will no longer remain beyond approach of the tax-administration. Whether or not a transaction or series of transaction have a commercial purpose, whether or not the decision to structure the transaction in a particular manner has any economic substance or is a mere façade to minimize tax-liability etc.[127] are the questions which have cropped up infrequently, if not exceptionally in India. However with GAAR coming into picture the weighing of commerciality of every any transaction crossing the prescribed monetary threshold of tax benefit (if any is prescribed) will become the order of the day. Thus corporate decisions will require to be tested not just from the perspective of corporate managers but also from a reverse perspective as to how the tax-administration may view (or rather 'portray') the transaction to be.

There is another lesson to be drawn for corporate governance. When such cases are fought and the judicial authorities are entrusted with the responsibility of entailing the final-word, though obliged to decide cases dispassionately, the judges often pass scathing remarks over the conduct of the corporation in the event of coming across socially unacceptable behaviour. This aspect has a critical bearing upon the governance standards in vogue. For illustration, the Bombay High Court in a high-pitched battle between various telecommunication players vis-à-vis the tax-administration did not just lean in favour of the

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[126] It has time and again been declared by the Indian courts that the tax-payer is the best judge of commercial expediency and the tax officer cannot dictate how the tax-payer should conduct business. *See for illustration*, S.A. Builders Ltd. v. Commissioner of Income Tax, (2007) 1 SCC 781; Commissioner of Income Tax v. Dhanrajgirji Raja Narasingir, (1974) 3 SCC 520. In Commissioner of Income Tax v. A. Raman & Co. AIR 1968 SC 49 the Supreme Court on this count observed inter alia that "Counsel for the Commissioner contended that if by resorting to a 'device or contrivance', income which would normally have been earned by the assessee is divided between the assessee and another person, the Income Tax Officer would be entitled to bring the entire income to tax as if it had been earned by him. But the law does not oblige a trader to make the maximum profit that he can out of his trading transactions."

[127] *See*, Chapter 2 of the Expert Committee Report, *supra* note 71 which notes that GAAR has been "enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form".

tax-administration but also made castigating remarks upon the corporations for having suppressed relevant facts and making incorrect representations to the tax-administration.[128] In fact the Indian legal context is replete with instants where the judiciary has taken note of the corporate decisions and economic realities in order to rule upon 'allegation of subterfuge' and 'fictitious arrangements' to evade taxes.[129] These decisions cast a definitive indictment on non-acceptable corporate conduct, and therefore it goes without saying that they have a bearing upon the governance standards and thus requiring rectification.

Further, a successful application of GAAR in a given set of facts is also a pointer to the fact that the corporation paid lip-service to the spirit of the law even though it may have abided by the letter of the law. Thus losing the case with the tax-administration implies not just defrayment of taxes and penalties but also extends to negative publicity and reputational impact for the corporation. Since perception in the eyes of the stakeholder is critical for corporations,[130] a proactive and media-friendly tax-administration can become an eyesore for corporations especially in the wake of wide powers under GAAR.

GAAR is stated to be a welcome change from a shareholder perspective. It is commented that "a general anti-avoidance rule, as well as other strong tax enforcement policies, would lower the return to tax avoidance strategies and would guarantee a higher level of transparency in the corporate governance dimension. Moreover, the higher transparency would reduce the amount of income diversion, private benefits and would reduce the agency costs. In other words, since strategic tax behaviors reduce tax revenues and have a negative impact on corporate governance, an anti-avoidance rule may have a positive impact not only on tax compliance (i.e. guaranteeing a higher level of compliance with the tax system), but also on corporate

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[128] Aditya Birla Nuvo Ltd. v. Deputy Director of Income Tax, (2011) 342 ITR 308 (Bom).

[129] *See*, Commissioner of Customs v. Phoenix International Ltd., (2007) 10 SCC 114; Commissioner of Income Tax v. Sri Meenakshi Mills Ltd., AIR 1967 SC 819; Lachminarayan Madan Lal v. Commissioner of Income Tax, (1973) 3 SCC 76; Yeshwant Rao Ghorpade v. Commissioner of Wealth Tax, AIR 1967 SC 135; Union of India v. Playworld Electronics (P) Ltd., (1989) 3 SCC 181.

[130] *Supra* note 28.

governance (since it would grant lower information asymmetry between managers and shareholders and therefore lower agency costs and higher level of disclosure of information)." [131]

One aspect, however, which may be a significant factor limiting the GAAR in having the desired effect is non-imposition of commensurate penalties even if GAAR is successfully invoked by the tax-administration. Since the very application of GAAR implies a difference in perspectives of the tax-payer and the tax-administration over the substance and effect of the transaction, the application of GAAR is nothing more than an interpretative exercise. Thus even if GAAR is invoked against the tax-payer, at best the tax-administration can demand the tax as legitimately due and nothing beyond.[132] Even the amendments made to the Income Tax Act, 1961 inserting GAAR therein do not provide for any additional penal liability[133] which can be imposed on the tax-payer even upon a successful application of GAAR. This is in line with the settled law in India[134] that statutory best-judgment assessments of tax-liability (which will be the order of the day under GAAR) as against the disclosures made by the tax-payer do not imply any concealment by the tax-payer. Thus, from a purely commercial angle, even GAAR poses only the risk of additional tax costs for the corporation[135] and may therefore not have a long-lasting effect on corporate managers inclined to adopt aggressive tax-positions.

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[131] Nicola Sartori, *supra* note 14.

[132] *See*, *Halifax Plc.* (supra) where at ¶ 93 the ECJ declare the European law in the following terms:- "It must also be borne in mind that a finding of abusive practice must not lead to a penalty, for which a clear and unambiguous legal basis would be necessary, but rather to an obligation to repay, simply as a consequence of that finding, which rendered undue all or part of the deductions of input VAT".

[133] In terms of § 271(1)(c) of the Income Tax Act, 1961 penalty is leviable only if the tax-payer has 'concealed the particulars of his income or furnished inaccurate particulars of such income". Other provisions providing imposition of penalty relate to non-furnishing of returns, documents etc. and therefore may not have a bearing for GAAR cases.

[134] K.P. Varghese v. Income Tax Officer, (1981) 4 SCC 173.

[135] *See*, Tax Law Review Committee, *Tax Avoidance*, (November 1997), which notes that "the risk of an arrangement being challenged and found to be unsuccessful avoidance is taken account of and factored into a tax planning arrangement. If the risk is limited to the costs of the scheme and of defending it, if challenged, almost any arrangement may be worth trying".

## VI. Conclusion

An appraisal of legal and economic considerations affecting tax-avoidance and corporate governance interplay clearly reflect an intertwined relationship between the two. In fact there exists a concave relationship where on one side untamed tax-avoidance leads to deterioration in corporate governance standards and on the other hand excessive emphasis of tax-administrations to counter tax-avoidance can actually imply these administrations dictating corporate governance standards. In this amalgam of affairs, statutory enactment of anti-avoidance rules confers legitimacy on the actions of tax-administration bent upon reconstructing commercial realities in a manner which will expand the tax-collection. The GAAR, therefore, has rightly been criticized as magic wand wiping out the effect of other portions of tax law and thus diluting the predictability of tax-regime which is critical for any corporation in the business environment.

It is academically recognised that even GAAR "would not solve every problem with the tax system" but can only act as a pointer for the taxpayers towards a "reasonable exercise of choices of conduct under the relevant tax provisions".[136] Thus even after GAAR, the issue as far as corporate decision-making is concerned, would boil down to the likelihood of the tax-structure passing the test of anti-avoidance. The long experience of working of GAAR in other jurisdictions has clearly shown that despite GAAR the instances of opportunistic tax-behaviour have not declined. In any case, there are no two views that GAAR acts as a deterrent against opportunist tax-behaviour, and corporate-decisions indeed reflect concern of getting caught under these rules. It is therefore likely that GAAR will bring out a shift in outlook of corporate managers towards tax-planning and in particular adoption of aggressive tax-strategies, particularly the closely-held corporations,[137]

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[136] Judith Freedman, *GAAR as a process and the process of discussing the GAAR*, (2012) BRITISH TAX REVIEW 22. It is relevant to point out that Prof. Freedman was a member of the Advisory Committee appointed to assist Graham Aaronson QC to conduct inquiry into feasibility of GAAR for UK and this paper was written after the preparation of final report of the Committee.

[137] S. Chen, X. Chen, Q. Cheng, and T. Shevlin, *Are family firms more tax aggressive than non-family firms?*, 95 JOURNAL OF FINANCIAL ECONOMICS 41 (2009) whose analysis reflects that costs associated with adopting tax-aggressive stands

and therefore add a new leaf to the existing literature on corporate governance. Nonetheless the doubt persists on whether GAAR can serve as a statutory corporate governance rule to aid corporate decision-making.

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directly befall upon those corporate managers who command a greater proportion of ownership over the corporation as compared to other shareholders.