

Round-up of the Indian
General Anti-Avoidance Rule (GAAR)

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GENERAL
ANTI
AVOIDANCE
RULE



Outline

- ▶ Background of GAAR
- ▶ Summary of Legislative Provisions
- ▶ Issues and observations



BACKGROUND OF GAAR

- **Form v Substance Theory**
- **Specific-Anti Avoidance Rules (SAAR)** — Legislative history
- **Avoidance vs. Evasion** – India and UK
- **Need for GAAR** — Steps taken

Form v. Substance

- ▶ Two types of transactions:
 - ▶ Sham transactions — Form and Substance both illegal; tax evasion
 - ▶ Legal transactions — Formal documents entered into; tax avoidance
 - W.T. Ramsay v Irc
 - IRC v Burmah Oil
 - Furniss v Dawson
- ▶ Response of the Legislature: Specific Anti-Avoidance Rules (SAAR)
 - ▶ E.g. Transfer Pricing provisions in the Income-tax Act, 1961
 - ▶ E.g. Limitation of Benefits (LOB) clauses in treaties

SAAR — Legislative history

- ▶ ***1939 Enquiry Report:*** Identified principal classes of cases that dealt with avoidance of tax payment using legal means
 - ▶ Diversion of income by settlement or disposition
 - ▶ Revocable transfers
 - ▶ Distribution of Income by way of bonus shares or liquidation
 - ▶ Transfer of Assets abroad
- ▶ ***Subsequent Amendments:***
 - ▶ *Section 2(6A) of 1922 Act (Section 2(22) of 1961 Act):* Definition of dividend
 - ▶ *Section 44D of 1922 Act (Section 93 of 1961 Act):* Transfer pricing provisions

Avoidance vs. evasion – the UK saga

▶ **Ramsay v. IR** 54 TC 101

Also:

- ▶ IR v. Burma Oil 54 TC 200
- ▶ Furniss v. Dawson 55 TC 324

Involved a case where the assessee purchased a ready made scheme which resulted in artificial capital losses being generated in one transaction, while a parallel transaction resulted in an exempt gain. (These two transactions were self-cancelling in the commercial sense.) The capital loss was sought to be set off against a capital gain that arose from the primary transaction.

▶ **Craven v. White** [1988] STC 476

- ▶ Schemes and arrangements are to be distinguished from single transactions

▶ **Macniven v. Westmoreland Investment Ltd** (2001) 255 ITR 612

Held that:

- No new principle in Ramsay
- Courts cannot disregard language in a section
- Ramsay does not depart from Westminster
- Treating Ramsay as judicial legislation is incorrect

Avoidance vs. evasion – India

- ▶ **CIT v. Raman & Co.** *67 ITR 11*
 - ▶ Avoidance is not prohibited
 - ▶ Diversion of income should happen before income accrues to the assessee
 - ▶ Morality vs. the Income-tax Act
- ▶ **Mc Dowell v CTO** *(1985) 154 ITR 148*
 - ▶ Following Ramsay, Burma Oil and Furniss v Dawson
- ▶ **UOI v Azadi Bachao Aandolan** *(2003) 263 ITR 706*
- ▶ **Vodafone International Holdings v UOI** *(2012) 341 ITR 1*

Need for GAAR — Steps taken

▶ ***Direct Taxes Code, 2009***

- ▶ Section 112: *Factors for determining consequences of impermissible avoidance arrangement.*
- ▶ Section 113: *Definitions like Accommodating Party, Impermissible avoidance arrangement, round trip financing, lacking commercial substance, benefit, tax benefit etc.*
- ▶ Section 114: *Rebuttable Presumption*

▶ ***Standing Committee on Finance — 2011-12***

- ▶ GAAR should not penalize tax payers as the main objective is deterrence.
- ▶ Prescription of threshold limit for application of GAAR.
- ▶ Burden of Proof on Assessee
- ▶ Prospective application of provisions and grandfather provisions to protect existing arrangements or transactions.
- ▶ Instead of Dispute Resolution Panel (a departmental body), there should be an independent body consisting of Chief CIT and two independent technical members.

Need for GAAR — Steps taken ... *contd*

▶ ***Finance Act, 2012***

- ▶ Deferring applicability of GAAR by one year (2013-14)
- ▶ Insertion of New Chapter X-A in Income Tax Act, 1962
- ▶ Insertion of Section 144BA
- ▶ Amendment to Section 245N(a) [Advance Rulings]

▶ ***Shome Committee Report 2012***

- ▶ Amend “the main purpose or one of the main purposes” to “main purpose”
- ▶ AO to issue Show Cause Notice to Assessee and give opportunity of hearing.
- ▶ Constitution and Powers of Approving Panel.
- ▶ Grandfathering investments made prior to August 30,2010
- ▶ GAAR to not apply to FII in certain cases.
- ▶ Corresponding adjustments should be allowed.

SUMMARY OF LEGISLATIVE PROVISIONS

- **Finance Act, 2013**
 - Chapter X-A of Income-Tax Act, 1961
 - Section 144BA of Income-Tax Act, 1961
- **Income-Tax (Seventeenth Amendment) Rules, 2013**
 - Rules 10U-10C

Applicability of GAAR – s. 95

▶ Section 95(1):

- ▶ Non-obstante provision
- ▶ Provides for ‘declaration’ of arrangement as Impermissible Avoidance Arrangement by Assessing Authority. (Procedure in Section 144BA)
- ▶ ‘Consequence in relation to tax arising therefrom may be determined subject to the provisions of this Chapter’
 - Indication that tax liability can increase.
 - Corresponding adjustment allowed? — Section 100 and Question 13 of Circular 7 of 2017
- ▶ *Explanation:* Loophole plugging provision; Rule 10UA

▶ Section 95(2):

- ▶ Grandfathering provision
- ▶ Transfer of investments or investments before April 1, 2017?
- ▶ Rule 10U(1)(d) and Rule 10U(2) – difference?
- ▶ Questions 5 & 6 of Circular 7 of 2017

Impermissible Avoidance Arrangements – s. 96

- ▶ Section 96(1): Defines an impermissible avoidance arrangement
 - ▶ Main Purpose to obtain tax benefit (highly subjective criteria)
 - earlier read as ‘one of the main purpose’
 - Read with Section 99
 - ▶ Tainted element test – clauses (a) to (d)
 - Arm’s length transaction
 - Misuse or abuse of the Act
 - Lacking commercial substance
 - Entering into or carrying transaction not employed for *bonafide purposes*
- ▶ Section 96(2): Rebuttable presumption
 - ▶ Burden of Proof

Commercial Substance – s. 97

- ▶ Section 97: Gives an exhaustive list of arrangements which lack commercial substance
 - ▶ Substance v form — Ramsay Principle
 - ▶ Round trip financing — defined in Section 97(2) — IRC v Burmah Oil
 - ▶ Accommodating party — defined in Section 97(3) — Furniss v Dawson
 - ▶ Transaction cancelling each other — Ramsay Principle
 - ▶ Section 97(4) — inclusive list to help in determining arrangement lacking commercial substance; Supreme Court in *Vodafone* and Shome Committee Report
 - Time of existence of the arrangement
 - Payments of taxes
 - Exit route

Commercial Substance ... *contd.*

- ▶ Round trip financing:
 - ▶ (A) – even if ‘all’ the parties are not involved in the fund movement, the arrangement might still be characterized as round trip financing
 - ▶ (C) – fund transfers through banking channels etc. could also be round trip financing
 - ▶ In other words, (A), (B), and (C) in s. 97(2) are defenses which cannot be taken by the assessee
- ▶ S. 97(4) – originally enacted to treat the time, payment of taxes, and exit route, as conditions / explanations which would not be relevant at all – later amended to ‘may be relevant but shall not be sufficient’

Tax consequences – s. 98

- ▶ Section 98: Consequence of Impermissible avoidance agreement
 - ▶ Two Fold — denial of tax benefit and denial if tax treaty benefit
 - ▶ South African GAAR Provision (Section 80B) and Section 57(1) of Maharashtra Value Added Tax Act
 - ▶ Clauses (a) to (g) — methods of disregarding or ignoring corporate structure.
 - ▶ Who is to decide on the tax consequences?
 - To be decided by the Assessing Officer
 - Absence of guidelines; hence best judgment assessment

Determining tax benefit – s. 99

- ▶ Section 99: Situations when tax benefit will be deemed to exist
- ▶ To be read with Section 96, for the purpose of determining whether an arrangement is an ‘impermissible avoidance arrangement’ or not
- ▶ Ignoring corporate structure to decide accrual of tax benefit. Same as clauses (a) to (g) in Section 98.
- ▶ Narrower in scope than s. 98

Application of GAAR – s. 100

- ▶ Section 100: Application of Chapter X-A
 - ▶ “...in addition to, or in lieu of...”
 - ▶ South African GAAR (Section 80I) says “...in the alternative for or in addition to...”
 - ▶ SAAR v. GAAR (Circular dated 27.01.2017 discusses that where SAAR provisions like transfer pricing and LOB clauses in treaties have been applied to remove the scope of an arrangement being treated as an impermissible avoidance arrangement, GAAR would not be invoked.)

Guidelines – s. 101

- ▶ Section 101: Provisions of Chapter X-A subject to guidelines prescribed — Rules 10U to 10C
 - ▶ Chapter X-A to not apply to Foreign Institutional Investors.
 - ▶ Chapter X-A subject to monetary threshold limit of Rs. 3 Crore.

Definitions – s. 102

▶ Section 102: Definitions

▶ Tax benefit:

- reduction of liability, increase of refund etc under the Income-Tax Act and Treaty.
- *'Relevant previous year or any other previous year'*

▶ Other definitions:

- Arrangement
- Step
- Connected person
- Substantial interest

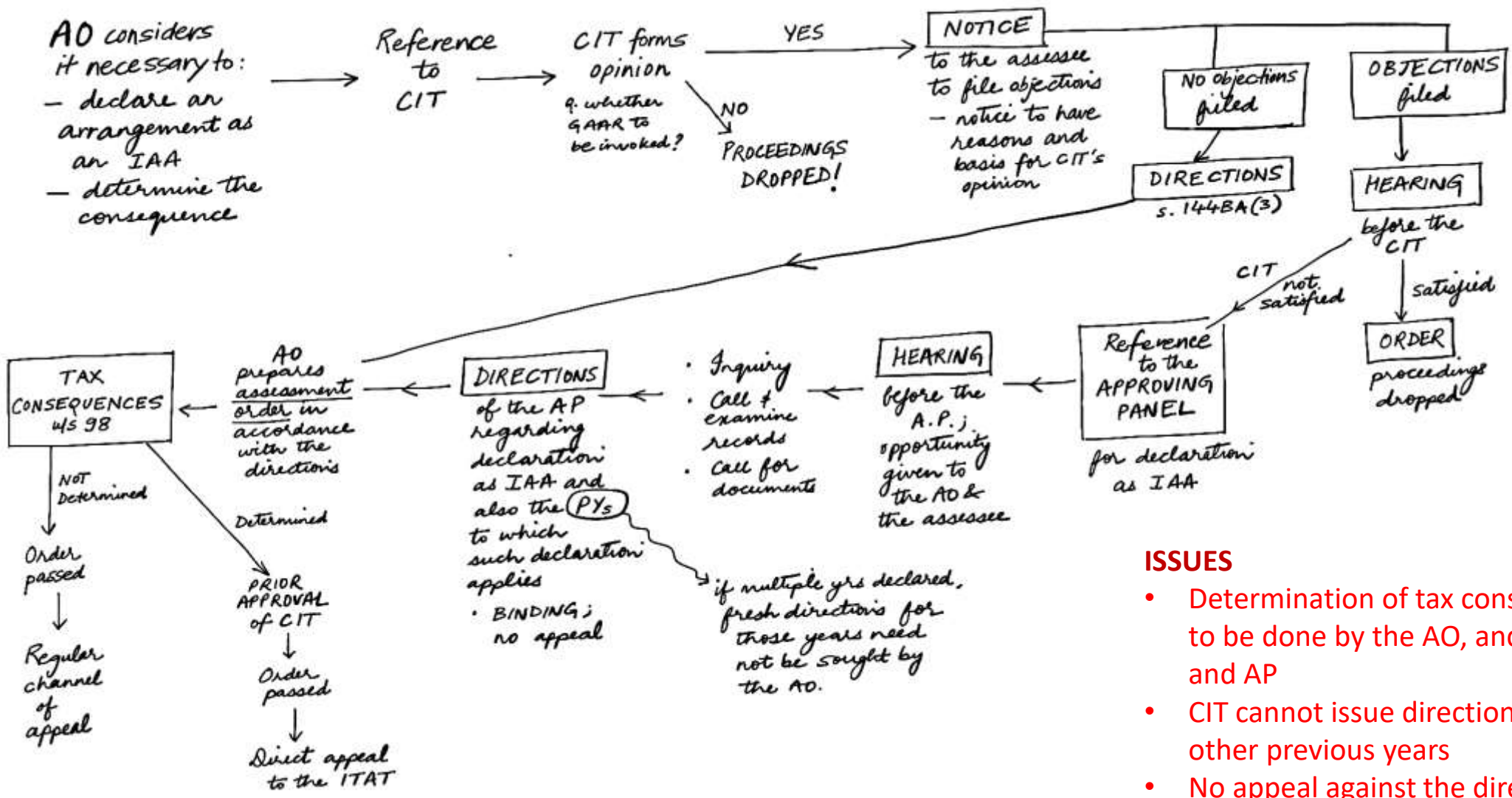
The GAAR Procedure – s. 144BA

- ▶ S. 144BA – Procedure for declaration of arrangement to be impermissible avoidance agreement.
 - ▶ Any stage of assessment proceedings — assessment, reassessment etc.
 - ▶ Assessing Officer(AO) to make reference to CIT — Must provide hearing opportunity to Assessee (Rule 10UB(1))
 - ▶ If CIT agrees with AO — Notice to Assessee
 - ▶ Assessee to file objections – if no objections, CIT to pass order
 - ▶ If assessee objects:
 - CIT satisfied – proceedings dropped
 - CIT not satisfied – referral made to Approving Panel (AP)
 - ▶ AP – opportunity of being heard to assessee and AO – issue directions – within 6 months of receipt of reference from CIT

The GAAR Procedure ... *contd*

- ▶ AP may conduct inquiries, examine record
- ▶ AO, on receipt of directions, shall complete proceedings
- ▶ Directions may relate to other previous years also, than the ones referred to by the AO
- ▶ Tax consequences have to be approved by the CIT
- ▶ Directions to be binding
- ▶ No appeal against the directions
- ▶ AP shall have powers of the AAR

The GAAR Procedure



ISSUES

- Determination of tax consequences – to be done by the AO, and not the CIT and AP
- CIT cannot issue directions relating to other previous years
- No appeal against the directions of AP

The GAAR Procedure - observations

- ▶ Determination of tax consequences – to be done by the AO
 - ▶ Can CIT and AP determine tax consequences?
- ▶ No appeal against the directions – remedy? writ ?
 - ▶ Order of the AO containing the directions can be challenged? Will that amount to challenging the directions itself?
 - ▶ No appeal – brought in by amendment in 2013

ISSUES AND OBSERVATIONS

- **Rule 10U(1)(d) v. Rule 10U(2)**
- **Court sanctioned arrangements**
- **Other issues**
- **Abuse or misuse of the Act**

Rule 10U(1)(d) vs. Rule 10U(2)

- ▶ Rule 10U(1)(d) states that GAAR provisions shall not apply to – any income arising to any person from transfer of investments made before 01.04.2017 by such person
 - ▶ Circular dated 27.01.2017 states that grandfathering under Rule 10U(1)(d) will be available to investments made before 01.04.2017. It also states that protection would be available to shares brought into existence by splitting or consolidation of holdings, or bonus issuance in respect of shares acquired prior to 01.04.2017.
 - ▶ The Rule should not mean ‘transfer’ to have been made before 01.04.2017 for availing the protection – it means ‘investment’ to have been made before the date – the language of the Circular also clearly shows this as the intent

Rule 10U(1)(d) vs. Rule 10U(2) ... *contd.*

- ▶ Rule 10U(2) states that without prejudice to Rule 10U(1)(d), GAAR provisions shall apply to any arrangement, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after 01.04.2017
 - ▶ Does this mean that though income by transfer of investments would be grandfathered, the GAAR provisions would apply to the arrangement as a whole?
 - ▶ ‘Without prejudice’ is not correct – it could not mean that whatever benefit has been granted by Rule 10U(1)(d) is taken away by Rule 10U(2)
 - ▶ If the ‘tax benefit’ arises post 01.04.2017, it would be covered by GAAR
 - ▶ It does not matter when the arrangement was entered into

Court approved arrangements

- ▶ Purpose of GAAR is to tackle avoidance of tax
- ▶ If a Court has already, after examining with diligence, sanctioned an arrangement, a question arises as to whether GAAR provisions could be invoked or not.
- ▶ Circular dated 27.01.2017 clarifies that where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.
 - ▶ Objections are asked from the tax department by NCLT – if the tax department does not place any objections at all, the Court would not have the opportunity to consider the GAAR implications.

Other Issues - 1

- ▶ Will GAAR provisions have retroactive or retrospective or prospective effect?
 - ▶ Rule 10U(1)(d) and Rule 10U(2) read with Section 95(2): Investments and tax benefit after April 2017 will be covered. Therefore, to some extent there is retrospectivity.
- ▶ Whether GAAR provisions will apply in cases of specific anti-avoidance provisions? Or How will GAAR operate with respect to specific anti-avoidance provisions in Treaty?
 - ▶ GAAR and SAAR can apply simultaneously due to Section 100. Section 95 overrides Section 90 and hence treaty benefits can be overridden.

Other Issues - 2

- ▶ In case where taxpayer escapes the specific anti-avoidance provisions, will GAAR still remain applicable to him/her?
 - ▶ It can be proven that when one has escaped SAAR, there is commercial substance to the arrangement and hence GAAR is inapplicable
- ▶ Does GAAR provisions allow for corresponding adjustments?
 - ▶ Corresponding adjustments will not be allowed as per CBDT Circular.
 - ▶ A wrong view:
 - Fiction once created must be taken to its logical conclusion
 - A provision enacted to prevent a mischief should not create a greater mischief.
- ▶ Appeal against the directions of the Approving Panel
 - ▶ Whether the scheme is similar to that of the DRP – wherein the appeal lies directly against the final assessment order

Other Issues – 3

- ▶ Rule of interpretation to be followed for GAAR provisions
 - ▶ Strict interpretation
 - ▶ Rule of mischief
- ▶ What would be the fate of these cases, were to be decided now?
 - ▶ Vodafone, Sanofi, Calcutta Discount
- ▶ GAAR provisions not penal in nature
 - ▶ Even though the Circular says otherwise
 - ▶ Special provision – for this a special penal section has to be created, which has not been done

Abuse or misuse of the Act - 1

Halifax Plc v. C & E Commrs - [2006] STC 919

- ▶ Bank and associate companies involved in the transaction.
 - ▶ Financial Services – Exempt
 - ▶ Leasing Services - Exempt
- ▶ VAT Groups optional – Associate companies not part of VAT Group.
- ▶ Bank wants to construct call centres – But ITC not available as all output of Bank is exempt.
- ▶ Bank leased the land to associate company which got the call centres contracted and availed the credit.
- ▶ Associate company leased the call centre to Bank's Subsidiary company which in turn leased back to Bank.

Abuse or misuse of the Act - 2

Halifax Plc v. C & E Commrs – [2006] STC 919

▶ Held –

- ▶ The application of Community Legislation cannot be extended to cover abusive practices by economic operators.
- ▶ Transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided by the community law.
- ▶ The tax authorities are entitled to demand, with retrospective effect, repayment of the amounts deducted in relation to each transaction, whenever they find that the right to deduct has been exercised abusively.

Abuse or misuse of the Act - 3

WHA Ltd. v. HMRC - [2013] UKSC 24

- ▶ WHA markets and sell the insurance policies issued by NIG.
 - ▶ Insurance services are exempt from tax and ITC cannot be claimed on repair services and parts.
 - ▶ NIG reinsures the policies from a non-EU based company (A Ltd.) which in turn reinsurers 85% of the policies to another non-EU based company (B Ltd).
 - ▶ WHA supplied claim handling services to B Ltd.
 - ▶ Claim Handling services provided by non-EU company is not taxable.
 - ▶ WHA claimed full ITC of repair services received from garage owners.
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- Both the insurance company and garage owner were in UK. But routing the transaction through non-EU companies, the input tax credit was claimed.
 - Denying the credit held that, although each step of the scheme in question works, the overall effect of the scheme is unacceptable.

Abuse or misuse of the Act - 4

Pendragon Plc v. HMRC – [2015] STC 1825

- ▶ Pendragon was a leading car distributor in UK.
- ▶ It devised a scheme to avail ITC on new cars acquired as demo vehicle, while avoiding payment of output tax on sale of these cars to customers.
- ▶ The benefit was availed of following statutory provisions:
 - ▶ Assignment of Lease agreements and title to goods – Not a supply
 - ▶ Transfer of business as going concern – Not a supply
 - ▶ Sale of second hand cars purchased in transfer of going concern – Tax only on profit margin.

Abuse or misuse of the Act – 5

Pendragon Plc v. HMRC – [2015] STC 1825 – the transaction

- ▶ Pendragon purchased vehicle and sold the same to Captive Leasing Co. (CLC) – Availed ITC and charged output tax. CLC gave the cars on lease to Distributors of Pendragon – CLC availed ITC on cars and charged output tax on leasing.
- ▶ CLC then assigned the agreements along with title to goods to an Offshore Bank.
- ▶ The Offshore Bank transfer the hire business as a going concern to Group Co. of Pendragon.
- ▶ The Group Co. sold the cars to customer by availing the scheme and paying tax only on profit margin.

Held, as the scheme was an abuse of law, it fell to be redefined as a sale and leaseback transaction followed by a sale to customer to which the Second Hand Goods Scheme does not apply.

THANK YOU!