Report on

General Anti Avoidance Rules (GAAR)

in Income-tax Act, 1961

Expert Committee

(2012)

Report on General Anti-Avoidance Rules (GAAR)

INDEX

Executive Summary

Recommendations for Amendments in the Act, Guidelines, and Clarifications through Circular

Countries impose taxes of various types with the objective of raising revenue for Government spending. Taxpayers may be expected to minimize their tax liabilities by arranging their affairs in a manner that is termed tax efficient i.e. through *tax mitigation*. This does not include *tax evasion*. It has been universally accepted that tax evasion through falsification of records or suppression of facts is illegal. Tax reduction through legal means, on the other hand, is increasingly considered a matter of right by taxpayers. The courts also tend not to frown upon this emergent approach of tax payers. This could perhaps be considered a paradigm shift in the approach towards taxability, and has given rise to the grey area of *tax avoidance* which is perceived by tax authorities as strictly legal in form but perhaps not in substance i.e. a business arrangement to avoid tax may not reflect its embedded legislative intent .

Various authorities, have, therefore, felt that tax reduction through unethical means should not be allowed, particularly when effective rates of tax are unduly reduced. This has led to the introduction of anti-avoidance rules in tax statutes across tax jurisdictions internationally. Vide Finance Act, 2012, India introduced the General Anti-Avoidance Rules (GAAR) in the Income-tax Act, 1961. These GAAR provisions were analyzed and, based on inputs received from various stakeholders, a number of recommendations are being made by the present Committee. The recommendations are for amendment in the Act, for guidelines to be prescribed under Income-tax Rules, 1962, and for clarifications and illustrations through circular. They are summarized in these categories as under.

1 Recommendations for amendments in the Income-tax Act, 1961

The Committee makes the following recommendations for amendment in the Act-

(i) The implementation of GAAR may be deferred by three years on administrative grounds. GAAR is an extremely advanced instrument of tax administration – one of deterrence, rather than for revenue generation – for which intensive training of tax officers, who would specialize in the finer aspects of international taxation, is needed. The experience with international taxation such as transfer pricing, as well as the thin training module in specialized fields for Indian tax officers, increasingly in contrast to international benchmarked modules, tends to result in administrative challenges, as strongly pointed out by most stakeholders. This does not guarantee that an environment of certainty can be regenerated with an immediate application of GAAR, however modified. To note, the tax expenditure for not implementing GAAR (after a requisite threshold is applied) would be minimal. Hence GAAR should be deferred for 3 years. But the year, 2016-17, should be announced now. In effect, therefore, GAAR would apply from A.Y. 2017-18. Pre-announcement is a common practice internationally, in today's global environment of freely flowing capital.

(ii) Abolish the tax on gains arising from transfer of listed securities, whether in the nature of capital gains or business income, to both residents as well as non-residents.

(iii) The Act should be amended to provide that only arrangements which have the main purpose (and not one of the main purposes) of obtaining tax benefit should be covered under GAAR.

(iv) Section 97 of the Act should be amended to include a definition of "commercial substance" as under –

> *"An arrangement shall be deemed to be lacking commercial substance, if it does not have a significant effect upon the business risks, or net cash flows, of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained but for the provisions of this Chapter."*

(v) The definition of "connected person" may be restricted to "associated person" under section 102 and "associated enterprise" under section 92A.

(vi) The section 97(2) may be amended to provide that the following factors:

> (i) the period or time for which the arrangement (including operations therein) exists;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;

(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement,

are relevant but may not be sufficient to prove commercial substance. These factors will be taken into account in forming a holistic assessment to determine whether an arrangement lacks commercial substance.

(vii) As regards constitution of the Approving Panel(AP), the Committee recommends that –

(i) The Approving Panel should consist of five members including Chairman;

(ii) The Chairman should be a retired judge of the High Court;

(iii) Two members should be from outside Govt. and persons of eminence drawn from the fields of accountancy, economics or business, with knowledge of matters of income-tax; and

(iv) Two members should be Chief Commissioners of income tax; or one Chief Commissioner and one Commissioner.

The AP should be a permanent body with a secretariat. It should have a two year term. In the first AP that is to be appointed, one Chief Commissioner and one external member from a specified field would be appointed to a one-year term. This should ensure an overlap among members in future AP's. If there is any need for further representation from particularly specialized fields, an updated roster of specialists should be maintained from which any additional member, may be drawn in an individual GAAR case.

A decision of the AP should occur by a majority of members.

2 Recommendations for guidelines to be prescribed under Income-tax Rules

The Committee makes the following recommendations for incorporation in guidelines to be prescribed under section 101 and 144BA of the Act in the Income-tax Rules, 1962 –

(i) The GAAR provisions should be subject to an overarching principle that –

(1) Tax mitigation should be distinguished from tax avoidance before invoking GAAR.

(2) An illustrative list of tax mitigation or a negative list for the purposes of invoking GAAR, as mentioned below, should be specified-

(i) Selection of one of the options offered in law. For instance –

(a) payment of dividend or buy back of shares by a company

(b) setting up of a branch or subsidiary

(c) setting up of a unit in SEZ or any other place

(d) funding through debt or equity

(e) purchase or lease of a capital asset

(ii) Timing of a transaction, for instance, sale of property in loss while having profit in other transactions

(iii) Amalgamations and demergers (as defined in the Act) as approved by the High Court.

(3) GAAR should not be invoked in intra-group transactions (i.e. transactions between associated persons or enterprises) which may result in tax benefit to one person but overall tax revenue is not affected either by actual loss of revenue or deferral of revenue.

(4) GAAR is to be applicable only in cases of abusive, contrived and artificial arrangements.

(ii) A monetary threshold of Rs 3 crore of tax benefit (including tax only, and not interest etc) to a taxpayer in a year should be used for the applicability of GAAR provisions. In case of tax deferral, the tax benefit shall be determined based on the present value of money.

(iii) All investments (though not arrangements) made by a resident or non-resident and existing as on the date of commencement of the GAAR provisions should be grandfathered so that on exit (sale of such investments) on or after this date, GAAR provisions are not invoked for examination or denial of tax benefit.

(iv) Where SAAR is applicable to a particular aspect/element, then GAAR shall not be invoked to look into that aspect/element. Similarly, where anti-avoidance rules are provided in a tax treaty in the form of limitation of benefit (as in the case of Singapore) etc., the GAAR provisions shall not apply overriding the treaty.

(v) Where only a part of the arrangement is impermissible, the tax consequences of an "impermissible avoidance arrangement" will be limited to that portion of the arrangement.

(vi) While determining the tax consequences of an impermissible avoidance arrangement, corresponding adjustment should be allowed in the case of the same taxpayer in the same year as well as in different years, if any. However, no relief by way of corresponding adjustment should be allowed in the case of any other taxpayer.

(vii) A requirement of detailed reasoning by the Assessing Officer in the show cause to the taxpayer may be prescribed in the rules.

(viii) The tax audit report may be amended to include reporting of tax avoidance schemes above a specific threshold of tax benefit of Rs. 3 crores or above.

(ix) The following statutory forms need to be prescribed:-

a. For the Assessing Officer to make a reference to the Commissioner u/s 144BA(1) (Annexe-8)
b. For the Commissioner to make a reference to the Approving Panel u/s 144BA(4) (Annexe-9)
c. For the Commissioner to return the reference to the Assessing Officer u/s 144BA(5) (Annexe-10)

(x) The following time limits should be prescribed that -

i) in terms of section 144BA(4), the Commissioner (CIT) should make a reference to the Approving Panel within 60 days of the receipt of the objection from the assessee with a copy to the assessee;

ii) in the case of the CIT accepting the assessee's objection and being satisfied that provision of Chapter X-A are not applicable, the CIT shall communicate his decision to the AO within 60 days of the receipt of the assessee's objection as prescribed under section 144BA(4) r.w.s. 144BA(5)with a copy to the assessee.

iii) no action u/s 144BA(4) or 144BA(5) shall be taken by the CIT after a period of six months from the end of the month in which the reference under sub-section 144BA(1) was received by the CIT and consequently GAAR cannot be invoked against the assessee.

3 Recommendations for clarifications and illustrations through circular

The GAAR provisions in the statute as well in the rules should be explained through a circular as discussed in the report with categorical clarification on the following issues:-

(i) GAAR shall apply only to the income received, accruing or arising, or deemed to accrue or arise, to the taxpayers on or after the date GAAR provisions come into force. In other words, GAAR will apply to income of the previous year, relevant to the assessment year in which GAAR becomes effective, and subsequent years.

(ii) Where Circular No. 789 of 2000 with respect to Mauritius is applicable, GAAR provisions shall not apply to examine the genuineness of the residency of an entity set up in Mauritius.

(iii) When the AO informs the assessee in his initial intimation invoking GAAR, he should include how the factors listed in section 97(2) have been considered (after amendment as recommended).

4 Other recommendations

The Committee has made following recommendations in respect of tax administration:-

(i) The administration of Authority for Advance Ruling (AAR) should be strengthened so that an advance ruling may be obtained within the statutory time frame of six months.

(ii) Until the abolition of the tax on transfer of listed securities, the Circular 789 of 2000 accepting Tax Residence Certificate (TRC) issued by the Mauritius authorities may be retained.

(iii) while processing an application under section 195(2) or 197 of the Act, pertaining to the withholding of taxes, the assessing officer

> (a) shall not invoke GAAR where the taxpayer submits a satisfactory undertaking to pay tax along with interest in case it is found that GAAR provisions are applicable in relation to the remittance during the course of assessment proceedings; or
>
> (b) may invoke GAAR with the prior approval of Commissioner in his detailed reasoned order u/s 195 (2) or 197, in case the taxpayer does not submit any satisfactory undertaking as mentioned above.

(iv) To minimize the deficiency of trust between the tax administration and taxpayers, concerted training programmes should be initiated for all AO's placed, or to be placed, in the area of international taxation, to maintain officials in this field for elongated periods as in other countries, to place on the intranet details of all GAAR cases in an encrypted manner to comprise an additive log of guidelines for future application.

It would be perspicacious as indicated above, for Govt. to postpone the implementation of GAAR for three years with an immediate pre-announcement of the date to remove uncertainty from the minds of stakeholders. A longer period of preparation should enable appropriate training at the AO and Commissioner levels. It would also enable taxpayers to plan for a change in the anti-avoidance regime that would allow legitimate tax planning reflecting a proper understanding of the new legislation and guidelines, while eschewing dubious tax avoidance arrangements.

General Anti-Avoidance Rules (GAAR)

1. Introduction

1.1 Terms of Reference of the Committee

The Prime Minister constituted an Expert Committee on General Anti Avoidance Rules (GAAR) to undertake stakeholder consultations and finalise the guidelines for GAAR after widespread consultations so that there is a greater clarity on GAAR issues. A copy of the Notification is appended. The Expert Committee consists of:

1) Dr. Parthasarathi Shome - Chairman

2) Shri N. Rangachary, former Chairman, IRDA - Member

3) Dr. Ajay Shah, Professor, NIPFP - Member

4) Shri Sunil Gupta, Joint Secretary, Tax Policy & Legislation, Department of Revenue - Member

The terms of reference of the Committee are:

i) Receive comments from stakeholders and the general public on the draft GAAR guidelines which have been published by the Government on its website.

ii) Vet and rework the guidelines based on this feedback and publish the second draft of the GAAR guidelines for comments and consultations.

iii) Undertake widespread consultations on the second draft GAAR guidelines.

iv) Finalise the GAAR guidelines and a roadmap for implementation and submit these to the government.

The Committee is mandated to work to the following time schedule:

i) Receive comments from stakeholders and general public till end-July 2012.

ii) Vet and rework the guidelines based on this feedback and publish the second draft GAAR guidelines by 31 August 2012.

iii) Finalise the GAAR guidelines and a roadmap for implementation and submit these to the government by 30 September 2012.

1

F. No.A.50050/95/2012-Ad.I
Government of India
Ministry of Finance
Department of Revenue
*****

New Delhi Dated 17th July, 2012

OFFICE MEMORANDUM

Sub.:- Constitution of an Expert Committee on GAAR to undertake stakeholder consultations to finalize the guidelines for General Anti Avoidance Rule (GAAR)- Reg.

*****

An Expert Committee on GAAR has been constituted with the approval of the Prime Minister to undertake stakeholder consultations and finalise the guidelines for General Anti Avoidance Rule (GAAR). This Committee would manage the consultation process and finalise the draft GAAR Guidelines. The Expert Committee consist of the following persons:-

(i)	Dr. Parthasarathi Shome	-	Chairman
(ii)	Shri N. Rangachary, former Chairman, IRDA & CBDT	-	Member
(iii)	Dr. Ajay Shah, Professor, NIPFP	-	Member
(iv)	Shri Sunil Gupta, Joint Secretary, Tax Policy & Legislation, Deptt. of Revenue	-	Member

The terms of reference of the Committee is to.-

(i) Receive comments from stakeholders and the general public on the draft GAAR guidelines which have been published by the Government on its website.
(ii) Vet and rework the guidelines based on this feedback and publish the second draft of the GAAR guidelines for comments and consultations.
(iii) Undertake widespread consultations on the second draft GAAR guidelines.
(iv) Finalise the GAAR guidelines and a roadmap for implementation and submit these to the Government.

(2)

The Committee will work to the following time schedule.-

(i) Receive comments from stakeholders and general public till end – July 2012.

(ii) Vet and rework the guidelines based on this feedback and publish the second draft GAAR guidelines by 31 August, 2012.

(iii) Finalise the GAAR guidelines and a roadmap for implementation and submit these to the Government by 30 September, 2012.

2. The Department of Revenue shall provide all necessary support to the Expert Committee to facilitate its work including office assistance and assistance to facilitate consultations.

3. The non-official members of the Committee shall be allowed travelling allowance and daily allowance as admissible to the Secretary to the Government of India.

(M.L. Meena)
Joint Secretary to the Government of India

Copy to:

(i) Dr. Parthasarathi Shome.
(ii) Shri N. Rangachary, former Chairman, IRDA & CBDT.
(iii) Dr. Ajay Shah, Professor, NIPFP.
(iv) Shri Sunil Gupta, Joint Secretary (TPL), Deptt. of Revenue.
(v) Joint Secretary, ES-I, PMO.
(vi) PPS to Finance Secretary.
(vii) PPS to Chairman (CBDT).

(M.L. Meena) 17.7.12.
Joint Secretary to the Government of India

1.2 Background

GAAR has been received poorly in India due to the somewhat more stringent versions put out by Govt. between 2009-12 (see Annexe-1 for a comparison)[1] as well as the perceived lack of adequate consultation with stakeholders even though there was some accommodation of stakeholders concerns.[2] International practice on GAAR has generally comprised review and analysis by experts, wide ranging discussions with stakeholders, and caution and perspicacity in its introduction and implementation. As India opens up its economy, it has to make its administrative processes, in particular its tax administration, internationally comparable. Without that, invoking modern and benchmarked control instruments are likely to be misinterpreted and misused, vitiating the objectives of equity and revenue productivity in taxation.

At the outset, therefore, it may be helpful to note an ongoing international process to introduce a GAAR, that of the UK. To put the matter in context, one should not refrain from recognizing that India has closely followed UK's principles and judicial pronouncements on such issues for a century while taking a different view wherever appropriate. However, India's 2012 GAAR draft guidelines cannot be said to have resembled UK's GAAR process. The UK has spent approximately four years in its GAAR consultation process. In India, GAAR as an instrument itself became clubbed with the matter of the Revenue Department's (henceforth, the Revenue) countering the Supreme Court's view by way of retrospective taxation through Finance Act 2012. GAAR, in conjunction with retrospective taxation, has thus generated world-wide opprobrium not only against the unpredictable approach to administration of the Indian tax authorities but also of policy makers who enact laws. The outcome is a widely held view that India is not a good place for investment at the moment.

With this backdrop, three useful points may be noted -

- The Indian government (henceforth Govt.) has no problem with tax *mitigation* by which is implied the use of tax incentives in not only a legal, but also transparent, manner by means of legitimate tax planning with the objective of achieving what tax professionals term

[1] For example tax benefit being the 'main purpose' was converted to 'main purpose' or, one of the main purposes.

[2] For example later versions shifted the onus of proof from taxpayer to the tax administration, advance ruling and a threshold were provided.

"tax efficiency". Instead, Govt's intention is to target tax *avoidance* which is technically legal (in that it is not *evasion* which is illegal) but may represent tax planning with the sheer objective of obtaining a tax benefit without any supporting justification in terms of commercial, economic or business purpose. The determination of this separation of objectives comprises a crucial challenge in modern global practices in designing complex corporate structures with good or bad motives.

Hence GAAR may be necessary to incisively analyse and detect the purpose of a business structure. The UK's proposed target is egregious, aggressive, highly abusive, contrived, and artificial arrangements, thus truncating the scope of GAAR arrangements. It is narrower in scope than India's which is misuse or abuse (section 96(1). In essence, the outcome of UK's consultation process has been to opt for a model that will be applied only in exceptional cases where there is clear evidence of an extremely aggressive arrangement to escape tax.

- India has not defined <u>commercial</u> *substance,* an essential term in the context of GAAR. This was included in the original version of Direct Tax Code (DTC) of 2009 and 2010, but was omitted in the 2012 version. <u>This would be reinstated.</u> India has provided illustrative examples that have been considered insufficient or confusing by stakeholders. This is addressed by the current Committee which has modified, and has provided more, illustrations on the basis of its consultations.

- UK's GAAR was formulated, drafted and recommended by an independent panel, representing good practice. In India, the GAAR guidelines were formulated by a Departmental Committee. While there were some consultations, India's consultations on GAAR drafts were deemed to be insufficient by stakeholders. This Committee has attempted to carry out in-depth consultations within the time period allotted to it. A list of meetings is provided in Annexe-2 while Annexe-3 lists the documents examined.

A short description of the process undertaken by the UK appears in Annexe-4 which details prevailing practices on GAAR in selected countries including Australia, Canada, South Africa and the United States. It is crucial for India to balance, on the one hand, the concerns of revenue by protecting the tax base from erosion with, on the other, high compliance costs of taxpayers as well as the uncertainty in the overall investment environment that instability in tax legislation and practice create.

The Committee considered the process of consultation as a mainstay of its task. It undertook intensive consultations with stakeholders. It also received written representation from a number of stakeholders including professionals in tax advisory work, chambers of commerce and industry, foreign investor associations, industrialists, and policy makers.

Based on inputs from consultations received in writing as well as orally, and applying its own views on each matter, the Committee has formulated its draft report. It must be mentioned, as will be seen from its recommendations, the Committee viewed that an appropriate implementation of GAAR should require selected legislative changes. It has not desisted, therefore, from making such recommendations. The Report follows.

2. Tax Evasion, Tax Mitigation and Tax Avoidance

Tax mitigation is a situation where the taxpayer uses a fiscal incentive available to him in the tax legislation by submitting to the conditions and economic consequences that the particular tax legislation entails. An example of tax mitigation is the setting up of a business undertaking by a taxpayer in a designated area such as a Special Economic Zone (SEZ). In such a case the taxpayer is taking advantage of a fiscal incentive offered to him in the SEZ provisions in the Income-tax Act e.g., setting up the business only in the SEZ areas and exporting from the SEZ area. Tax mitigation is, thus, allowed under the tax statute.

Tax avoidance, on the other hand, is by and large not defined in taxing statutes. Tax avoidance is, nevertheless, the outcome of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law as such. International literature, on the subject tends to describe it as :

- Tax avoidance involves the legal exploitation of tax laws to one's own advantage.
- Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions in the law…it presupposes the existence of alternatives, one of which would result in less tax than the other… except where the taxpayer adopts the same course for business or personal reasons.[3]
- An arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.[4]

Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. They are routinely supported in their approach by UK's common law courts.[5] However, tax authorities internationally consider aggressive tax planning schemes by taxpayers to erode the tax base unnaturally, particularly when effective rates of tax diminish significantly. Several countries have, therefore, legislated to prevent tax avoidance in various ways (Annexe-4).

[3] Royal Commission on Taxation (Carter Commission), 1966.
[4] Taxation Review Committee (Asprey Committee), 1975
[5] IRC v Duke of Westminster (1936)

Tax evasion is unlawful and is the result of illegality, suppression, misrepresentation and fraud.

Tax avoidance could seriously undermine horizontal equity in taxation and result in wide variation in the tax burdens of comparable taxpayers, as well as affect vertical equity adversely among differently placed businesses. Abusive tax avoidance erodes revenue collection. Sectors that provide a greater opportunity for tax avoidance tend to cause distortions in the allocation of resources. Therefore, there is a strong view in the literature on tax policy that tax avoidance through artificial structures, is economically undesirable. Thus, on considerations of economic efficiency, fiscal justice, and revenue productivity, a taxpayer should not be allowed to use legal structures or transactions exclusively to avoid tax.

In the past, the response to tax avoidance has been through 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 have appeared. The problem has been compounded by tax avoidance arrangements spanning multiple tax jurisdictions.

While introducing the GAAR provisions in the Income-tax Act, it was mentioned in the Explanatory Memorandum to the Finance Bill 2012, that the question of substance over form has consistently arisen in the implementation of taxation laws. In the Indian context, judicial decisions have varied on this. While some courts in certain circumstances have held that legal form of transactions can be dispensed with and the real substance of transaction should be considered while applying the taxation laws, others have held that form is to be given sanctity in the absence of specific or general anti-avoidance rules in the statute.

There are specific anti-avoidance provisions, as indicated earlier, but avoidance methods other than through specific rules, remain unaddressed except through judicial decisions. In a regime of moderate rates of tax, it is necessary that the correct tax base be subjected to tax and that aggressive tax planning be countered. Internationally, selected countries have codified the "substance over form" doctrine in the form of General Anti Avoidance Rule (GAAR) and are administering statutory GAAR provisions (Annexe-4).

In the Indian case, GAAR has, therefore, been enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form. Transactions have to be real and are not to be looked at in isolation. The fact that they are legal, does not imply that they are acceptable with reference to the underlying meaning embedded in the fiscal statute. Thus, where there is no business purpose except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have comprised part of jurisprudence in direct tax laws as reflected in various judicial decisions. The GAAR provisions codify this 'substance' over 'form' basis of the tax law. It is, therefore, necessary and desirable to introduce a general anti-avoidance rule which will serve as a deterrent against such practices. An overview of the current specific anti-avoidance rules in the Act is presented in Annexe-5.

The basic critique of a statutory GAAR which is raised worldwide is that it provides wide discretion and authority to the tax administration which can cast an excessive tax and compliance burden on the taxpayer without commensurate remedies. This has to be addressed by providing adequate safeguards. In the case of India, the matter of consultation and authority needs to be considered with due diligence, together with the adequacy of use of the new instruments recently made available to the tax administration such as transfer pricing and Large Taxpayer Units (LTUs). In other words, the prevailing state of preparedness of tax officers needs to be correctly assessed for taking up challenges in the implementation of additional emerging, complex aspects of international and domestic taxation, in a manner commensurate with international practice.

3. GAAR Provisions : Analysis and Recommendations

3.1 Applicability of General Anti-Avoidance Rule

The provisions relating to GAAR appear in Chapter X-A (sections 95 to 102) of the Act. Section 95 reads as under –

> *"95. Notwithstanding anything contained in the Act, an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising therefrom may be determined subject to the provisions of this Chapter.*
>
> *Explanation.—For the removal of doubts, it is hereby declared that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement."*

The section starts with a non-obstante clause which means, if there is a conflict with provisions, in other sections, then those of this section shall prevail over other conflicting provisions. The provisions allow the tax authority to, notwithstanding anything contained in the Act, declare an 'arrangement' which an assessee has entered into, as an 'impermissible avoidance arrangement'. Once an 'arrangement' has been declared as an 'impermissible avoidance arrangement', the consequence as regards tax liability would also be determined.

The term "arrangement" has been defined in section 102 as under-

> *'(1) "arrangement" means any step in, or a part or whole of, any transaction, operation, scheme, agreement or understanding, whether enforceable or not, and includes the alienation of any property in such transaction, operation, scheme, agreement or understanding;'*

Thus, the term arrangement covers not only a scheme but also a transaction, operation, agreement or understanding. It also includes alienation of any property in all the aforesaid activities. The term impermissible arrangement is defined in section 96 of the Act.

3.2 Impermissible avoidance arrangement.

The phrase "impermissible avoidance arrangement" has been defined under section 96(1) as under –

"96. (1) An impermissible avoidance arrangement means an arrangement, the <u>main purpose or one of the main purposes</u> of which is to obtain a tax benefit and it—

(a) creates rights, or obligations, which are <u>not</u> ordinarily created between persons dealing <u>at arm's length</u>;

(b) results, directly or indirectly, in the <u>misuse, or abuse</u>, of the provisions of this Act;

(c) <u>lacks commercial substance</u> or is deemed to lack commercial substance under section 97, in whole or in part; or

(d) is entered into, or carried out, by means, or in a manner, which are <u>not</u> ordinarily employed <u>for bona fide purposes</u>."

The <u>purpose test of obtaining tax benefit</u> and <u>tainted element test as under clauses (a) to (d) above</u> are twin conditions that satisfy an 'impermissible avoidance arrangement'. The purpose test requires that the main purpose or one of the main purposes is to obtain <u>tax benefit</u>. The term, tax benefit, has been defined in section 102 as under -

(11) "tax benefit" means—

(a) a reduction or avoidance or deferral of tax or other amount payable under this Act; or

(b) an increase in a refund of tax or other amount under this Act; or

(c) a reduction or avoidance or deferral of tax or other amount that would be payable under this Act, as a result of a tax treaty; or

(d) an increase in a refund of tax or other amount under this Act as a result of a tax treaty; or

(e) a reduction in total income including increase in loss,

in the relevant previous year or any other previous year.

The term “benefit” has also been defined under section 102 as under –

> *‘(4) "benefit" includes a payment of any kind whether in tangible or intangible form;’*

An analysis of these two definitions show that –

(i) the term benefit has always been used as in the phrase “tax benefit” except in section 98 as “a benefit under a tax treaty”, which implies the tax benefit only;. Hence, there is no need to define “benefit” separately;

(ii) tax benefit includes not only tax but also other payments which could be interest, penalty etc.;

(iii) tax benefit also means reduction in total income;

(iv) tax benefit also includes deferral of tax liability even if there is no reduction of tax liability of all years taken together;

(v) use of the phrase “increase in loss” suggests the intention to include potential loss of revenue.

It has been pointed out by stakeholders that the original version of GAAR in DTC 2009 and DTC 2010, the purpose test required that the main purpose of the arrangement was to obtain tax benefit. However, the GAAR provisions introduced through Finance Act, 2012 provides for “main purpose or one of the main purposes is to obtain tax benefit”. Though initially only those arrangements were covered under GAAR where the most predominant purpose was to obtain tax benefit this has been diluted in the recent version of GAAR as there could be many dominant purposes of an arrangement and to obtain tax benefit is one of such purposes Then also GAAR can be invoked even if obtaining tax benefit is not the most predominant or the sole purpose of the arrangement. It was suggested that the provisions as per original DTC 2009 may be restored so that only the arrangements which have the main purpose or the most dominant purpose to obtain tax benefit should be covered under GAAR.

In view of the above, the Committee recommends that the Act may be amended to provide that only arrangements which have the main purpose (and not one of the main purposes) of obtaining tax benefit should be covered under GAAR.

The "tainted element" test requires that the arrangement should have one or more specified tainted elements mentioned at clauses (a) to (d) above.

The first tainted element refers to non-arm's length dealings where an arrangement creates rights and obligations, which are not normally created between parties dealing at arm's length. As there are specific transfer pricing regulations (SAAR) applicable to international transactions and certain specified domestic transactions, this tainted element is to be examined only in those transactions which are not covered by TP regulations and where the main purpose of the arrangement is to obtain tax benefit. As current transfer pricing regulations are applicable to international transactions and some specified domestic transactions, a mechanism needs to be provided for the Assessing Officer (AO) to ascertain whether rights, or obligations, created in an arrangement are the same as ordinarily created between persons dealing at arm's length. He should be able to seek expert opinion in this regard from the Transfer Pricing Officer (TPO). For instance, refer to illustration 22 in section 4 of the report.

The second tainted element refers to an arrangement which results in misuse or abuse of the provisions of the tax law. It implies cases where the law is followed in letter or form but not in spirit or substance, or where the arrangement results in consequences which are not intended by the legislation, revealing an intent to misuse or abuse the law. For instance, refer to illustration 15 in section 4 of the report.

The third tainted element refers to an arrangement which lacks commercial substance or is deemed to lack commercial substance. It is discussed in detail in the next section.

The fourth element refers to an arrangement which is carried out in, or by means of, a manner which is normally not employed for a bona fide purpose. In other words, it means an arrangement that possesses abnormal features. This is not a purpose test but a manner test. For instance, refer to illustration 24 in section 4 of the report.

Concerns have been raised that section 96(2) provides that an arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit, notwithstanding the fact that the main purpose of the whole arrangement is not to obtain a tax benefit. In view of this provision, where only a part of the arrangement is to obtain a tax benefit even if the whole arrangement is permissible, the whole arrangement may be treated as an impermissible arrangement.

In order to allay the apprehensions of taxpayers in this regard, the Committee recommends that it should be clarified that, where only a part of the arrangement is impermissible, the tax consequences of an "impermissible avoidance arrangement" will be limited to that portion of the arrangement.

3.3 Arrangement lacking commercial substance

The phrase "arrangement to lack commercial substance" has not been defined. It is noted that earlier version of GAAR in the DTC Bill 2009 and 2010 defined the commercial substance as under –

> *"an arrangement shall be deemed to be lacking commercial substance if it does not have a significant effect upon the business risks, or net cash flows, of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained but for the provisions of section…"*
>
> *It implies that besides having a commercial purpose, the taxpayer should also have commercial substance in the arrangement, which mean change in economic position of the taxpayer by altering the business risks or net cash flow to him.*
>
> *The Committee recommends that above generic definition of commercial substance may be introduced in GAAR provisions by way of amendment of the Act.*
>
> *Under section 97, certain arrangements have been deemed to lack commercial substance as under -*
>
> *(a) 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; or*
>
> *(b) it involves or includes—*

(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; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

Clause (a) is the codification of substance v. form doctrine. It implies that where substance of an arrangement is different from what is intended to be shown by the form of the arrangement, then tax consequence of a particular arrangement should be assessed based on the "substance" of what took place. In other words, it reflects the inherent ability of the law to remove the corporate veil and look beyond form.

Item (i) of clause (b) deems an arrangement, which includes round tripping of funds, to lack commercial substance. The phrase "round trip financing" has been further defined as under –

"(2) For the purposes of sub-section (1), round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter),

without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received."

Refer to illustration 7 in section 4 of the report.

Item (ii) of clause (b) deems an arrangement which includes an accommodating party to lack commercial substance. The phrase "accommodating party" has been further defined as under –

"(3) For the purposes of this Chapter, a party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement."

It means that where a party is included in an arrangement mainly for obtaining tax benefit to the taxpayer, then such party may be treated as an accommodating party and consequently the arrangement shall be deemed to lack commercial substance. Also, it is not necessary that such party should be connected to the taxpayer.

Item (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

Item (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance. In other words, such arrangements have an element of deceit as regards funds. Refer to illustration no 5B in section 4 of the report.

Clause (c) deems an arrangement to lack commercial substance where it involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose. It means if a particular location is selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance. Refer to illustrations 7, 10 and 11 in section 4 of the report.

In sub-section (4), the following factors are not considered relevant for determining whether an arrangement lacks commercial substance, namely—

(i) the period or time for which the arrangement (including operations therein) exists;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;

(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

Stakeholders raised serious doubts regarding ignoring the attributes of an arrangement in sub section (4) since they tend to reflect the intentions, bonafide or otherwise, behind an arrangement. Their view is relevant and discussed later in para 3.17.

It should be clarified through legislative amendment that factors (i) to (iii) in section 97(4) of the Act are not sufficient (instead of being totally irrelevant) for an arrangement to be excluded from the commercial substance test but may be relevant in the consideration of other aspects of GAAR.

3.4 Consequence of impermissible avoidance arrangement

As per section 98(1), if an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence may be determined in such manner as is deemed appropriate in the circumstances of the case. Certain illustrations of the manner have been provided, namely:—

(a) disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement;

(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;

(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

(d) 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;

(e) reallocating amongst the parties to the arrangement—

(i) any accrual, or receipt, of a capital or revenue nature; or

(ii) any expenditure, deduction, relief or rebate;

(f) treating—

(i) the place of residence of any party to the arrangement; or

(ii) the situs of an asset or of a transaction,

at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

It has also been provided that –

(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 recharacterised.

3.5 Treatment of connected persons and accommodating party.

As per section 99, for the purposes of Chapter X-A, in determining whether a tax benefit exists—

(i) the parties who are connected persons in relation to each other may be treated as one and the same person;

(ii) any accommodating party may be disregarded;

(iii) such accommodating party and any other party may be treated as one and the same person;

(iv) the arrangement may be considered or looked through by disregarding any corporate structure.

The term tax benefit has been defined to include such benefit to any person who is connected directly or indirectly to another person and includes associated person. Concerns have been raised that the definition of "connected person" u/s 102(5) is too broad and ambiguous. A committee under DGIT (IT) had recommended that it may be clarified that -

> "Connected person" would include the definition of "associated enterprise" given in section 92A, the definition of 'relative' in section 56 and the "persons" covered u/s 40A(2)(b).

The clarification, instead of restricting the scope of the term, effectively broadened it. Moreover, 'relative' in section 56 and the "persons" covered u/s 40A(2)(b) are already covered in the definition of associated person under section 102.

In view of the above, the Committee recommends that the definition of connected person may be restricted only to "associated person" under section 102 and "associated enterprise" under section 92A.

3.6 Application of Chapter

As per section 100, the provisions of Chapter X-A shall apply in addition to, or in lieu of, any other basis for determination of tax liability.

3.7 Framing of guidelines

As per section 101, the provisions of Chapter X-A shall be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed.

3.8 Treaty Override

Sections 90 and 90A of the Act provide the legal authority to the executive for entering into an agreement for avoidance of double taxation (DTAA) with another country or specified territory. Sub-section (2) of these sections provide that a taxpayer may choose any provision between domestic law and DTAA whichever is more beneficial. Thus, tax treaties have an overriding status over domestic law.

The aforesaid benefit is restricted to the taxpayer for invoking GAAR by insertion of subsection (2A) through amendment in Act as under –

> *"(2A) Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee, even if such provisions are not beneficial to him."*

This insertion has raised the ire of foreign investors and generated an atmosphere of deep uncertainty. Later in the Report, the Committee has recommended to refrain from treaty override where the treaty itself addresses the issue of tax avoidance.

3.9 Advance Ruling

An advance ruling can be obtained in relation to tax liability of a non-resident arising from a transaction to be undertaken from the Authority for Advance Ruling (AAR). This benefit is not available to a resident. Moreover, the AAR is precluded from giving any advance ruling where it involves any tax avoidance scheme.

By amendment of the Act through Finance Act, 2012, any resident or non-resident may approach AAR for determination whether an arrangement to be undertaken by him is an impermissible avoidance arrangement or not.

Concerns were raised by the stakeholders on delay in obtaining advance ruling. The statute provides a time limit of 6 months but rarely any ruling is obtained in time.

The Committee, therefore, recommends that the administration of AAR should be strengthened so that ruling may obtained within the time frame of 6 months.

3.10. Procedural GAAR provisions

3.10.1 Procedure to invoke GAAR

The procedure for invoking GAAR is provided under section 144BA as under:-

(i) The Assessing Officer (AO) shall make a reference to the Commissioner (CIT) for invoking GAAR and on receipt of reference the Commissioner (CIT) shall hear the taxpayer and if he is not satisfied by the reply of taxpayer and is of the opinion that GAAR provisions are to be invoked, he shall refer the matter to an Approving Panel (AP). In case the assessee does not reply or object, the CIT shall make determination as to whether the arrangement is an impermissible avoidance arrangement or not.

(ii) The AP has to dispose of the reference within a period of six months from the end of the month in which the reference was received from the CIT.

(iii) The AP shall either declare an arrangement to be impermissible or declare it not to be so after examining material and getting further inquiry to be made.

(iv) The AO will determine the consequences of a positive declaration of arrangement as impermissible avoidance arrangement.

(v) The final order in case any consequence of GAAR is determined shall be passed by the AO only after approval by the CIT and, thereafter, first appeal against such order shall lie to the Appellate Tribunal.

(vi) The period taken by the proceedings before the CIT and AP shall be excluded from time limitation for completion of assessment.

In addition to the above, it is provided that the Board (CBDT) shall prescribe a scheme for regulating the condition and manner of application of these provisions.

3.10.2 Prescription of statutory forms

Consistency of approach is essential in the procedures for invoking the GAAR provisions. Adequate safeguards should be provided to ensure that principles of natural justice were not violated and there is transparency in the procedures. Therefore, following statutory forms need to be prescribed:-

i) For the Assessing Officer to make a reference to the Commissioner u/s 144BA(1) (Annexe-8)

ii) For the Commissioner to make a reference to the Approving Panel u/s 144BA(4) (Annexe-9)

iii) For the Commissioner to return the reference to the Assessing Officer u/s 144BA(5) (Annexe-10)

3.10.3 Prescribing time limits

There should be absolute certainty about the time limits during which the various actions under the GAAR provisions are to be completed. Some of these time lines have been prescribed under the Act under sections 144BA(1) and 144BA(13). There are remaining actions for which time lines are also needed.

The Committee recommends that it should be prescribed that

i) in terms of section 144BA(4), the Commissioner (CIT) should make a reference to the Approving Panel within 60 days of the receipt of the objection from the assessee with a copy to the assessee;

ii)in the case of the CIT accepting the assessee's objection and being satisfied that provision of Chapter X-A are not applicable, the CIT shall communicate his decision to the AO within 60 days of the receipt of the assessee's objection as prescribed under section 144BA(4) r.w.s. 144BA(5) with a copy to the assessee.

iii) No action u/s 144BA(4) or 144BA(5) shall be taken by the CIT after a period of six months from the end of the month in which the reference under sub-section 144BA(1) was received by the CIT and consequently GAAR cannot be invoked against the assessee.

3.11 Overarching principle for applicability of GAAR

Almost all stakeholders who were consulted (Annexe-2) expressed serious apprehension that GAAR may be widely invoked by the tax administration whenever tax benefit was perceived to have been taken by the taxpayer whether or not it represented tax avoidance. According to them, the provisions were ambiguous and had led to uncertainty. It was feared that GAAR would end in harassment and litigation. For instance, selection of one option out of two or more options offered by law, or the timing of a particular transaction, in itself, may be considered to be tax avoidance. Reference was made several times to the UK experience where an independent study commissioned by HMRC arrived at the view that a broad spectrum GAAR would not be beneficial to the UK system as it may erode the attractiveness of the UK's tax regime to businesses, and therefore suggested a moderate rule which is targeted at arrangements that are contrived and artificial. It was, therefore, submitted to this Committee to take a balanced approach.

It is being generally perceived that GAAR provisions, as currently drawn up, provide for treating an arrangement as an impermissible avoidance arrangement without first examining whether the arrangement is an avoidance arrangement or not. This is particularly important since an avoidance arrangement should be first distinguished from tax mitigation and second, if it is avoidance, whether it may, nevertheless, be permissible. Thus, every case of tax avoidance should not be considered under GAAR unless it is an abusive, artificial and contrived arrangement.

Tax mitigation, as has been explained in Section 2, means an attempt to minimize tax liability by a taxpayer as per the existing law, and it is an intended consequence of the legislation. As there may be a thin line between tax mitigation and tax avoidance, an illustrative list of tax mitigation or a negative list for the purpose of invoking GAAR should be considered. **The negative list, not exhaustive however, should include –**

(i) Selection of one of the options offered in law. For instance –

> **(a) payment of dividend or buy back of shares by a company**
>
> **(b) setting up of a branch or subsidiary**
>
> **(c) setting up of a unit in SEZ or any other place**
>
> **(d) funding through debt or equity**
>
> **(f) purchase or lease of a capital asset**

(ii) Timing of a transaction, for instance, sale of property in loss while having profit in other transactions

(iii) Amalgamations and demergers (as defined in the Act) as approved by the High Court.

(iv) Intra-group transactions (i.e. transactions between associated persons or enterprises) which may result in tax benefit to one

person but overall tax revenue is not affected either by actual loss of revenue or deferral of revenue.

The Committee recommends that

(1) Tax mitigation should be distinguished from tax avoidance before invoking GAAR.

(2) An illustrative list of tax mitigation or a negative list for the purposes of invoking GAAR, as mentioned above, should be specified.

(3) The overarching principle should be that GAAR is to be applicable only in cases of abusive, contrived and artificial arrangements.

3.12 Taxing capital gains and business income; validation of Tax Residence Certificate and Limitation of Benefits clause; and application of GAAR to Large Taxpayer Units

Stakeholders indicated that several countries do not tax gains from the transfer of listed securities. A copy of a chart submitted by stakeholders is enclosed as Annexe-6. They submitted that slowdown in the world economy has impacted investments into India. The FDI inflow in the first quarter of 2012-13 has been less than half as compared to last year. The issue raised was whether India should implement GAAR at this stage, particularly in the context of foreign inward investments.

FIIs make portfolio investments in listed securities as per SEBI guidelines. Currently, all these transactions in listed securities are subject to Securities Transaction Tax (STT). Long term capital gains (on holdings for more than 12 months) are exempt from taxation; and short term capital gains are taxable at 15%. Present revenue from taxation of capital gains from such securities is less than Rs 3000 crore. However, there would be some revenue foregone on account of non-taxation of short term capital gains in the case of FIIs who avail treaty benefit (mainly India-Mauritius and India-Singapore tax treaties).

The tax depends also on the nature of income, whether business profit or capital gains. Thus business income is taxed at 30%. Distinguishing capital gains and business income depends on several factors, and disagreements have resulted in numerous litigation cases between the Revenue and taxpayers. A significant outcome of the present tax regime is that fund managers of foreign investors do not base themselves in India as the presence of fund managers would constitute permanent establishment of such investors in India. Consequently, the business income of foreign investors would be taxed in India. The abolition of tax on portfolio investment may encourage fund managers to shift their bases to India.

In view of the above, the Committee recommends that the Government should abolish the tax on gains arising from transfer of listed securities, whether in the nature of capital gains or business income, to both residents as well as non-residents. In order to make the proposal tax neutral, the Govt may consider to increase the rate of Securities Transaction Tax (STT) appropriately.

While it would make this tax aspect internationally comparable, if Government cannot accept it on political economy grounds, a second best alternative would be to retain, until the abolition of the tax as mentioned above, the Circular accepting Tax Residence Certificate issued by the Mauritius authorities.(See subsection 3.14 below).

3.13 Deferring implementation of GAAR

Stakeholders submitted that implementation of GAAR be deferred by one to five years so that -

(i) The guidelines to be notified would be better understood by both the taxpayers and the income-tax department;

(ii) Ambiguities in the law may be removed by way of amendments;

(iii) Tax administration is more mature for implementation of such law;

(iv) There is a conducive economic environment for application of such law.

The GAAR provisions were introduced in the public domain in 2009 through the first draft of the Direct Taxes Code (DTC). Subsequently, the provisions were introduced in the DTC Bill 2010. The Parliamentary Standing Committee on Finance has had discussions with stakeholders. The Govt. has deferred it by one year from 2012 to 2013. The guidelines could now be notified once this Committee’s report is commented upon and selected comments are incorporated.

As discussed earlier, there has been a paradigm shift in tax policy and countries all over the world have resorted to anti-avoidance rules in their domestic law. In India, introduction of GAAR through Finance Act, 2012 has been taken as a shock by the stakeholders although GAAR has been in public domain for discussion since 2009. Probably, it was due to the challenging economic environment. The market had also not prepared itself for such a measure. There has been serious apprehension about its immediate implementation. Considering the vast discretionary powers to the Revenue, intensive training of officers is needed for a prolonged period, and good care and attention should be focused on setting up appropriate procedures including the Approving Panel and related processes. Time is required for taxpayers to be convinced about this paradigm shift in tax policy and to establish a critical mass of confidence to counter any doubt regarding GAAR.

The Committee recommends that there is a need for deferring the implementation of GAAR by three years on administrative grounds. It needs to be realized that GAAR is an extremely advanced instrument of tax administration – one of deterrence, rather than for revenue generation – for which intensive training of tax officers, who would specialize in the finer aspects of international taxation, is needed. The experience with transfer pricing, the thin training module in specialized fields for Indian tax officers, increasingly in contrast to international benchmarked modules and the time needed to put in place appropriate procedures and processes including the establishment of an Approving Panel, do not impart the needed confidence that an environment of certainty can be regenerated with an immediate application of GAAR, however modified. To note, the immediate tax expenditure for not implementing GAAR (after a requisite threshold is applied) would be minimal. Hence GAAR should be deferred for 3 years. But the year, 2016-17, should be announced now, so that it could apply from A.Y. 2017-18. Pre-announcement is a common practice internationally, in today's global environment of freely flowing capital.

3.14 Grandfathering of existing structures or investments

Certain apprehensions were raised about retrospective application of GAAR. It was feared that GAAR provisions may be applied retrospectively if they are considered to be procedural provisions and not substantive in nature.

Considering those apprehensions, the Committee is of the view that it may be clarified as under, **in the case that Govt. adheres to the implementation of GAAR from 2013-14.**

"GAAR shall apply only to the income received, accruing or arising, or deemed to accrue or arise, to the taxpayers on or after 01.04.2013. In other words, GAAR will apply to income of the previous year 2013-14 relevant to assessment year 2014-15 and subsequent years".

The FDI and FII growth story cannot be overlooked. Stakeholders submitted that it was well known that certain treaties were used for treaty shopping but the method was kept alive on account of investments that flowed into India. Be that as it may, Govt. defended its action before the Supreme Court in the case of Azadi Bachao Andolan wherein the Court held that treaty shopping may be unethical but not illegal. It had also upheld Circular 789 dated 13.04.2000 which precluded the tax administration to enquire into the genuineness of tax residency certificate (TRC) issued by the Mauritius authorities. It was, therefore, requested to grandfather all existing arrangements.

Stakeholders pointed that substantive investments have come to India by way of portfolio investment or foreign direct investment from two jurisdictions Singapore and Mauritius based on the effective assurance that, on exit, no tax would be levied in accordance with the relevant tax treaty. Now, it would be unfair according to many stakeholders, both domestic and international, to say that no tax exemption would be provided if they exit after 01.04.2013.

While examining the DTC Bill 2010, the Parliamentary Standing Committee on Finance recommended that all existing <u>arrangements</u> existing as on the date of commencement of the DTC should be grandfathered.

Grandfathering an existing arrangement (instead of existing **investments**) may inadvertently keep many future advance tax avoidance schemes out of examination under GAAR since a tax avoidance structure itself would receive indefinite protection, and diminish the effectiveness of GAAR. In other words, it would allow an impermissible arrangement to exist in perpetuity if created before commencement of GAAR and grandfathered under GAAR provisions. For instance, if a conduit company (says a letter box company) is incorporated in a favourable jurisdiction in 2008 and this arrangement is grandfathered, then, all future investments made by it would also enjoy tax exemption for the indefinite future. Once this was explained, stakeholders agreed that the intention should be to grandfather investments rather than arrangements.

It was also suggested to grandfather only those investments which have remained invested in India for a number of years (say five years or so), this would be unfair to those who invested within the last five years, considering the existing law at that point of time. Thus it is important to grandfather all investments.

In view of the above, the Committee recommends that all investments (though not arrangements) made by a resident or non-resident and existing as on the date of commencement of the GAAR provisions should be grandfathered so that on exit (sale of such investments) on or after this date, GAAR provisions are not invoked for examination or denial of tax benefit.

3.15 Status of Circular 789 of 2000 with reference to Mauritius Treaty

Stakeholders also raised an issue regarding the status of Circular No 789 of 2000 issued by the Govt. The Circular provided that a Certificate of Residence (TRC) issued by the Govt. of Mauritius would constitute sufficient evidence for accepting the status of residence of a person as well as beneficial ownership for applying the tax treaty. Currently, the Revenue cannot look into the genuineness of residence of a company incorporated in Mauritius based on commercial substance, or other criteria, once a TRC is issued by the Mauritius authorities. Thus, the Circular would be in direct conflict with GAAR provisions. Hence, clarity was sought by stakeholders whether the Circular would be withdrawn after commencement of GAAR or, if not withdrawn, whether it would still be applicable to avail treaty benefit.

In view of the above, the Committee recommends that, where Circular No. 789 of 2000 with respect to Mauritius is applicable, GAAR provisions shall not apply to examine the genuineness of the residency of an entity set up in Mauritius.

As needed, the Mauritius treaty itself should be revisited if policy so dictates, rather than challenged indirectly through the use of the GAAR instrument.

3.16 Treaty override

Stakeholders submitted that so long as the taxpayer falls in the definition of resident as defined in the relevant tax treaty, it should be sufficient and he should be precluded from the applicability of GAAR.

It is an internationally accepted principle of interpretation of interplay between domestic law and a tax treaty that, in case of conflict between the provisions of the domestic law and the treaty, **whatever is more beneficial** (between domestic law and the treaty) **to the taxpayer is applicable.** This principle has also been codified in section 90 of the Income-tax Act.

Reliance is usually placed on the preamble of a tax treaty i.e. the treaty is for avoidance of double taxation and prevention of fiscal evasion. In some countries, however, treaty benefit is denied in cases of treaty abuse (like treaty shopping) based on purposive interpretation of the treaty.[6] These States consider that a proper construction of tax conventions allows them to disregard abusive transactions such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (Article 31 of the Vienna Convention on the Law of Treaties).

However, in India the courts have not favoured purposive interpretation, taking a strictly legal stance. In the case of Azadi Bachao Andolan, the Supreme Court held that treaty shopping is legal. The relevant observation of the court is reproduced below-

> *"In para 3.3.2, the working group recommended introduction of anti-abuse provisions in the domestic law.*
>
> *Finally, in paragraph 3.3.3 it is stated "The Working Group recommends that in future negotiations, provisions relating to anti-abuse/limitation of benefit may be incorporated in the DTAAs also."*

[6] OECD commentary on MC, para 9.2

We are afraid that the weighty recommendations of the Working Group on Non-Resident Taxation are again about what the law ought to be, and a pointer to the Parliament and the Executive for incorporating suitable limitation provisions in the treaty itself or by domestic legislation. This per se does not render an attempt by resident of a third party to take advantage of the existing provisions of the DTAC illegal." (emphasis added)

The Supreme Court in the Vodafone case, again opting for a legalistic stance, expressed the need for a policy decision in such matter as under-

Justice Kapadia and Swatantra Kumar of SC in Vodafone (dated 20 Jan 2012):

"Tax policy certainty is crucial for taxpayers (including foreign investors) to make rational economic choices in the most efficient manner. Legal doctrines like "Limitation of Benefits" and "look through" are matters of policy. It is for the Government of the day to have them incorporated in the Treaties and in the laws so as to avoid conflicting views. Investors should know where they stand. It also helps the tax administration in enforcing the provisions of the taxing laws."(para 91)(emphasis added)

Justice Radhakrishnan in the above judgment:

"It is often said that insufficient legislation in the countries where they operate gives opportunities for money laundering, tax evasion etc. and, hence, it is imperative that the Indian Parliament would address all these issues with utmost urgency."(para 53)(emphasis added)

Considering such views expressed by the courts, there is a role for anti-avoidance rules to prevent abuse of tax treaties. Indeed, Parliament enacted GAAR to deal with tax avoidance schemes in both domestic law as well as cross-border transactions though GAAR's perceived wide interpretation rather than a narrow and strict focus on anti-abuse, has led to vociferous opposition to it.

On the issue whether specific provisions of the domestic law of a contracting state that are intended to prevent tax abuse conflict with tax treaties, the OECD in its commentary on Model Convention has stated as under-

> 9.2 For many States, the answer to the first question is based on their answer to the second question. These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax conventions. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied. For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law. <u>As indicated in paragraph 22.1 below, the answer to that second question is that, to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions."</u> (emphasis added)

Thus, the view of the OECD is that if domestic law that covers GAAR provisions is not reflected in a tax treaty, then GAAR can be invoked since there is no conflict with the treaty. However, the OECD does not address the case in which tax avoidance matters are directly or indirectly addressed in a treaty. It may, therefore, be presumed that, in the latter case, the treaty provisions, rather than domestic law, would apply. This has particular relevance for the Indian GAAR with respect to the Mauritius and Singapore treaties.

However, in order to provide certainty on this issue, section 90 of the Income-tax Act (which is the legal basis of Indian tax treaties) has been amended vide Finance Act 2012 to specifically provide for treaty override in case where GAAR is applicable. This has been done as a matter of abundant precaution as there is no conflict between anti-avoidance rules in the domestic law and the treaty provisions which do not have any anti-avoidance rule as such.

However, there may be conflict with treaty provisions which specifically have special anti avoidance rules (SAAR) in the form of limitation of benefits clause etc. as the tax avoidance is being addressed both in the domestic law as well as the treaty law. It should, therefore be clarified through subordinate legislation so that there is no treaty override where the treaty itself has anti-avoidance provisions in the form of limitation of benefits clause. In other words, in such cases, GAAR should not be invoked.

In view of the above, the Committee recommends that where the treaty itself has anti-avoidance provisions, such provisions should not be substituted by GAAR provisions under the treaty override provisions

3.17 Factors not relevant for determination of commercial substance

Stakeholders submitted that certain terms used in GAAR should be defined in a positive way instead of being negatively defined. It was suggested that a negative list in the GAAR provisions relating to commercial substance under section 97(4) of the Act be deleted.

Provisions of section 97(4) of the Act read as under -

> *"97(4) The following shall not be taken into account while determining whether an arrangement lacks commercial substance or not, namely:—*
>
> *(i) the period or time for which the arrangement (including operations therein) exists;*
>
> *(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;*
>
> *(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement."*

It was argued that the above provisions have introduced in direct conflict with the observation of the Supreme Court in the case of Vodafone wherein the Court laid down the following test while analyzing international tax aspects of holding structures,-

> *"we are of the view that every strategic foreign direct investment coming to India, as an investment destination, should be seen in a holistic manner. While doing so, the Revenue/Courts should keep in mind the following factors: the concept of participation in investment, the duration of time during which the Holding Structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; the continuity of business on*

such exit. In short, the <u>onus will be on the Revenue to identify the scheme and its dominant purpose</u>. The corporate business purpose of a transaction is evidence of the fact that the impugned transaction is not undertaken as a colourable or artificial device. The stronger the evidence of a device, the stronger the corporate business purpose must exist to overcome the evidence of a device" (emphasis addedd)

Factors were considered by the Court to determine whether an arrangement is a colorable or sham device. In the case of conduit company structures created for investment in India through favourable tax jurisdictions, there is always a gap between the time of investment and exit as the value of investment should grow with time. At the time of exit and also, there is a need to judge the permissibility of the structure since the factum of payment of taxes on regular income from investment in India (i.e. by way of business income or interest or dividend income or indirect taxes) will not only be there during the course of the life of the business, but the real and significant gains may be expected to arise also at the time of exit. Thus, a holistic view encompassing the life of the business as well as aspects that arise at the point of exit must be taken into account.

In view of the above, the Committee recommends that section 97(2) may be amended to provide that following factors:

(i) the period or time for which the arrangement (including operations therein) exists;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;

(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement."

are relevant but may not be sufficient and these factors will be taken into full account in forming a holistic assessment to determine whether an arrangement lacks commercial substance. When the AO informs the assessee in his initial intimation invoking GAAR, he should include how the above factors (i) to (iii) have been considered and why they fail to convince the AO that GAAR should not be applied in the particular case.

3.18 Threshold to be prescribed for applying GAAR provisions.

Stakeholders submitted that the threshold to be prescribed for applying GAAR should be high enough to capture only highly sophisticated structures.

In the draft guidelines, it is proposed to provide a monetary threshold of tax benefit of ….lakhs of rupees to the taxpayer in a year. Various concerns expressed by stakeholders relating to this were –

(i) the monetary threshold of "tax benefit" should consider only the tax amount and not any other amount;

(ii) in cases of tax deferral, how the tax benefit would be computed;

(iii) the threshold should be high enough;

(iv) can there be any other criterion of specifying monetary threshold i.e. total turnover, sales or value of transactions;

(v) threshold should be qua an arrangement.

As proposed, the threshold has three elements i.e. tax benefit should be more than a specified amount, the benefit should arise to the taxpayer involved, and the benefit should be in the income year involved.

The term "tax benefit" has been defined to include tax or other amount payable under this Act or reduction in income or increase in loss. The other amount could cover interest. For the sake of clarity, it may be specified that tax benefit for the purposes of the threshold shall include only income tax, dividend distribution tax and profit distribution tax, and shall not include other amounts like interest, income etc. The tax liability may be actual or potential (i.e. in case of increase in loss).

However, in cases of tax deferral, the only benefit to the taxpayer is not paying taxes in one year but paying it in a later year. Overall there may not be any tax benefit but the benefit is in terms of the present value of money. In such cases, tax benefit should be computed in the year of deferral as the amount of taxes not paid in that year on account of the tax avoidance scheme which exceeds the present value of money of corresponding taxes paid in subsequent years. The present value of money should be ascertained based on the rate of interest charged under the Act for shortfall of tax payment under section 234B of the Act.

It is noted that in case of transfer pricing regulations, being SAAR, a threshold of Rs. 15 crores as value of international transactions in a year is considered for the purpose of undertaking transfer pricing audit by the Transfer Pricing Officer. Presuming net profit from such transactions at 10%, the average net profit to the taxpayer would be Rs. 1.5 crore and the average tax payable on such transaction would be around Rs. 50 lakhs. In other words, the cases having tax implications of Rs. 50 lakh and above are selected for transfer pricing audit. While this is quite low, having too high a threshold also carries a potential danger of a perception that tax avoidance below that threshold will not be questioned. Thus the threshold has to be determined with due care.

The threshold level should be decided based on the taxpayer population in different slabs. (Receipt Budget 2012) Companies having profit before tax (PBT) of Rs 1 crore and above, account for 6.2% (28,767 in number) of all companies (4,59,270) and contribute about 95% of total corporate tax revenue. Similarly, companies having PBT of Rs 10 crore and above account for 1.34% (6,141 in number) of all companies and contribute about 87% of total corporate tax revenue (see Annexe-7).

It is recommended to apply GAAR to companies having PBT in a year of more than Rs.10 crore in the initial five years to minimize any adverse impact on smaller taxpayers. As large scale training in enhancing tax administration practices and accountability is undertaken and put in place, the threshold level may be reduced (so that the number of companies covered may increase under GAAR).

Based on the above figures, a threshold tax benefit limit of Rs 3crore may be considered. Hence the recommended threshold based on tax benefit should imply a scope of about 6000 companies.

The tax benefit should be considered separately for each arrangement, not taking all arrangements together unless the arrangements are interlinked or connected with each other.

Other criteria such as turnover or sales should not be used as profitability of different sectors varies widely.

In view of the above, the Committee recommends that a monetary threshold of Rs 3 crore of tax benefit (including tax only, and not interest etc) to a taxpayer in a year should be used for the

applicability of GAAR provisions. In case of tax deferral, the tax benefit shall be determined based on the present value of money.

3.19 GAAR vs SAAR; and GAAR vs LOB

Considering the concerns that there could be interplay between Specific Anti Avoidance Rules (SAAR) and GAAR, stakeholders submitted that many countries do not apply GAAR where SAAR is applicable. It was, therefore, suggested that the guidelines should clearly state this and, in case SAAR is misused, then it should be amended to make that particular SAAR more robust.

It is in this context that a related statement by the earlier committee under DGIT (IT) came under criticism. It said :-

> *"While SAARs are promulgated to counter a specific abusive behavior, GAARs are used to support SAARs and to cover transactions that are not covered by SAARs. Under normal circumstances, where specific SAAR is applicable, GAAR will not be invoked. However, in an exceptional case of abusive behavior on the part of a taxpayer that might defeat a SAAR, as illustrated in Example No. 16 in Annexure E (or similar cases), GAAR could also be invoked."*

It is a settled principle that, where a specific rule is available, a general rule will not apply. SAAR normally covers a specific aspect or situation of tax avoidance and provides a specific rule to deal with specific tax avoidance schemes. For instance, transfer pricing regulation in respect of transactions between associated enterprises ensures determination of taxable income based on arm's length price of such transactions. Here GAAR cannot be applied if such transactions between associated enterprises are not at arm's length even though one of the tainted elements of GAAR refers to dealings not at arm's length.

The Limitation of Benefit (LOB) clause in some of India's tax treaties is a specific anti-avoidance rule to prevent tax abuse. For instance, the India-Singapore treaty provides that a company A, resident of a Contracting State, is deemed not to be a shell/conduit company if:

(a) it is listed on a recognized stock exchange of the Contracting State; or

(b) its total annual expenditure on operations in that Contracting State is equal to or more than S$200,000 or Indian Rs. 50,00,000 in the respective contracting state as the case may be, in the immediately preceding period of 24 months from the date the gains arise.

So, if a company incorporated in Singapore incurs operating expenditure equal to, or in excess of, the aforesaid limits, then GAAR cannot be invoked to look into the genuineness of the company. But if there are SAAR elements that are revealed in its operations, then SAAR would be invoked.

In view of the above, the Committee recommends that that where SAAR is applicable to a particular aspect/element, then GAAR shall not be invoked to look into that aspect/element. Similarly where anti-avoidance rules are provided in a tax treaty in the form of limitation of benefit (as in the Singapore treaty) etc., the GAAR provisions shall not apply overriding the treaty. If there is evidence of violations of anti-avoidance provisions in the treaty, the treaty should be revisited, but GAAR should not override the treaty.

3.20 Corresponding adjustments

Stakeholders submitted that, where adjustments are made to the income of a party to an arrangement, then, corresponding adjustment should be allowed: (i) in case of the same party; and (ii) in cases of other parties to the arrangement.

In the Indian tax system, proceedings for a taxpayer for each assessment year are separate and distinct. Hence, on the face of it, corresponding adjustment or complete symmetry in the tax system is not feasible. There can be the following three types of asymmetry -

(i) In the case of the same taxpayer in the same assessment year (for instance, some expenditure may not be allowable under GAAR: then corresponding income also may be made not taxable).

(ii) In the case of the same taxpayer in different assessment years (for instance, in case of deferral of income not allowed under GAAR: then, income offered by the taxpayer voluntarily in a subsequent year should not be taxed).

(iii) In the case of different taxpayers (for instance, recharacterization of payment from income to dividend: corresponding adjustments would potentially require different tax payers with different assessment years to be compared at the same time).

The asymmetry mentioned at (i) and (ii) should be taken care of when determining the consequences of an impermissible tax avoidance scheme as indicated above.

However, providing symmetry to situations at (iii) is not feasible. Stakeholders expressed their view that, if by applying GAAR a payment which has been claimed as deduction by one party to the arrangement is disallowed, the tax liability of the recipient should be computed considering as if such payment is never made and thus, such payment should not form part of the recipient's income. Similarly, if by applying GAAR, an interest payment is recharacterized as dividend and the payer company is required to pay Dividend Distribution Tax (DDT) on the same, the tax liability of the recipient should be computed treating the payment as dividend. It was also stated by stakeholders that this treatment may be intended/ implicit in the provisions of Section 98(1) which prescribes that the consequences of an impermissible avoidance arrangement shall be computed in such a manner as is deemed appropriate.

Nevertheless, it is the Committee's view that such compensation across parties is not desirable since it would diminish GAAR's deterrent role. GAAR is after all an anti-avoidance provision that should have deterrent consequences as a potential risk faced by aggressive tax planners and corresponding adjustments across different taxpayers would militate against deterrence. And, under SAAR, such corresponding adjustments are not allowed either.

In view of the above, the Committee recommends that, while determining tax consequences of an impermissible avoidance arrangement, corresponding adjustment should be allowed in the case of the same taxpayer in the same year as well as in different years, if any. However, no relief by way of corresponding adjustment should be allowed in the case of any other taxpayer.

3.21 Implementation of onus on the Revenue authority

Stakeholders represented that adequate safeguards should be built in to ensure that the Revenue discharge their onus effectively, by providing detailed reasoning for claiming an arrangement to be an impermissible avoidance arrangement rather than merely alleging an arrangement to be an impermissible avoidance arrangement.

The onus of initiating and demonstrating that there is an impermissible avoidance arrangement is indeed on the Revenue as has been clarified by Govt. The onus of demonstrating that -

(A) there is an arrangement,

(B) the arrangement leads to a 'tax benefit',

(C) the main purpose of the 'arrangement' is to obtain a 'tax benefit', and

(D) the arrangement has one or more of the specified tainted elements,

is on the Revenue. (Note that this Committee already recommended above that condition (C) above should be confined to 'main purpose' only as was specified in the 2009 DTC, as also other elements to be included in the initial intimation by the Assessing Officer (AO) to the assessee.

The AO is empowered to initiate GAAR proceedings only during the course of pending assessment proceedings. He should collect all the relevant information and documents from the taxpayer about an arrangement, examine them, and should come to a finding based on facts of the case. Thereafter, he should inform the taxpayer of his finding along with the information he possesses and his detailed reasons thereof. He should not simply ask the taxpayer as to why a particular arrangement should not be treated as impermissible. In his letter to the taxpayer, he should specify in addition to the components already recommended above-

(i) what is the arrangement;

(ii) why it results in any tax avoidance in the case of the taxpayer;

(iii) what is the amount of likely tax benefit and how it is initially calculated;

(iv) why obtaining the tax benefit is the main purpose of the arrangement, with the detailed explanation thereof, including full and exhaustive background information in the possession of the Revenue so that it may be presumed that the Revenue has no additional information on the matter;

(v) the show cause notice should specify what are the tainted element(s) of the arrangement;

In view of the above, the Committee recommends that a requirement of detailed reasoning by the Assessing Officer in the show cause to the taxpayer may be prescribed in the rules, that should list explanations based on specifications (i) to (v) mentioned above.

3.22 Constitution of Approving Panel (AP)

Some stakeholders submitted that, instead of having a standing body, at least one member of the AP should be drawn in each GAAR case from a field considering the business, commercial and economic aspects of the arrangement. Such member should be a person having expertise in the industry in which the relevant taxpayer is engaged.

Section 144BA(14) has empowered the CBDT to constitute an AP consisting of not less than 3 members, out of which one member of the panel would be an officer of the level of Joint Secretary or above from the Ministry of Law, the others being from the Revenue of the rank of Commissioner or above. In the draft guidelines that are under examination by this Committee, the following recommendations were made-

(a) To begin with, there should be one AP, which shall be situated in Delhi. Subsequently, the CBDT should review the number of Approving Panels required on the basis of the workload in FY 2014-15.

(b) The AP should comprise three members, of which two members should be of the level of Chief Commissioner of Income Tax and the third member should be an officer of the level of Joint Secretary or above from the Ministry of Law. All the members should be full time members.

(c) The AP should be provided secretariat staff along with appropriate budgetary and infrastructure support by the CBDT. The secretariat should be headed by an officer of the level of Joint/Additional Commissioner of Income Tax.

There are three factors that are relevant for the effectiveness of the AP, i.e. whether reference to the AP is binding or not; whether order/advice of AP is binding on the Revenue; and if independence of the AP can be ensured by including members from outside Govt. On the last issue, as the GAAR provisions are subjective in nature, it is necessary to have a high level of independence to ensure confidence of taxpayers.

The statute has already provided that reference to the AP is binding and its order is also binding on the Revenue.

After taking into account the numerous representations made to the present Committee, and with the objective of ensuring that the objective of GAAR be deterrence rather than revenue, the Committee recommends that –

(i) The Approving Panel should consist of five members including Chairman;

(ii) The Chairman should be a retired judge of the High Court;

(iii) Two members should be from outside Govt. and persons of eminence drawn from the fields of accountancy, economics or business, with knowledge of matters of income-tax; and

(iv) Two members should be Chief Commissioners of income tax; or one Chief Commissioner and one Commissioner.

The AP should be a permanent body with a secretariat. It should have a two year term. In the first AP that is to be appointed, one Chief Commissioner and one member from a specified field would be appointed to a one-year term. This should ensure an overlap among members in future AP's. If there is any need for further representation from particularly specialized fields, an updated roster of specialists should be maintained from which any additional member, may be drawn in an individual GAAR case.

A decision of the AP should occur by a majority of members.

In view of the above, the Committee recommends amendment of the Act for the constitution and working of the Approving Panel as elaborated above.

3.23 Withholding of taxes

Stakeholders raised concerns about the procedure to be followed while determining withholding tax liability. They submitted that at the time of withholding, GAAR provisions should not be considered.

Specific safeguards of seeking approval from the AP have been provided in determining tax liability under an assessment proceeding. There is no clarity whether GAAR provisions can be invoked by the AO while disposing of an application for determination of a withholding tax amount under section 195(2) or 197 of the Act.

On the one hand, the concern of the Revenue is that, if remittance is allowed without consideration of GAAR, then subsequently it may not be feasible to recover the amount from a non-resident in case an instance of impermissible avoidance arrangement comes to light at a later stage. On the other hand, stakeholders felt that invoking GAAR at the stage of withholding would increase their compliance burden disproportionately and that there would be undue delay in remittance. This would, in turn, make business processes unworkable and prohibitive.

Concerns of both the Revenue and stakeholders are valid and, therefore, a balanced approach needs to be adopted. Seeking approval from the AP in every case of withholding tax may be a lengthy procedure. As the orders under section 195(2) and 197 are only provisional in nature, in case the AO invokes GAAR, the AO may dispose of the applications with prior approval of his Commissioner.

However, in cases where the taxpayer submits an undertaking to pay the taxes payable in India if GAAR is found applicable in respect of the remittance being made, the AO will allow remittance to be made based on the domestic law without considering the GAAR provisions. However, where the taxpayer is not willing to give any satisfactory undertaking to the

Revenue, the AO may pass a detailed reasoned order with prior approval of the CIT if GAAR is applicable to the transaction.

In view of the above, the Committee recommends that, while processing an application under section 195(2) or 197 of the Act pertaining to the withholding of taxes, the assessing officer

(i) **shall not invoke GAAR where the taxpayer submits a satisfactory undertaking to pay tax along with interest in case it is found that GAAR provisions are applicable in relation to the remittance during the course of assessment proceedings.**

(ii) **may invoke GAAR with the prior approval of his Commissioner in his detailed reasoned order u/s 195 (2) or 197, in case the taxpayer does not submit any satisfactory undertaking as mentioned above. .**

3.24 Concerns of FIIs

The draft guidelines under examination by this Committee recommended the following-

> "Where a Foreign Institutional Investor (FII) chooses not to take any benefit under an agreement entered into by India under section 90 or 90A of the Act and subjects itself to tax in accordance with the domestic law provisions, then, the provisions of Chapter X-A shall not apply to such FII or to the non-resident investors of the FII.
>
> Where an FII chooses to take a treaty benefit, GAAR provisions may be invoked in the case of the FII, but would not in any case be invoked in the case of the non-resident investors of the FII."

Stakeholders expressed the concern that the above clarification provides certainty only to immediate (first level) investors in the FII. As the FII structure is generally multi-layered and may be a synthetic investment structure, an investor may exist at subsequent / upper levels, and may not be a direct investor in the FII.

It was also stated that some FII's are allowed to invest in unlisted securities with prior permission. Clarification was sought by stakeholders if the intention of the guidelines was to cover those cases as well.

As it is the FII which is the unit for taxation in India, this Committee felt that the intention of the guidelines should be to exclude all investors in portfolio investments above the FII stage from the purview of GAAR.

In view of the above, the Committee recommends that –

(i) where a Foreign Institutional Investor (FII) chooses not to take any benefit under an agreement entered into by India under section 90 or 90A of the Act and subjects itself to tax in accordance with domestic law provisions, then, the provisions of Chapter X-A shall not apply to such FII;

(ii) Whether an FII chooses <u>or</u> does not chose to take a treaty benefit, GAAR provisions would not be invoked in the case of a non-resident who has invested, directly or indirectly, in the FII i.e. where the investment of the non-resident has underlying assets as investments made by the FII in India. However, this exemption to a non-resident shall be available only in respect of listed securities made by the FII in India.

3.25 Implementation issues

Though a number of stakeholders agreed to the objective of preventing abusive tax planning schemes, they expressed apprehension in the manner in which the GAAR provisions were likely to be implemented in their view. Various reasons cited for such apprehension were -

- deficiency of trust between tax administration and taxpayers;
- anticipated attempts to invoke GAAR in a general manner, if not in every possible case;
- lack of accountability in the manner in which tax officers conduct business, and for its outcome;
- fear of audit by C&AG ;
- compulsion for tax officers to meet budget targets;
- past experience in implementing regulations pertaining to transfer pricing which gave little confidence, according to them, in fair and appropriate implementation;
- advance ruling not being obtained in the specified period of six months.

In order to allay fears of tax payers, a number of safeguards have been built into the GAAR provisions. It is not a one-to-one relationship between the tax officer and taxpayer like in other tax implementation instruments. A three stage process for invoking GAAR with a national level panel is intended to provide consistency and uniformity in the application of GAAR. Nevertheless, there is indeed a significant trust deficiency, some of which reflects the independence of interpretation of various statutes by AO's across the administration, against which taxpayers have little option to raise issues except with considerable loss of time and financial resources. This problem can be allayed only with appropriate training and guidance for AO's to ensure uniformity which is currently not ensured.

In view of the above, the Committee recommends that, to minimize the deficiency of trust between the tax administration and taxpayers, concerted training programmes should be initiated for all AO's placed, or to be placed, in the area of international taxation, to maintain officials in this field for elongated periods as in other countries, to place on the intranet details of all GAAR cases in an encrypted manner to comprise an additive log of guidelines for future application.

It may also be perspicacious as indicated above, for Govt. to postpone the implementation of GAAR for three years with an immediate pre-announcement of the date to remove uncertainty from the minds of stakeholders. A longer period of preparation should ensure much needed training at the AO and Commissioner levels. It would also enable taxpayers to plan for a change in the anti-avoidance regime based on legitimate tax planning that reflects a proper understanding of the new legislation and guidelines.

Further, it should be considered to make Large Taxpayer Units (LTUs) compulsory for a specified class of taxpayers reflecting international practice. Considering the high threshold of tax benefit for invocation of GAAR, the majority of cases may come in LTU only. Given the importance of such very large taxpayers, the Revenue would need to be very analytical in its invocation and application of GAAR.

3.26 Reporting Requirement

In selected jurisdictions such as the UK, tax professionals are required to report any tax avoidance scheme directly advised by them. This helps the tax administration in the selection of cases for audit.

In India, taxpayers having a turnover of Rs 1 crore and above are required to get their accounts audited by an accountant and to obtain a tax audit report in a specified format.

A suggestion was made by some stakeholders to include reporting of tax avoidance schemes in such tax audit reports by a tax professional. As the income-tax department plans to collect online all statutory reports, an annexure forming part of the return of income would help in picking up potential anti-avoidance cases in good time.

In view of the above, the Committee recommends that the tax audit report may be amended to include reporting of tax avoidance schemes above a specific threshold of tax benefit of Rs. 3 crores or above which is considered by the tax auditor as more likely than not to be held as an impermissible avoidance arrangement under the Act.

4. <u>Illustrative cases where GAAR provisions will be considered applicable or not applicable</u>

It is clarified that the illustrations given below should be considered as a guide to the overall intent of GAAR. They comprise an indicative list, and cannot be construed as an exhaustive list of GAAR cases

Example 1:

Facts:

M/s India Chem Ltd. is a company incorporated in India. It sets up a unit in a Special Economic Zone (SEZ) in F.Y. 2013-14 for manufacturing of chemicals. It claims 100% deduction of profits earned from that unit in F.Y. 2021 -22 and subsequent years as per section 10AA of the Act. Is GAAR applicable in such a case?

Interpretation:

There is an arrangement of setting up of a unit in SEZ which results into a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by submitting to the conditions and economic consequences of the provisions in the legislation e.g., setting up the business unit in SEZ area. Hence, the Revenue would not invoke GAAR as regards this arrangement.

Example 1A:

Facts:

In the above example 1, let us presume M/s India Chem Ltd. has another unit for manufacturing chemicals in a non-SEZ area. It then diverts its production from such manufacturing unit and shows the same as manufactured in the tax exempt SEZ unit, while doing only process of packaging there. Is GAAR applicable in such a case?

Interpretation:

This is a case of misrepresentation of facts by showing production of non-SEZ unit as production of SEZ unit. Hence, this is an arrangement of tax evasion and not tax avoidance.

Tax evasion, being unlawful, can be dealt with directly by establishing correct facts. GAAR provisions will not be invoked in such a case.

Example 1B

Facts:

In the above example 1A, let us presume that M/s India Chem Ltd. does not show production of non-SEZ unit as a production of SEZ unit but transfers the product of non-SEZ unit at a price lower than the fair market value and does only some insignificant activity in SEZ unit. Thus, it is able to show higher profits in SEZ unit than in non-SEZ unit, and consequently claims higher deduction in computation of income. Can GAAR be invoked to deny the tax benefit?

Interpretation:

As there is no misrepresentation of facts or false submissions, it is not a case of tax evasion. The company has tried to take advantage of tax provisions by diverting profits from non-SEZ unit to SEZ unit. This is not the intention of the SEZ legislation. However, such tax avoidance is specifically dealt with through transfer pricing regulations that deny tax benefits. Hence, the Revenue would not invoke GAAR in such a case.

Example 1C

Facts:

In the above example 1B, let us presume, that both units in SEZ area (say A) and non-SEZ area (say B) work independently. M/s India Chem Ltd. started taking new export orders from existing as well as new clients for unit A and gradually, the export from unit B declined. There has not been any shifting of equipment from unit B to unit A. The company offered lower profits from unit B in computation of income. Can GAAR be invoked on the ground that there has been shifting or reconstruction of business from unit B to unit A for the main purpose of obtaining tax benefit?

Interpretation:

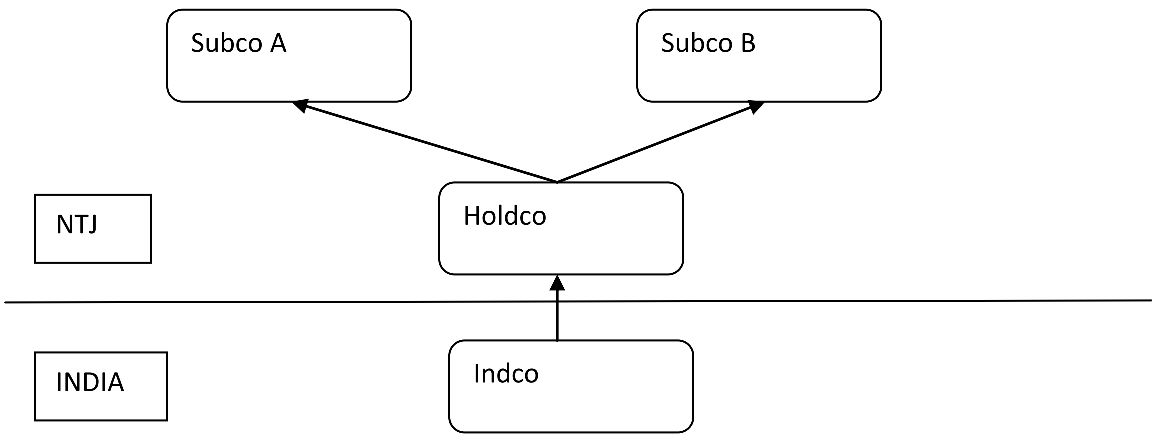
The issue of tax avoidance through shifting/reconstruction of existing business from one unit to another has been specifically dealt with in section

10AA of the Act. Hence, the Revenue would not invoke GAAR in such a case.

Example -2:

Facts:

An Indian company (Indco) has set up a holding company (Holdco) in a no tax jurisdiction outside India (say NTJ) which has set up further subsidiary companies (Subco A and Subco B) which pay dividends to Holdco. Such dividends are not repatriated to Indco. Can GAAR be invoked to look through Holdco to tax dividends in the hands of Indco?



Interpretation:

Declaration/repatriation of dividend is a business choice of a company. India does not have anti-deferral provisions in the form of Controlled Foreign Company (CFC) rules in the I.T. Act. Accordingly, GAAR would not be invoked in such a case.

Example -2A:

Facts:

In the above example 2, dividend is accumulated in Holdco for a number of years and subsequently, Holdco is merged into Indco through a cross–border merger. Can GAAR be invoked on the ground that the merger route has been adopted to avoid payment of tax on dividend in India?

Interpretation:

It is true that if Holdco declares dividends to Indco before merger, then, such dividend would have been taxable in India. But the timing or sequencing of an activity is a business choice available to the taxpayer. Moreover, section 47 of the Act specifically exempts capital gains on cross border merger of a foreign company into an Indian company.

Hence, GAAR cannot be invoked when taxpayer makes a choice about timing or sequencing of an activity to deny a tax benefit granted by the statute.

Example -3:

Facts:

The merger of a loss making company into a profit making one results in losses setting off profits, a lower net profit and lower tax liability for the merged company. Would the losses be disallowed under GAAR?

Interpretation:

As regards setting off of losses, the provisions relating to merger and amalgamation already contain specific anti-avoidance safeguards. Therefore, GAAR would not be invoked when SAAR is applicable.

Example -3A:

Facts:

In the above example 3, let us presume, the profit making company merges into a loss making one. This results in losses setting off profits, a lower net profit and lower tax liability for both companies taken together. Can this be examined under GAAR?

Interpretation:

In case of merger of profit making company with loss making company, there is no specific anti-avoidance safeguards. However, since such merger would be under the order of High Court, GAAR cannot be invoked as it falls in the negative list (as recommended) for invoking GAAR as mentioned in guidelines.

Example -4:

Facts:

A choice is made by a company by acquiring an asset on lease over outright purchase. The company claims deduction for lease rentals in case of acquisition through lease rather than depreciation as in the case of purchase of the asset. Would the lease rent payment, being higher than the depreciation, be disallowed as expense under GAAR?

Interpretation:

GAAR provisions would not apply in this case as the taxpayer merely makes a selection out of the options available to him.

Example -5:

Facts:

Indco has raised funds from a company (X Ltd.) incorporated in a low tax jurisdiction outside India (LTJ) through borrowings, when it could have issued equity. Would the interest be denied as an expense deduction under GAAR?

Interpretation:

There is no specific provision dealing with thin-capitalization in the I.T. Act. An evaluation of whether a business should have raised funds through equity instead of debt should generally be left to commercial judgment of a taxpayer and GAAR would not be attracted.

Example 5A

Facts:

In the above example 5, the loan agreement between Indco and X Ltd. provide that Indco shall pay interest annually at the rate as mentioned below:

Rate of interest = (Annual Profit of the Indco/Loan amount)*100

Can GAAR be invoked in such a case?

Interpretation:

This is a case where the form of the arrangement is to show Indco has received a debt from X Ltd. but in substance there is high likelihood that it is equity investment, as the rate of interest is directly based on the rate of return, or profit of Indco. Thus, it could be viewed as an arrangement whose main purpose is to obtain a tax benefit by claiming actual dividend payment as interest payment. The tainted element here is the abnormal manner in which such a transaction is being carried out which would not be so in case of a bonafide transaction (loan). Hence, GAAR provisions would be invoked in the case of Indco to treat the arrangement as an impermissible avoidance arrangement.

Consequently, in the case of Indco, the loan by X Ltd. would be treated as equity for tax purposes; interest payment would not be allowed as deduction as this would be re-characterized as dividend; and dividend distribution tax (DDT) may be levied on the amount of payment made/credited to the account of X Ltd. by way of claimed interest payment.

No corresponding adjustment would be allowed in the case of X Ltd. for recharacterisation of payment received from Indco as dividend (which would have been exempt from taxation).

Example 5B

Facts:

In the above example 5, let us assume, that

(i) X Ltd. is a banking institution in LTJ;

(ii) there is a closely held company Subco in LTJ which is a wholly owned subsidiary of another closely held Indian company Indco;

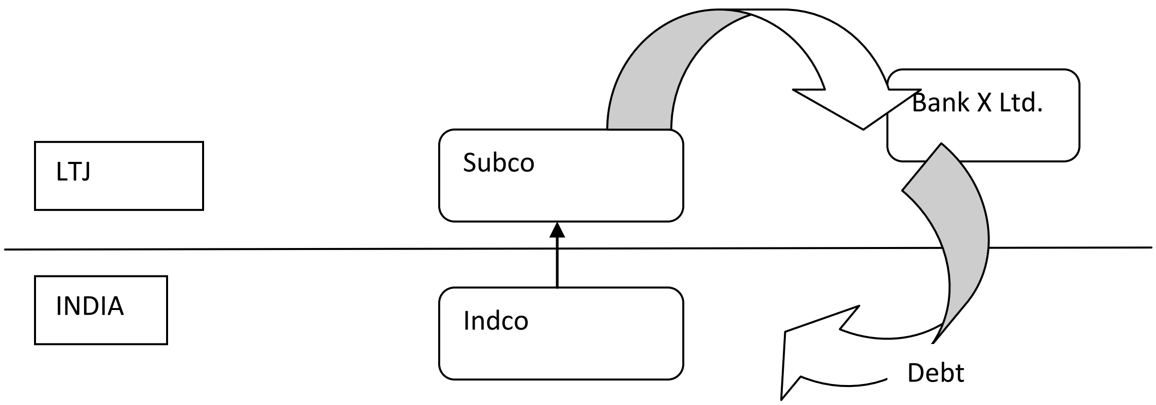
(iii) Subco has reserves and, if it provides a loan to Indco, it may be treated as deemed dividend under section 2(22)(e) of the Act.

(iv) Subco makes a term deposit with X Ltd. bank and X Ltd. bank based on this security provides a back to back loan to Indco.

Say, India-LTJ tax treaty provides that interest payment to a LTJ banking company is not taxable in India.

Can this be examined under GAAR?

Deposit



Interpretation:

This is an arrangement whose main purpose is to bring money out of reserves in Subco to India without payment of due taxes. The tax benefit is saving of taxes on income to be received from Subco by way of dividend or deemed dividend. The arrangement disguises the source of funds by routing it through X Ltd. bank. X Ltd. bank may also be treated as an accommodating party. Hence the arrangement shall be deemed to lack commercial substance.

Consequently, in the case of Indco, the loan amount would be treated as dividend income received from Subco to the extent reserves are available in Subco; and no expense by way of interest would be allowed.

In the case of bank X Ltd, exemption from tax on interest under the DTAA may not be allowed as X Ltd is not a beneficial owner of the interest, provided the DTAA has anti-avoidance rule of beneficial ownership. If such anti-avoidance rule is absent in DTAA, then GAAR may be invoked to deny treaty benefit as arrangement will be perceived as an attempt to hide the source of funds of Subco.

Example 6

Facts:

Indco incorporates a Subco in a NTJ with equity of US$100. Subco has no reserves; it gives a loan of US$100 to Indco at the rate of 10% p.a. which is utilized for business purposes. Indco claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?

Interpretation:

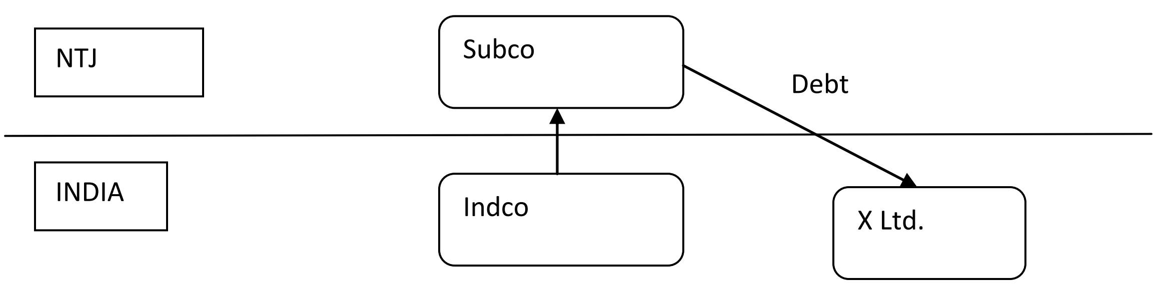
The main purpose of the arrangement is to obtain interest deduction in the hands of Indco and thereby tax benefit. There is no commercial substance in establishing Subco since without it there is no effect on the business risk of Indco or any change in the cash flow (apart from the tax benefit). Moreover, it is a case of round tripping which means a case of deemed lack of commercial substance. Hence, it would be treated as an impermissible avoidance arrangement.

Consequently, in the case of Indco, interest payment would be disallowed by disregarding Subco. No corresponding relief would be allowed in the case of Subco by way of refund of taxes withheld, if any.

Example 7

Facts:

Indco incorporates a Subco in a NTJ with equity of US$100. Subco gives a loan of US$100 to another Indian company (X Ltd.) at the rate of 10% p.a. X Ltd. claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?



Interpretation:

The arrangement appears to be to avoid payment of tax on interest income by Indco in the case loan is directly provided by Indco to X Ltd. The arrangement involves round tripping of funds even though the funds emanating from Indco are not traced back to Indco in this case. Hence, the arrangement may be deemed to lack commercial substance.

Consequently, in the case of Indco, Subco may be disregarded and the interest income may be taxed in the hands of Indco.

Example -8:

Facts:

A large corporate group has created a service company to manage all its non core activities. The service company then charges each company for the services rendered on a cost plus basis. Can the mark up in the cost of services be questioned using GAAR.

Interpretation:

There are specific anti avoidance provisions through transfer pricing regulations as regards transactions among related parties. GAAR will not be invoked in this case.

Example -9:

Facts:

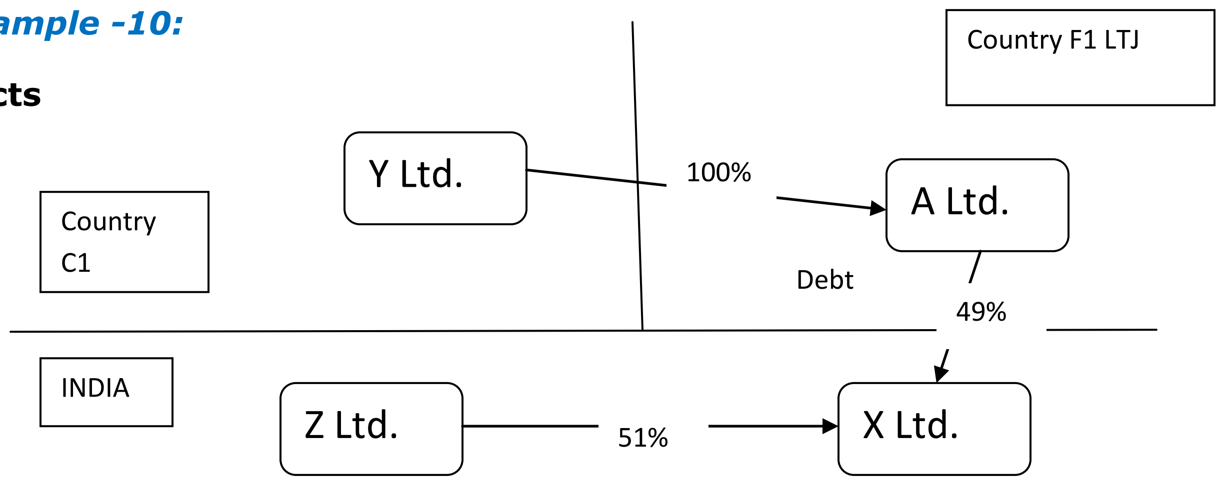
A company sets off losses in the stock market against gains which is aimed at balancing the portfolio.

Interpretation:

Sale/purchase through stock market transactions would not come under GAAR provisions. Moreover, timing of a transaction by a taxpayer would not be questioned under GAAR.

Example -10:

Facts



(i) Y Ltd. is a company incorporated in country C1. It is a non-resident in India.

(ii) Z Ltd. is a company resident in India.

(iii) A Ltd. is a company incorporated in country F1 and it is a 100% subsidiary of Y Ltd.

(iv) A Ltd. and Z Ltd. form a joint venture company X Ltd. in India after the date of commencement of GAAR provisions. There is no other activity in A Ltd.

(v) The India-F1 tax treaty provides for non-taxation of capital gains in the source country and country F1 charges no capital gains tax in its domestic law.

(vi) A Ltd. is also designated as a “permitted transferee” of Y Ltd. “Permitted transferee” means that though shares are held by A Ltd, all rights of voting, management, right to sell etc., are vested in Y Ltd.

(vii) As per the joint venture agreement, 49% of X Ltd’s equity is allotted to A Ltd. and 51% is allotted to Z Ltd..

(viii) Thereafter, the shares of X Ltd. held by A Ltd. are sold to C Ltd., a company connected to the Z Ltd. group.

As per the tax treaty with country F1, capital gains arising to A Ltd. are not taxable in India. Can GAAR be invoked to deny the treaty benefit?

Interpretation

The arrangement of routing investment through country F1 results into a tax benefit. Since there is no business purpose in incorporating company A Ltd. in country F1 which is a LTJ, it can be said that the main purpose of the arrangement is to obtain a tax benefit. The alternate course available in this case is direct investment in X Ltd. joint venture by Y Ltd. The tax benefit would be the difference in tax liabilities between the two available courses.

The next question is, does the arrangement have any tainted element? It is evident that there is no commercial substance in incorporating A Ltd. as it does not have any effect on the business risk of Y Ltd. or cash flow of Y Ltd. As the twin conditions of main purpose being tax benefit and existence of a tainted element are satisfied, GAAR may be invoked.

Additionally, as all rights of shareholders of X Ltd. are being exercised by Y Ltd instead of A Ltd, it again shows that A Ltd lacks commercial substance.

Hence, unless it is a case where Circular 789 relating Tax Residence Certificate in the case of Mauritius, or Limitation of Benefits clause in India-Singapore treaty is applicable, GAAR can be invoked.

Example -11:

***Facts**:*

A Ltd. is incorporated in country F1 as a wholly owned subsidiary of company Y Ltd. which is not a resident of F1 or of India. The India-F1 tax treaty provides for non-taxation of capital gains in India (the source country) and country F1 charges no capital gains tax in its domestic law. Some shares of X Ltd., an Indian company, are acquired by A Ltd in the year after date of coming into force of GAAR provisions. The entire funding for investment by A Ltd. in X Ltd. was done by Y Ltd. These shares are subsequently disposed of by A Ltd after 5 years. This results in capital gains which A Ltd. claims as not being taxable in India by virtue of the India-F1 tax treaty. A Ltd. has not made any other transaction during this period. Can GAAR be invoked?

Interpretation:

This is an arrangement which has been created with the main purpose of avoiding capital gains tax in India by routing investments through a favourable jurisdiction. There is neither a commercial purpose nor commercial substance in terms of business risks or cash flow to Y Ltd in setting up A Ltd. It should be immaterial here whether A Ltd has office, employee etc in country F1. Both the purpose test and tainted element tests are satisfied for the purpose of invoking GAAR. Unless it is a case where Circular 789 relating Tax Residence Certificate in the case of Mauritius, or Limitation of Benefits clause in India-Singapore treaty is applicable, the Revenue may invoke GAAR and consequently deny treaty benefit.

Example -12:

Facts*:*

An Indian company, X Ltd., is a closely held company and it is a subsidiary of company Y Ltd. incorporated in country C1. X Ltd. was regularly distributing dividends but stopped distributing dividends from 1.4.2003, the date when DDT was introduced in India. X Ltd. allowed its reserves to grow by not paying out dividends. As a result no DDT was paid by the company. Subsequently, buyback of shares was offered by X Ltd. to its shareholder company Y Ltd.
Y Ltd. paid taxes on the capital gains arising on buyback of shares at the applicable rate. Can GAAR be invoked on the ground that there is a deferral of tax liability by X Ltd., the Indian company?

Interpretation:
Whether to pay dividend to its shareholder, or buy back its shares or issue bonus shares out of the accumulated reserves is a business choice of a company. Further, at what point of time a company makes such a choice is its strategic policy decision. Such decisions cannot be questioned under GAAR.

Example -12A:

Facts*:*

In the above example 12, let us presume, there is a DTAA between India and Country C1 which provides that capital gains arising in India to a resident of country C1 shall not be taxed in India provided that the resident incurs $200,000 annually as operating expenditure. The shareholder Y Ltd. incurs an operating expenditure above that limit and is entitled to the treaty benefit. Y Ltd. therefore does not pay any tax on capital gains.
Can GAAR be invoked on the ground that accumulation of profits by company X Ltd. and subsequent buyback is an arrangement mainly to obtain tax benefit?

Interpretation:
Payment of dividend to its shareholder or buy back of its shares or issuing bonus shares out of the accumulated reserves is a business choice of a company, which a company is entitled to exercise at any point of time. It should be interpreted as incidental that the shareholder is entitled to a treaty benefit which exempts capital gains, but it is subject to SAAR (i.e. Limitation of Benefit clause). The decision of X Ltd. cannot be questioned under GAAR.

Example -12B:

Facts:
In the above example 12, let us presume that there are three shareholders of company X Ltd. i.e. Y Ltd. (resident of country C1), D Ltd. and E Ltd.. (resident of country C2). All three shareholders are associated enterprises. DTAA with C2 provides India the right of taxation of capital gains as per domestic law.
After GAAR coming into force, X Ltd. makes an offer of buy back of shares to all its three shareholders. Only company Y Ltd. accepts that offer and other shareholders declines. In the process, all accumulated reserves of X Ltd are exhausted and Y Ltd. does not pay any tax in India.
Can this be questioned under GAAR?

Interpretation:
No dividends were distributed by X Ltd. since 1.4.2003, the day the DDT was implemented. Subsequently X Ltd. obtained tax benefit by not declaring dividend and passing this on as exempt capital gain in the hands of connected company Y Ltd. The buyback of shares was accepted only by company Y Ltd. and not by other shareholders companies D Ltd. and E Ltd.

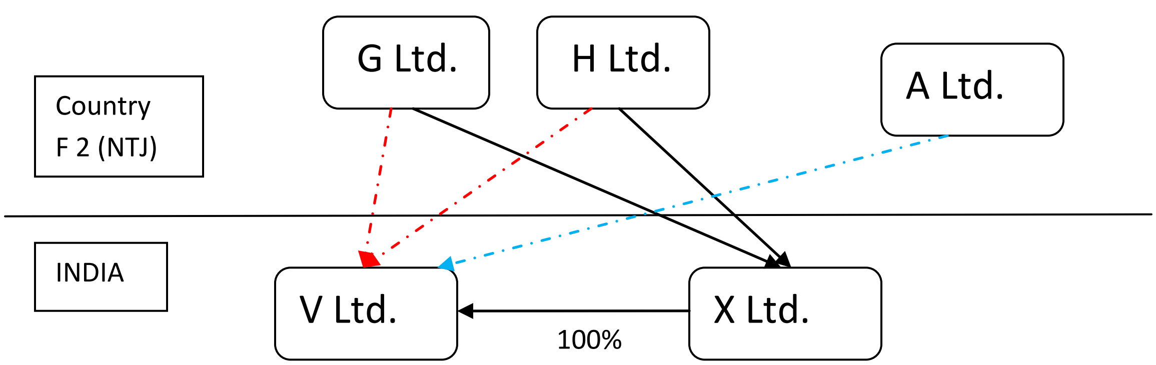
D Ltd and E Ltd would have invited capital gains tax by accepting such offer. This appears to be a dubious method; at the same time, there may or may not be genuine commercial reasons for D Ltd and E Ltd for not accepting the buyback offer by X Ltd.

The Revenue may, therefore, examine the arrangement under GAAR to ascertain the economic substance and main purpose of the arrangement.

Example -13:

Facts:

The shares of V Ltd., an asset owning Indian company, was held by another Indian company X Ltd. X Ltd. was in turn held by two companies G Ltd. and H Ltd., incorporated in country F2, a NTJ. The India-F2 tax treaty provides for non-taxation of capital gains in the source country and country F2 charges no capital gains tax in its domestic law. X Ltd. was liquidated by consent and without any Court Decree. This resulted in transfer of the asset/shares from X Ltd., to G Ltd. and H Ltd. Subsequently companies G Ltd and H Ltd sold the shares of V Ltd to A Ltd. which was incorporated in F2. The companies G Ltd and H Ltd claimed benefit of tax treaty and the resultant gains from the transaction are claimed to be not taxable. Can GAAR be invoked to deny treaty benefit?



Interpretation:

The alternative courses available to taxpayer to achieve the same result (with or without the tax benefit) are:

(i) Option 1 (as mentioned in facts) : X Ltd. liquidated, G Ltd. and H Ltd. become shareholders of V Ltd.; A Ltd. acquires shares from G Ltd. and H Ltd.; and becomes shareholder of V Ltd.

(ii) Option 2: A Ltd. acquires shares of X Ltd. from G Ltd. and H Ltd.; X Ltd. is liquidated; and A Ltd. becomes shareholder of V Ltd.

(iii) Option 3: X Ltd. sells its entire shareholding in V Ltd. to A Ltd. and subsequently, X Ltd is liquidated.

In Options 1 & 2, there is no tax liability in India except the deemed dividend taxation to the extent reserves are available in X Ltd. This is because of the treaty between India and country F1. In option 3, tax liability arises to X Ltd., an Indian company, on sale of shares of V Ltd. Subsequently, when X Ltd. is liquidated, tax liability arises on account of deemed dividend to the extent reserves are available in X Ltd.

The taxpayer exercises the most tax efficient manner in disposal of its assets through proper sequencing of transactions.

The Revenue cannot invoke GAAR as regards this arrangement.

Example -14:

Facts

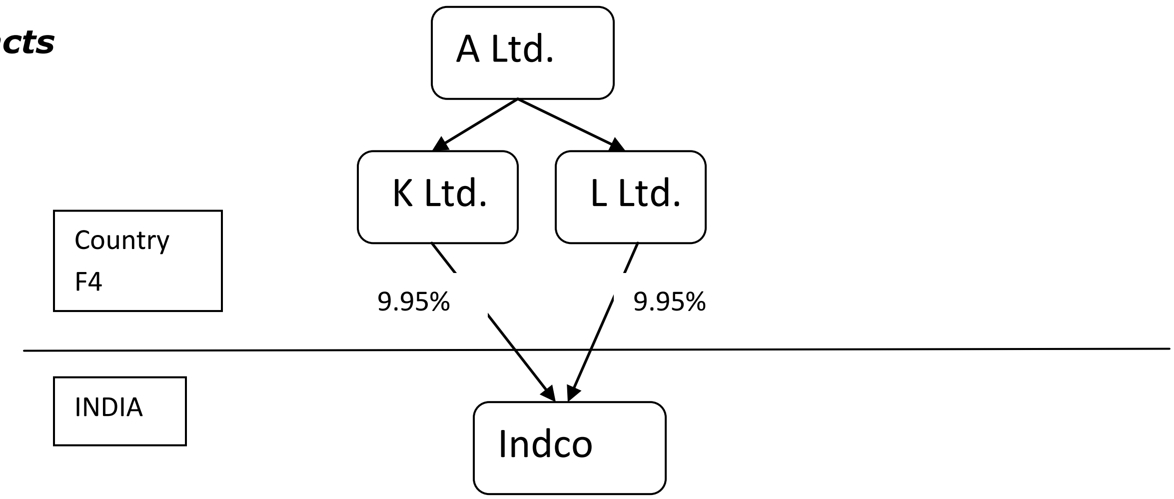
A foreign bank J Ltd.'s branch in India arranges loan for an Indian borrower from another branch of J located in a third country. The loan is later assigned to J's subsidiary in country F 3. The India-F3 Treaty provides no source based withholding tax on interest to a bank carrying out bona-fide business. This, therefore, results in no withholding tax on interest payment out of India.

Interpretation:

The above arrangement of finalizing the loan from one country and assigning it to another country has been made mainly to avoid withholding tax provisions on the basis that there is no withholding provision on interest earned by F3 residents under the India-F3 treaty. There is a tainted element being abuse of the treaty and thus may be treated as an impermissible avoidance arrangement. The Revenue may invoke GAAR with regard to this arrangement.

Example -15:

Facts



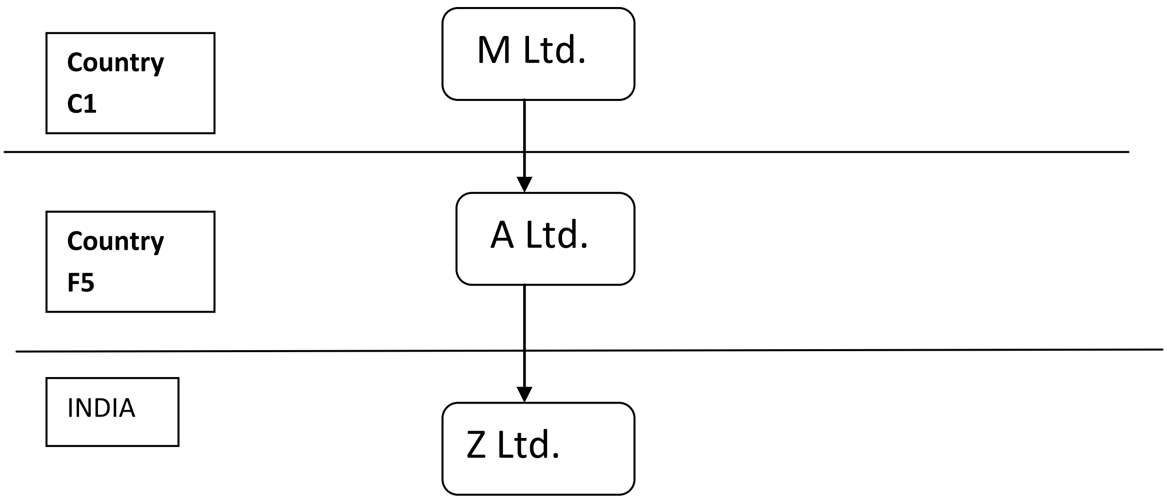
Under the provisions of a tax treaty between India and country F4, any capital gains arising from the sale of shares of Indco, an Indian company would be taxable only in F4 if the transferor is a resident of F4 except where the transferor holds more than 10% interest in the capital stock of Indco. A company, A Ltd., being resident in F4, makes an investment in Indco through two wholly owned subsidiaries (K Ltd. and L Ltd.) located in F4. Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of Indco. The subsidiaries sell the shares of Indco and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

Interpretation:

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor A Ltd. in any manner (i.e on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement would be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit would be denied by ignoring K and L, the two subsidiaries, or by treating K and L as one and the same company for tax computation purposes.

Example -16:

Facts:



A Ltd. is a resident of country F5 and is wholly owned by company M Ltd. in country C1. M Ltd. is a financial company with substantial reserves and is looking for investments in India. M Ltd uses A Ltd, its subsidiary company, to route its investment in Z Ltd., an Indian company, whereby A Ltd purchases the shares of Z ltd. Later, A Ltd sells the shares of Z Ltd to C Ltd., another company, and realizes capital gains.

As per the provisions of relevant DTAA between country F5 and India, a shell/conduit company is not eligible for capital gains exemption in India. However, a company shall not be deemed to be a shell/conduit company if its total annual expenditure on operations in country F5 is equal to, or more than, $ 200,000/- in the immediately preceding period of 24 months from the date the gains arise. A Ltd claims that capital gains are not taxable in India as it is not a shell company as per the relevant DTAA Protocol since it incurred $250,000/- as annual operating business expenses exceeding the limit prescribed therein. Can GAAR be invoked when Limitation of Benefit clause is satisfied?

Interpretation:

As A Ltd. has satisfied the Limitation of Benefit (SAAR) conditions, it cannot be treated as a shell/conduit company. Hence GAAR cannot be invoked on the ground of A Ltd. being a conduit company or that it lacks commercial substance.

Example -17:

Facts:

Z Ltd., an Indian company, is in the business of import and export of certain goods. It purchases goods from Country P and sells the same in country Q. It sets up a subsidiary in Country A – a zero / low tax jurisdiction. The director of Z Ltd. finalizes the contracts in India but shows the documentation of the purchase and sale in Country A. The day to day management operations are carried out in India. The goods move from P directly to Q. The transactions are recorded in the books of subsidiary in country A, where the profits are tax exempt. Can GAAR be invoked?

Interpretation:

The above facts reflect the following possibilities:

(A) Z Ltd. misrepresents the facts by showing on paper that everything is done outside India and therefore, nothing is taxable in India. This would be a case of tax evasion and not GAAR; or

(B) Z Ltd. represents that certain operations relating to A, its subsidiary, are carried out in India but it is not taxable under the relevant DTAA as these operations do not constitute a permanent establishment (PE) in India. This is not a case of tax avoidance but of determination of facts to ascertain whether there is a PE or not.

Again, the investigation should reveal if it is a case of correct reporting of facts or a mis-representation. If the latter, it would be tax evasion. Further, if any activity is being carried out by Z Ltd for A Ltd, then Z Ltd is required to be compensated at arm's length price which would be covered by specific anti-avoidance rules. Hence, it is not a fit case for invoking GAAR.

Example -18:

Facts:

A company "A" in country F6, a company "B" in country F7 and a company "C" in country F8 pool their resources and form a special purpose vehicle (SPV) as a company N situated in country F1 which has a provision of residence based taxation of capital gains in its tax treaty with India. N further invests the funds in equities in India and earns capital gains. The taxpayer claims that –

(i) as SPV, a neutral jurisdiction was needed and, after exploring various options, country F1 was selected;

(ii) it is easy to incorporate a company in F1; it is easy to operate; cost of compliance is low; and it is easy to migrate;

(iii) there is no tax liability in country F1;

(iv) the treaty network of country F1 protects investments and also saves taxes in jurisdictions including India.

Can GAAR be invoked in such a case?

Interpretation:

The arrangement results into a significant tax benefit to the investors by routing their investments through country F1. Can it be said that obtaining tax benefit in India is the main purpose of the arrangement? Given the facts, it may be held that forming an SPV in an efficient jurisdiction was the main purpose of the arrangement and obtaining tax benefit was not the main purpose of the arrangement.

Hence, the Revenue would not invoke GAAR with regard to this arrangement.

Example -19:

Facts

An employee of a company R is to receive a bonus in the form of preferential shares *or* salary. The employee subscribes for preferential shares of the employer company. The preferential shares are purchased by a connected company of R, or are redeemable at a premium (which is pre-decided with the employer) that reflects a portion of the employee's annual salary or bonus, after a period of one year. The employee thus receives the income as long term capital gain instead of salary and saves in taxes. Can GAAR be invoked?

Interpretation:

Investigation will reveal if tax avoidance is embedded in the arrangement. If the employee has been given the *option* of taking salary or bonus in the form of shares, then there is a risk attached to it. In this case, there is no tax avoidance.

However, if every employee's remuneration package comprises a mix of shares and salary in a fixed proportion, then the implications are different.

In the latter case, the acquisition of the preferential shares becomes part of an arrangement designed to avoid the tax that would have been required to be paid on salary. The main purpose of the arrangement is to obtain the tax benefit. The tainted elements are misuse of the tax provisions and the arrangement being not for bona fide purposes. The Revenue would invoke GAAR with regard to this arrangement and consequently, in the case of the employee, capital gains would be recharcterised as salary.

Example -20:

Facts:

Company S had a disputed claim with Company T. S transferred its actionable claims against T for an amount which was low, say, for example, 10% of the value of the actionable claim against T to a connected concern U by way of a transfer instrument. U transferred such claim to company V, and company V further gifted it to company W, another connected concern of S. Upon redemption of such actionable claims, W shows it as a capital receipt and claims exemption as not being in the nature of revenue receipt. Can GAAR be invoked?

Interpretation:

The transfer of actionable claims in the manner as detailed above to a connected concern appears to be dubious in nature if the same is not at arm's length price. The income in the instant case belongs to S. The Revenue would invoke GAAR as regards this arrangement.

Example -21:

Facts:

Company X borrowed money from Company Y and used it to buy shares in three 100% subsidiary companies of X. Though the fair market value per share was Rs.100, X paid Rs. 600. The amount received by the said subsidiary companies was transferred back to another company connected to Y. The said shares were sold by X for Rs. 100/5 each and a short-term capital loss was claimed. This was set off against short-term capital gains from other sources. All the companies are Indian companies. Can GAAR be invoked?

Interpretation:

By the above arrangement, the tax payer has obtained a tax benefit and created rights or obligations which are not ordinarily created between persons dealing at arm's length. Since transactions of purchase and sale of shares of a closely held company at a price other than the fair market value are covered under section 56 of the Act, GAAR may not be invoked as section 56, being SAAR, is applicable. However, if SAAR is not applicable considering the limited scope of section 56 to the shares of closely held companies only, then GAAR may be invoked.

Example -22:

Facts:

Y Tech Ltd. is a company resident of country C1. It enters into an agreement with Z Energy Ltd., an Indian company for setting up a power plant in India. It is a composite contract for an agreed price of US$ 100million. The payment has been split in the following parts as per separate agreements

(i) US$ 10 million for design of power plant outside India (payment for which is taxable at 10% on gross basis)

(ii) US$ 70 million for offshore supplies of equipment etc (not taxable as no role is played by any PE in India. There are not subject to import duty)

(iii) US$ 20 million for local supplies and installation charges (taxable on net income basis)

It is found that the fair market value of offshore design is about USD 30 million; therefore it is under invoiced. On the other hand, offshore supplies were over invoiced. The arrangement resulted in significant tax benefit to the taxpayer. Can GAAR be invoked in such a case?

Interpretation:

The allocation of price to different parts of the contract has been decided in such a manner as to reduce tax liability of the foreign company in India. Both conditions for declaring an arrangement as impermissible are satisfied. (1) The main purpose of this arrangement is to obtain tax benefit; and (2) the transactions are not at arm's length. Consequently, GAAR may be invoked and prices would be reallocated. However, determination of arm's length price should be based on transfer pricing regulations under the Act.

Example 23:

Facts:

A company A Ltd enters into a ready forward contract with B Ltd whereby A Ltd sells its some unlisted securities to M/s B Ltd for a price of Rs 1000 on 1st Jan 2020 and on 1st Jan 2021, the company A Ltd purchases the same unlisted securities for Rs 1100 as agreed in advance. The forward contract price was based on a rate of return of 10% p.a.

B Ltd claims the gain of Rs 100 as long term capital gains which are not taxable at the marginal rate of 30%.

Can GAAR be invoked in this case?

Interpretation

The ready forward contract and fixation of price based on the rate of interest clearly suggest that it was given a form of purchase and sale of goods but in fact it was a financing arrangement. The sole purpose of the arrangement is to obtain a tax benefit. The substance or effect of the arrangement as a whole, is inconsistent with the form of its individual steps. Thus, it may be deemed to lack commercial substance. Hence, GAAR may be invoked to recharacterise the capital gains in the hands of B Ltd as interest income and taxed at applicable rates. Further, corresponding deduction of interest expense would not be allowed in the case of A Ltd.

Example 23A:

Facts:

In the above example, let us presume that B Ltd instead of having a forward sale price, has a put option to sell at a rate of Rs 1100 on 1st Jan 2021. On that date, the market price of the assets is Rs 900 only. Hence, B Ltd exercises its option and sells the assets at Rs 1100 to A Ltd. as per the put option. Can GAAR be invoked in such a case?

Interpretation

This case is different from example 23 since it is not a simple financing arrangement, as an element of risk is involved. If the price of the goods on 1st Jan 2021 goes beyond Rs 1100, then B Ltd would not have exercised the put option and would have sold the goods in the market at the higher price. Thus, the gains to B Ltd would be much higher than the interest income. On the other hand, when prices go down, the return to B Ltd upto the agreed rate of interest is secured through the put option. This being a purely commercial transaction, GAAR cannot be invoked.

Example 24:

Facts:

An Indian company A Ltd makes an investment of Rs 1 crore in shares of a listed company on 1st Jan 2020. After a year, the prices go up and fair market value of shares becomes Rs 11 crore. If A Ltd sells these shares, the long term capital gains of Rs 10 crore would be exempt but it would be liable to tax under MAT @ 20%.

A Ltd forms a partnership firm with another person with nominal partnership. It transfers its shares in the firm at a cost price. No capital gain arises as per section 45 of the Act. After a year, the firm sells these shares and realises the gains of Rs 10 crore which is exempt from taxation and no MAT is payable. Subsequently, the firm is dissolved and share of A Ltd in the partnership firm is transferred back along with profits, which is exempt from tax under the Act.

Can GAAR be invoked in this case?

Interpretation

The only purpose of forming a partnership and transferring assets to such firm and selling the shares is to save tax from MAT liability of A Ltd. Further, there is no commercial substance in the formation of the partnership as it does alter the economic position of A Ltd in terms of business risks or cash flow. Moreover, the entire exercise is carried out in an abnormal manner. Even holding of shares by the partnership firm for a year or more is no significant economic risk to the company. Hence, GAAR may be invoked and the partnership firm may be disregarded and capital gains may be taxed under MAT in the hands of A Ltd.

Example 25:

Facts:

M/s Global Architects Inc is a company incorporated in country F1. It is engaged in the business of providing architectural design services all over the world. It receives an offer from Lovely Resorts Pvt Ltd, an Indian company, for design and development of resorts all over India.

India-F1 tax treaty provides that architectural services are technical services and payment for the same to a company may be taxed in India. However, if such professional services are provided by a firm or individual, then payment for such services are taxable only if the firm has a fixed base in India or stay of partners/ employees in India exceed 180 days.

M/s Global Architects Inc forms a partnership firm with a third party (director of the company) having only a nominal share in the F1. The firm enters into an agreement to carry out the services in India. The company seconded its trained manpower to the firm.

Thus, the partnership firm claimed the treaty benefit and no tax was paid in India. Can such an arrangement be examined under GAAR?

Interpretation

It is obvious that there was no commercial necessity to create a separate firm except to obtain the tax benefit. The firm was only on paper as the manpower was drawn from the company. The firm did not have any commercial substance. Moreover, it is a case of treaty abuse. Hence, GAAR may be invoked to disregard the firm and tax payment for architectural services as fee for technical services. However, the rate of tax on such payment shall be as applicable under the treaty, if more beneficial.

Example 26:

Facts:

A company X Ltd. has property that it proposes to transfer to a third party. Such a transfer would result in capital gains in its hands. Another company Y Ltd. (which is related to X Ltd.) has a carried forward capital loss. X Ltd. (instead of selling the property directly to third party) transfers the property to its abovementioned related company Y Ltd. at book value, which is less than fair market value. Such a transfer does not result in any capital gains in the hands of the X Ltd. (which would have resulted had the assessee transferred the property directly to the third party). Soon after, the related company Y Ltd. transfers the property to the third party at fair market value and sets off the resulting capital gains with its carried forward capital loss.

Interpretation

GAAR may be invoked in this situation since there is no commercial substance in first transferring the property to the related company at less than fair market value (i.e. at a non-arm's length price) followed by transfer of that property to third party by the related company. However, GAAR may not be invoked if the property is transferred by related company after a gap of reasonable time limit after the acquisition from assessee as that would reflect that main purpose of the arrangement was not to obtain tax benefit. This would comprise a matter of GAAR query.

Example 27:

Facts:

An Indian holding company Holdco borrows Rs. 10 crore for acquisition of shares of Subco which then became subsidiary of Holdco. Holdco and Subco amalgamate so that the interest payable on the monies borrowed to acquire the shares can be deducted in computing the income from the business of the amalgamated company.

Interpretation

The borrowing by Holdco followed by the amalgamation by Subco is not abusive and GAAR would not apply in the case of merger which is carried out under the orders of High Court.

Selected List of Abbreviations

SEZ	Special Economic Zone
Indco	Indian Company
X Ltd.	Another Indian Company
Subco	Subsidiary Company
CFC	Controlled Foreign Company
NTJ	No tax jurisdiction
LTJ	Low tax jurisdiction
DDT	Dividend distribution tax

Annexe 2. Meetings of GAAR Committee with Stakeholders.

Chambers of Commerce and Industry

Date &Time	Invitee	Contact Person
31st July, 12 11 a.m. 1.00 p.m.	FICCI	Mr. Batra, Mr.Kanoria
6th Aug. 12 1 a.m.to 1.00 p.m.	CII	Mr. Jairaj Purandre, Adi Godrej, Marut Sen Gupta, Sunil Munjal
6th Aug. 12 3 p.m. to 5 p.m.	ASIFMA	Mr. Nayak
7th Aug. 12 11 a.m.to 1 p.m.	IVCA	Mr. Swaroop
7th Aug. 12 2p.m. to 4 p.m.	ASSOCHAM	Mr. Rawat, Mr. Ved Jain
14th Aug. 12 2 p.m. to 4 p.m.	Chamber of Tax Consultants	Mr. Vipul B Joshi
17th Aug. 12 11 a.m. 12 noon	American Chambers of commerce	Mr. Ajay Singha, ED, Ms. Madhvi Kataria
17th Aug. 12 12 noon to 2 p.m.	ICC	Mr. Mukesh Butani
17th Aug. 12 2.30 p.m. to 3.30 p.m.	Cellular Operators of India	Mr. Sarat Chandra
17th Aug. 12 3.30 p.m. to5.30 p.m.	All India Federation of Tax Practitioners	Mr.Wadhwa
18th Aug. 12 12 noon	Bangalore Chambers of Commerce	Mr. Sekar

Tax Advisory firms

Date &Time	Invitee	Contact Person
20th July, 12 11 a.m.to1 p.m.	KPMG	Mr. Dinesh Kanabar
18thAug. 12 11 a.m. to	KPMG	Mr.Dinesh Kanabar
20th July,12 3 p.m.to 5 p.m.	PWC	Mr.Vijay Mathur
31st July, 12 3 p.m.to 5 p.m.	PWC	Mr.Vijay Mathur
13th Aug. 12 11 a.m. to 1 p.m.	Deloitte	Mr. Sekar
13th Aug. 12 3 p.m.to5 p.m.	Nishith Desai & Co.	Mr. Nisith Desai

14th Aug. 12 11 a.m.to 1 p.m.	E&Y	Mr. Satya Poddar

Industry

Date &Time	Invitee	Contact Person
16th Aug. 12	Mr.Bajoria,Kolkata	
13th Aug. 12 9.45 a.m. to 11 a.m.	TCS	Mr.S. Ramadorai, Vice Chairman
18th Aug. 12	WIPRO	Dr. Vegi Srinivasa R. Business Head for Media & Telecommunications at WIPRO

Policy Makers

Date &Time	Person	Designation /Organisation
	Shri P C Chidambaram	Finance Minister, GOI
13th Aug. 12 5 p.m.	Shri Yashwant Sinha	Chairman, Parliamentary Standing Committee on Finance
6th Aug. 12 5.30 p.m.	Shri Montek Singh Ahluwalia	Deputy Chairman, Planning Commission.

Annexe 3. Documents presented to GAAR Committee

S.No.	Letter/ Slide/ Report	Date	Name of the representative	Subject
CHAMBERS OF COMMERCE AND INDUSTRY				
1	Letter	02.08.2012	ASIFMA	Application of indirect transfer taxation rules to portfolio investments.
2.	Letter	02.08.2012	ASIFMA	ASIFMA/CMTC Submission Letters – GAAR Guidelines – 6 August 2012 Meeting.
3.	Letter	10.08.2012	ASIFMA	ASIFMA / CMTC Submission letter – Indirect Transfer Taxation Rules : Application to Intra Group Restructuring.
4.	Letter	07.08.2012	US India Business Council	
5.	Letter	11.08.2012	The Chamber of Tax Consultants	Suggestions on Draft guidelines on GAAR.
6.	Letter	14.08.2012	Dr. Arbind Prasad, Director General, FICCI	Comments / Suggestions on Draft Guidelines on GAAR.
7.	Letter	17.08.2012	International Chamber of Commerce	Review of taxability of 'indirect transfer'.
8.	Letter	18.08.2012	Bangalore Chamber of Industry & Commerce	
9.	Letter	18.08.2012	Bangalore Chamber of Industry & Commerce	BCIC Representation on the Application of GAAR.
10.	Letter	22.08.2012	Mukesh Butani, Vice Chair, ICC Taxation Commission, Paris	Recommendation for formulation of guidelines for GAAR and taxation of indirect transfer of capital assets situated in India.
11.	Mail	23.08.2012	Mukesh Butani	Review of GAAR guidelines-key recommendations.
12.	Letter/ Mail	27.08.2012	J.K.Batra, FICCI	GAAR-Clarifications on points.
13.	Slide		Indian Mobile Telecom Industry	Comments/Suggestions on Draft Guidelines regarding implementation of GAAR.
14.	Slide		AMCHAM India	Draft guidelines on GAAR and Taxability of Indirect Transfer of

				Assets – Issues and Recommendations.
15	Letter		Bombay Chamber of Commerce and Industry	Memorandum on Draft Guidelines – July 2012
16	Letter		Khaitan & Co.	Draft Guidelines on GAAR dated 28th June 2012 – some suggestions/Comments
17	Letter		Indian Broadcasting Foundation(IBF)	Recommendations
18	Letter	19th July 2012	United States Council for International Business(USCIB)	Comments on the proposed draft GAAR guidelines
19	Letter	20th July 2012	Alternative Investment Management Association(aima)	Comments on the Draft guidelines for implementation of GAAR provisions.
20	Letter		ALSTOM	Comments on Draft GAAR Guidelines
21	Letter	25.07.2012	Indian Private Equity & Venture Capital Association(IVCA)	Various representations on GAAR
22	Letter	03.08.2012	Cellular Operators Association of India	Representation on draft guidelines issued on implementation of GAAR in India.
23	Letter	31.07.2012	International Fiscal Association(Singapore Branch)	Submission to the Expert Committee on GAAR
24	Letter	3.04.2012	Investment Company Institute(ICI Global)	Finance Bill provisions that could impact foreign investors negatively.
25	Letter	17.08.2012	International Chamber of Commerce	Review of GAAR Guidelines.
26	Report	1/08/2012	Srinidh	Issues in GAAR
27	Letter	30th July, 2012	European Fund and Asset Management Association(efama)	General Anti Avoidance Rules('GAAR') Guidelines – Perspective of the European Investment fund industry.
28	Report	31st July, 2012	CII	CII Comments on Draft Guidelines on General Anti Avoidance Rules(GAAR)
29.	Letter	23.07.2012	ASIFMA through PMO	Certain amendments proposed in Finance bill dated 12/04/2012
Tax Advisory Firms				
30.	Letter	31.07.2012	PWC	Recommendation on 'Draft guidelines

				regarding implementation of GAAR in terms of section 101 of the IT Act, 1961.
31.	Letter	10.08.2012	Ernst & Young	Private equity/venture capital funds – comments/suggestions on draft guidelines for implementation of the GAAR.
32.	Slide		Ernst & Young	Views on GAAR Guidelines.
33.	Report	August'12	Ernst & Young	Memorandum on Draft GAAR Guidelines.
34.	Report	August'12	Ernst & Young	Memorandum on Draft GAAR Guidelines.
35.	Slide	17.08.2012	Ernst & Young	Representation on retrospective amendments made by Finance Act 2012.
36.	Slide	August'12	Ernst & Young	Views on Indirect transfer provisions.
37.	Report	August'12	Ernst & Young	Views on Indirect transfer provisions.
38.	Letter/ Mail	27.08.2012	Sh. Satya Poddar, Ernst & Young	Submission from Coalition on International Taxation in India.
39.	Letter	13.08.2012	Nishith Desai Associates	Comments on Draft guidelines on GAAR.
40.	Slide	13.08.2012	Nishith Desai Associates	Comments on Draft GAAR Guidelines.
41.	Slide	13.08.2012	Nishith Desai Associates	Comments on Indirect Transfer Provisions.
42.	Letter	13.08.2012	Nishith Desai Associates	Comments on indirect transfer provisions.
43.	Slide		Nishith Desai Associates	Implement GAAR only once economy stabilizes.
44.	Report		Nishith Desai Associates	GAAR Legislation, Administrative Guidance & Taxpayer Rights Global Practices – Submissions to Expert Committee on GAAR
45.	Slide	13.08.2012	Deloitte Haskins & Sells	GAAR and Retrospective Amendments – Recommendations.
46.	Report		Deloitte Haskins & Sells	General Anti-Avoidance Rules – India and International perspective.
47.	Report	24.08.2012	Deloitte Haskins & Sells	GAAR and taxability of indirect transfers – Note on some of the key issues.
48.	Letter	16.08.2012	Indian Venture Capital Association of India	Representation on GAAR and Indirect transfer provisions of the Income-tax Act, 1961.
49.	Letter	17.08.2012	All India Federation of Tax Practitioners Direct Taxes	Review of draft guidelines on GAAR and Retrospective Amendments – Submissions of AIFTP.

			Representation Committee	
50.	Letter/ Mail	27.08.2012	Mukesh Butani,BMR legal	1. Review of taxability of 'indirect transfer'. 2. Recommendation for formulation of revised guidelines-GAAR. 3. Review of GAAR guidelines-Key recommendation.
51.	Letter/ Mail	27.08.2012	Sh. Sunil Jain, Partner J. Sagar Associates	Inputs on GAAR.
52.	Letter/ Mail	27.08.2012	Bombay Chartered Accountant Society	Representation on Draft guidelines of GAAR in terms of section 101 of the IT Act, 1961.
53.	Slide	--	KPMG	Taxation of 'Indirect' Transfers.
54.	Note			India's General Anti-Avoidance Rule (GAAR) Draft Guidelines Released by Government Committee
55.	Letter	20th July 2012	PWC	Recommendation on draft GAAR Guidelines from the perspective of Asset Management industry
56.	Letter		CA Ankit Virendra Sudha Shah	Note on First Draft Guidelines regarding implementation of GAAR – Comments/Suggestions
57.	Letter		Manvendra Goyal	GAAR Comments on the Draft Guidelines.
58.	Letter		Niraj Shah	Comments
59.	Letter		Poornima Mepani	Comments
60.	Letter		S.G.Bhokarikar	Comments
61.	Letter		Swami Sharan Verma	Comments
62.	Letter		Manish Agarwal	Comments
63.	Slide		KPMG	Representation on Draft Guidelines on GAAR
64.	Report		KPMG	Comments/Suggestions on Draft Guidelines on GAAR
65.	Letter	17.08.2012	PWC	Potential impact of the provisions of the Finance Act, 2012 relating to tax on offshore transfers in the context of the Financial Services Sector.
66.	Letter		BMR	BMR Recommendations on the draft guidelines on GAAR
67	Letter		BMR & Associates	Recommendations on the proposed GAAR guidelines.
68	Mail	29.08.2012	Ernst & Young	Supplements to Memorandum dated 14.08.2012.

Annexe 4. Country Experiences with GAAR

In order to ascertain the type of arrangements which may be targeted under GAAR, a number of countries have provided GAAR in their taxing statutes as discussed below.

United Kingdom

Currently, there are no GAAR like provisions in UK Statutes. Since the process of introducing GAAR is ongoing in the UK, it is pertinent to present at the beginning, UK's ongoing experience that should provide useful indicators for India.

For some years, HMRC, the UK tax department[7] had expressed concern with tax avoidance. In June 2010, a *consultation* document contemplated a GAAR[2]. After public responses, HMRC commissioned Graham Aaronson to provide a Report on GAAR. The Report indicated the need for a GAAR but suggested eschewing a *broad spectrum* approach that would hurt responsible tax planning.

The relevant parts of the draft GAAR are reproduced as under –

> *2. Section 8 applies to counteract **abnormal arrangements** (see sections 6 and 7) which, but for this Part, would achieve an **abusive tax result** from the application to the arrangements of the provisions of the Acts, and which are **contrived to achieve** such a result.*
>
> *For the purposes of this Part an "**abusive tax result**" is an advantageous tax result (see section 15) which would be achieved by an arrangement that is neither reasonable tax planning (see section 4) nor an arrangement without tax intent.*
>
> *For the purposes of this Part **an abnormal arrangement is contrived** to achieve an abusive tax result if, and only if, the inclusion of any **abnormal feature** (see sections 6 and 7) can reasonably be*

[7] The direct tax and indirect tax departments were consolidated into HM Revenue and Customs in 2006 after a major *Review.*

considered to have as its sole purpose, or as one of its main purposes, the achievement of an abusive tax result by –
(a) avoiding the application of particular provisions of the Acts, or
(b) exploiting the application of particular provisions of the Acts, or
(c) exploiting inconsistencies in the application of provisions of the Acts, or
(d) exploiting perceived shortcomings in the provisions of the Acts.

Abnormal arrangements *and* ***abnormal features***

6. (1) For the purposes of this Part an "abnormal arrangement" is an arrangement which, considered objectively –

(a) viewed as a whole, and having regard to all the circumstances, has ***no significant purpose apart*** *from achieving an abusive tax result (so that in the context of such an arrangement all of its features shall be regarded as abnormal); or*

(b) has features which would not be in the arrangement if it did not also have as its <u>sole purpose, or as one of its main purposes</u>, achieving an abusive tax result.

The features are -

(a) that the arrangement would, apart from the operation of this Part, result in receipts being taken into account for tax purposes which are significantly less than the true economic income, profit or gain;

(b) that the arrangement would, apart from the operation of this Part, result in deductions being taken into account for tax purposes which are significantly greater than the true economic cost or loss;

(c) that the arrangement includes a transaction at a value significantly different from market value, or otherwise on non-commercial terms;

(d) that the arrangement, or any element of it, is inconsistent with the legal duties of the parties to it;

(e) that the arrangement includes a person, a transaction, a document or significant terms in a document, which would not be included if the arrangement were not designed to achieve an abusive tax result;

(f) that the arrangement omits a person, a transaction, a document or significant terms in a document, which would not be omitted if the arrangement were not designed to achieve an abusive tax result; and

(g) that the arrangement includes the location of an asset or a transaction, or of the place of residence of a person, which would not be so located if the arrangement were not designed to achieve an abusive tax result.

Thus, the proposed GAAR has two primary elements i.e. abnormal arrangement having abnormal features, and abusive tax results.

The Report also suggested that doubts be addressed quickly through guidance notes along with GAAR.

The Report also recommended that an independent advisory panel with majority non-HMRC members be set up to give its view on transactions on which GAAR is sought to be applied.

The Report suggested that the opinion should be considered by an appellate authority while deciding cases, and that its view be published as guidance.

UK's 2012 Budget accepted the Report's recommendations, converting the General Anti *Avoidance* Rule to General Anti *Abuse* Rule.

The UK Government announced that there would be a year's consultation before bringing the legislation through the 2013 Finance Bill. In May 2012, HMRC issued a consultation document laying down the draft GAAR provisions reflecting mainly the Aaronson Report. It elaborates on (i) certain safeguards before application of GAAR; (ii) the appropriateness of each draft GAAR provision; (iii) examples of arrangements under the scope of GAAR; and (iv) HMRC's position on GAAR's overriding tax treaties. The crux here is the elaborate consultation process to assess and incorporate where deemed right, the views of stakeholders.

It is pertinent to mention the role of safeguards. The first safeguard indicates that transactions that are outrightly unreasonable would come under GAAR while admitting that, given expected complexity, unanimous agreement on reasonableness of a transaction may be difficult to arrive at. If so, the appellate authority would come in.

The second safeguard protects arrangements that were not conceived solely for tax benefit and requires the beneficiary to prove that the transaction was not planned or designed solely for a favourable tax outcome. The Indian draft GAAR proposes that a transaction could become an *impermissible avoidance arrangement* even if a step in it benefits the taxpayer. This overarching Indian provision conveys a contrary position to the first UK safeguard that seems to limit the scope of GAAR; and the second safeguard is also milder than the implications of the Indian provision.

The third safeguard requires HMRC to prove that the transaction is *not* protected by the first two safeguards. This locks HMRC from using GAAR for a revenue objective. Only highly artificial tax avoidance schemes are to be targeted. This contrasts with the Indian presumption of an underlying tax benefit where the burden of proof lay on the taxpayer until a subsequent explanation was provided, indicating that the onus of proof was on the Revenue.

Australia[8]

Part IVA of the Income Tax Act is the general anti-avoidance rule for income tax. It protects the integrity of the income tax system by ensuring that arrangements that have been contrived to obtain tax benefits will fail.

Generally speaking, Part IVA will only apply to an arrangement if the answer is yes to both of the following questions:

1. Did you obtain a tax benefit from a scheme – a benefit that would not have been available if the scheme had not been entered into?

2. Having regard to the eight matters specified in Part IVA would it be objectively concluded that you or any other person entered into or carried out the scheme, or any part of it, for the sole or dominant purpose of obtaining the tax benefit?

The matters that would need to be considered in determining an answer to first question include:

- the overall practical financial consequences of the scheme and other outcomes of the scheme, and

[8] Australian Taxation Office, *"Part-IVA: the general anti-avoidance rule for income tax"*, Guide NAT 14332-12.2005

- whether the same outcomes (other than the tax advantage) could be achieved in a more straightforward, ordinary or convenient way than the way in which they were achieved by the scheme.

In some cases, it may even be that no economic activity would have been carried out by the taxpayer if the scheme had not been in place. This is particularly likely to be true if the scheme mainly results in a taxpayer artificially obtaining a tax deduction.

The eight matters to be considered for determining answer to second question are:

1. the manner in which the scheme was entered into or carried out;

2. the form and substance of the scheme;

3. the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

4. the result achieved by the scheme under the income tax law if Part IVA did not apply;

5. any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result from the scheme;

6. any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, that has resulted, will result, or may reasonably be expected to result, from the scheme;

7. any other consequences for the relevant taxpayer, or for any person referred to in matter 6 (above) of the scheme having been entered into or carried out; and

8. the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in matter 6.

Answering this purpose question will generally be the most critical step in determining whether Part IVA applies.

United States[9]

There is no provision like GAAR in the US statutes. US courts have applied five main common law doctrines to deny taxpayers desired tax benefits, i.e. (1) "economic substance"; (2) "substance over form"; (3) "step transaction"; (4) "business purpose"; and (5) "sham transaction". On 30 March 2010, the "economic substance doctrine" was codified in US law through insertion of section 7701(o) in the Internal Revenue Code (IRC). **The economic substance doctrine applies to transactions entered into after 31 March 2010.** The relevant part is reproduced as under-

" (1) Application of Doctrine – in the case of any transaction to which economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if –

> *(A) the transaction changes in a meaningful way (apart from federal income-tax effects) the taxpayers economic position, and*
>
> *(B) the taxpayer has a substantial purpose (apart from federal income-tax effects) for entering into such transaction.*
>
> *….*
>
> *The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks business purpose."*

Thus, it envisages that, for any transaction "to which the economic substance doctrine is relevant", the use of a conjunctive two-pronged test must be used to determine whether or not a transaction should be treated as having economic substance. A transaction should be treated as having economic substance if the two prongs are met. The first prong requires that the transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax effects) and the second requires the taxpayer to have a substantial purpose (apart from federal income tax effects) for entering into such a transaction. From this definition, it can be concluded that a conjunctive examination is required. Accordingly, there must be an inquiry regarding the objective effects of the transaction on the

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[9] Bulletin for International Taxation by IBFD, "An assessment of Anti Tax Avoidance Doctrines in United States and European Union", March 2012, page 153.

taxpayer’s financial position as well as an inquiry regarding the taxpayer’s subjective motives for engaging in the transaction. **What it also implies for India is that GAAR, if introduced, has to be applied to very selective cases, possibly above a high threshold, so that it can act as an anti-deterrent instrument, rather than a revenue generating device.**

Canada[10]

Subsection 245(2) of the Income-tax Act states that where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that would result from that transaction or from a series of transactions that includes that transaction.

An avoidance transaction is defined in subsection 245(3) as a single transaction or one that is a part of a series of transactions where the single transaction or the series results directly or indirectly in a tax benefit, unless the transaction is carried out primarily for bona fide purposes other than to obtain the tax benefit.

"Tax benefit" is defined to mean a reduction, avoidance or deferral of tax or other amount payable or an increase in a refund of tax or other amount under the Act.

Subsection 245(4) provides that the rule in subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of the Act or an abuse having regard to the provisions of the Act read as a whole.

Thus, in Canada the GAAR provisions are applied to a transaction which results into a tax benefit to a party, unless the transaction is carried out for bona fide purposes or it is not a misuse of the provisions of the Act. Nevertheless, such application has been very selective, being ……… over a period of ……..years (from 200 .. to 2011).

[10] Guidance Note (IC88- 2, Oct 21, 1988) on General Anti-Avoidance Rule section 245 of the Income-tax Act.

South Africa

In 2006, the Income Tax Act, 1962 was amended to introduce the general anti-avoidance rule (GAAR) which applies to "impermissible avoidance arrangements".

Four requirements have to be fulfilled in order for GAAR to apply, namely-

(i) the existence of an arrangement;

(ii) the existence of a tax benefit (that is, an arrangement resulting in a tax benefit);

(iii) the <u>sole or main purpose</u> of the avoidance arrangement is to obtain a tax benefit; and

(iv) the avoidance arrangement is characterized by the presence of any one or more of four tainted elements for arrangements in the context of business and any one or more of three tainted elements for arrangements in the context other than business, which renders it an impermissible avoidance arrangement.

The tainted element tests, any one or more of which must be present in an arrangement, in **a business context** are:

Test 1: Entered into or carried out by an abnormal means or manner, not used for a bona fide business purpose (the business abnormality test) other than obtaining a tax benefit

Test 2: Lack of commercial substance; which consists of objective indicative tests and an objective general or presumptive test

Test 3: Creation of non-arm�much's length rights or obligations

Test 4: Abuse or misuse of the provisions of the Income Tax Act

The so-called tainted elements or tainted element tests, any one or more of which must be present in an arrangement, **in a context other than business** are:

Test 1: Entered into or carried out by an abnormal means or manner, not used for a bona fide purpose other than obtaining a tax benefit

Test 2: Lack of commercial substance; which consists of objective indicative tests and an objective general or presumptive test

Test 3: Creation of non-arm‘s length rights or obligations

Test 4: Abuse or misuse of the provisions of the Income Tax Act.

Annexe 5.

Overview of India's Specific Anti-Avoidance Rules

A commonly used measure to prevent tax avoidance is to introduce specific tax avoidance rules (SAAR) in the tax statutes. The SAAR targets known tax planning schemes which are commonly used by taxpayers but are not acceptable owing to misuse or abuse of tax laws, or they result in a consequence unintended in the law.

In Income-tax Act, 1961, the following may be considered specific examples of SAAR –

(i) Section 40A(2)- Expenses or payments are not deductible in certain circumstances involving related parties.

(ii) Section 80-IA(8)- Market value concept to be followed in relation to transactions with tax exempt entities.

(iii) Sections 92 to 92F- Transfer Pricing Regulations applicable to international transactions, which have also been made applicable to domestic transactions by the Finance Act, 2012.

(iv) Section 93- Avoidance of Income-tax by transfer of income to non-residents through transfer of assets, rights or interest.

(v) Section 94- Avoidance of tax by certain transactions in securities.

(vi) Section 94A- Transactions with persons located in notified jurisdictions.

(vii) Section 2(22)(e)- Deemed dividend.

(viii) 40(a)(i) and (ia)- Disallowance of expenses for non deduction of tax at source.

(ix) Section 9- Scope of "income deemed to accrue or arise in India". Vide the Finance Act, 2012 its scope has been widened to overturn the Supreme Court's ruling in Vodafone and some other cases.

(x) Section 43(1)- Explanations 1 to 13- Determination of actual cost of assets ignoring agreements etc. in certain cases.

Tax treaties also provide certain anti-avoidance rules which may be considered to be SAAR. For instance, Limitation of Benefit (LOB) Clause and concept of beneficial ownership.

Annexe-6

Tax Rate on Capital Gains

ASIA PACIFIC

Australia	0%
Hong Kong	0%
Indonesia	0%
Japan	0%
Korea	0%
Malaysia	0%
New Zealand	0%
Singapore	0%
Taiwan	0%
China	[rule evolving]

AMERICAS

Argentina	0%
Canada	0%
Mexico	0%
United States	0%

EUROPE

Denmark	0%
Germany	0%
France	0%
Italy	0%
Netherlands	0%
Sweden	0%
Switzerland	0%
United Kingdom	0%

Assumptions:

- *Nonresident corporate investor*
- *Portfolio investments in listed securities*
- *No business income*
- *No real estate*
- *No tax treaty*

Annexe - 7

(a) Profile of sample companies across various limits of profits before taxes (financial year 2010-11)
[Sample size 4,59,270]

Sl.no.	Profit Before Taxes (in rupees)	Cumulative Number of Corporate Assessees	Share in total number of Corporate assessees	Cumulative share in Total Corporate Income tax Payable (in per centage	Maximum amount of Average Tax Payable by each Company (Rupees in crore)
1.	More than 50 crores	1,737	0.38%	76.59%	112.59 (considering maximum PBT is Rs. 500 crores)
2.	More than 10 crores	6,140	1.34%	86.83%	12.45 (considering maximum PBT is Rs. 50 crores)
3.	More than 1 crore	28,767	6.26%	94.65%	2.608 (considering maximum PBT is Rs.10 crores)
4.	Less than1 crore	4,30,503	93.73%	100%	0.27 (considering maximum PBTis Rs. 1 crore)

(b) Profile of sample companies across various limits of profits before taxes (financial year 2010-11) [Sample size 4,59,270]

Sl.no.	Profit Before Taxes (in rupees)	Total No. of Corporate Assessees	Share in total number of Corporate assessees	Share in Total Corporate Income-tax payable (in per centage)	Maximum amount of Average Tax Payable by each Company (Rupees in crore)
1.	More than 500 crores	239	0.052%	54.28	
2.	100 to 500 crores	763	0.17%	16.86	112.59 (considering maximum PBT is Rs. 500 crores)
3.	50 to 100 crores	735	0.16%	5.45	12.45(considering maximum PBT is Rs. 50 crores)
4.	10 to 50 crores	4403	0.96%	10.24	2.608 (considering maximum PBT is Rs. 10 crores)
5.	1 to 10 crores	22,627	4.93%	7.82	0.27 (considering maximum PBT is Rs.1 crores)

Annexe-8

FORM FOR MAKING THE REFERENCE TO THE COMMISSIONER BY THE ASSESSING OFFICER FOR INITIATING THE PROCEEDINGS U/S 144BA(1) rws 95 OF THE INCOME TAX ACT, 1961

1	Name and Address of the Assessee	
2	PAN	
3	Status	
4	Particulars of Assessing Officer	
5	Assessment year(s) in respect of which the proceedings u/s 144BA (1) are proposed to be invoked : (a) Assessment Years pending in scrutiny (b) Other assessment years proposed to be covered	
6	Provide a factual matrix of the “arrangement” entered into by the assessee	
7	Is there any “Tax Benefit” as defined in section 102(11) ?	
8	If yes, provide the approximate quantum thereof assessment year wise.	
9	Is “Tax Benefit” the “main purpose” or one of the “main purposes” of the “arrangement” ?	
10	Brief facts of the “Tax Benefit”	
11	Has the assessee been confronted with the details of the “Tax Benefit”? If yes, provide the gist of the reply furnished by the assessee on “Tax Benefit”	
12	If “Tax Benefit” is the “main purpose” or one of the “main purposes” specify which other condition, out of the following is satisfied giving details how the conclusion has been arrived at: (a) Creates rights, or obligations, which are not ordinarily created between persons dealing at arm’s length; (b) Results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act; (c) Lacks commercial substance or is deemed to	

	lack commercial substance under section 97, in whole or in part; or (d) Is entered into, or carried out, by means, or in manner, which are not ordinarily employed for bona fide purposes.	
13	Has the assessee been confronted with the findings given in column 12 ? If yes, provide the gist of the reply furnished by the assessee.	
14	Detailed reasons for treating the arrangement as "Impermissible Avoidance arrangement".	
15	Consequences likely to arise if arrangement is declared as "Impermissible Avoidance arrangement"	
16	Specify the time barring dates of original assessment or reassessment	

Date: Name & Designation of
Place: Assessing Officer

Annexe-9

FORM FOR RECORDING THE SATISFACTION BY THE COMMISSIONER OF INCOME TAX FOR REFERRING THE PROCEEDINGS U/S 144BA(4) rws 95 OF THE INCOME TAX ACT, 1961 TO THE APPROVING PANEL

1	Name and Address of the Assessee	
2	PAN	
3	Status	
4	Particulars of Assessing Officer	
5	Particular of Commissioner of Income Tax	
6	Assessment year(s) in respect of which the proceedings u/s 144BA (1) are proposed to be invoked : (a) Assessment Years pending in scrutiny (b) Other assessment years proposed to be covered	
7	Date of receipt of reference from the AO u/s 144BA (1)	
8	Date of issuance of notice, setting out reasons, by the CIT to the assessee (copy thereof to be enclosed)	
9	Date of receipt of reply from the assessee and date of hearing provided to the assessee (copy of reply of the assessee to be enclosed)	
10	Provide a factual matrix of the "arrangement" entered into by the assessee	
11	Is there any "Tax Benefit" as defined in section 102(11) ?	
12	If yes, provide the approximate quantum thereof assessment year wise.	

13	Is "Tax Benefit" the "main purpose" or one of the "main purposes" of the "arrangement" ?	
14	Brief facts of the "Tax Benefit"	
15	Has the assessee been confronted with the details of the "Tax Benefit" ? If yes, provide the gist of the reply furnished by the assessee on "Tax Benefit"	
16	If "Tax Benefit" is the "main purpose" or one of the "main purposes" specify which other condition, out of the following is satisfied giving details how the conclusion has been arrived at: (a) Creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length; (b) Results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act; (c) Lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or (d) Is entered into, or carried out, by means, or in manner, which are not ordinarily employed for bona fide purposes.	
17	Has the assessee been confronted with the findings given in column 16? If yes, provide the gist of the reply furnished by the assessee.	

18	Detailed reasons for treating the arrangement as “Impermissible Avoidance arrangement”.	
19	Consequences likely to arise if arrangement is declared as “Impermissible Avoidance arrangement”	
20	Specify the time barring dates of original assessment or reassessment	

Date: Name & Designation of

Place: Commissioner of Income Tax

Annexe-10

FORM FOR RETURNING THE REFERENCE U/S 144BA(5) rws SECTION 95 IN CASES OF REFERENCES MADE U/S 144BA(4) rws 95 OF THE INCOME TAX ACT, 1961 TO THE ASSESSING OFFICER

1	Name and Address of the Assessee	
2	PAN	
3	Status	
4	Particulars of Assessing Officer	
5	Assessment year(s) in respect of which the proceedings u/s 144BA (1) are proposed to be invoked.	
6	Date of receipt of reference from the AO u/s 144BA (1)	
7	Reasons for not agreeing with the reference from the AO u/s 144BA (1)	

Date: Name & Designation of

Place: Commissioner of Income Tax