GENERAL ANTI-AVOIDANCE RULE (GAAR)

- **GAAR provisions do not deal with cases of Tax Evasion.**
- **GAAR provisions do not deal with cases of Tax Planning.**
- **GAAR provisions do not apply with cases where there are specific provisions under the Act for anti-avoidance.**
- **Provisions of Specific Anti-Avoidance Rules and GAAR can co-exist.**
- **GAAR provisions are applicable for Assessment Year 2018-19 and onwards.**
- **Investments made/ acquired prior to 1st April 2017 grandfathered i.e. not covered by GAAR provisions.**
- **GAAR provisions apply where the aggregate tax benefit in the relevant Assessment Year arising to all the parties to the arrangement exceed ₹3 crores.**
- **Exemption from GAAR provisions to the following:**
  - **Foreign Institutional Investor ('FII') who:**
    - **is an assessee under the Act;**
    - **has not taken benefit of a DTAA; and**
    - **has invested in listed or unlisted securities with prior permission.**
  - **Non-resident, in relation to investment made by way of offshore derivative instruments ('P-notes') or otherwise, directly or indirectly, in a FII.**

SECTION 95: APPLICABILITY OF GAAR

- GAAR provisions are applicable to "impermissible avoidance arrangement". Consequences in relation to tax arising therefrom are to be determined in accordance with Chapter X-A.
- GAAR provisions are applicable from Assessment Year 2018-19 and onwards.
- In order to plug any loophole, GAAR provisions will apply to any step in or a part of an arrangement as they are applicable to the whole arrangement.
- **OVERRIDING EFFECT OF GAAR**

  GAAR has an overriding effect on other provisions of the Income-tax Act. Provisions of GAAR would be applicable, irrespective of other provisions of the Act.

  However, in cases where the Income-tax Act specifically provides tax incentives to the taxpayers upon fulfilment of prescribed conditions, provisions of GAAR shall not be applicable. Further, where there are specific provisions which deals with ways of stopping tax avoidance, GAAR shall not apply, but specific provisions will apply.

Illustration 1:

Facts:

M/s India Chem Ltd. is a company incorporated in India. It sets up a unit in a SEZ for manufacturing of chemicals. It claims 100% deduction of profits earned from that unit for 5 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 in a tax benefit. However, as already discussed above, this is a case of tax planning where the tax payer is taking advantage of a fiscal incentive offered to him by complying with the conditions imposed in the legislation e.g., setting up the business unit in SEZ area. Hence, the Revenue would not invoke GAAR as regards this arrangement.

Illustration 2:

Facts:

In the above Illustration 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 to SEZ unit and shows the same as manufactured in the tax exempt SEZ unit, whereas only the process of packaging is done in the SEZ. 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 and A.O. will not allow any deduction under section 10AA.

Illustration 3:

Facts:

In the above Illustration 2, 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 to 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. The Revenue will invoke Transfer Pricing regulations.

Illustration 4:

Facts:

In the above Illustration 3, 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.

Illustration 5:

Facts:

The amalgamation of a loss making company with a profit making company results in losses of amalgamating company being set off and hence, a lower net profit and lower tax liability for the amalgamated company. Would the losses be disallowed under GAAR?

Interpretation:

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

Illustration 6:

Facts:

In the above Illustration 5, let us presume, the profit making company merges into a loss making company. This results in losses setting off profits and hence, 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.

SECTION 96: IMPERMISSIBLE AVOIDANCE ARRANGEMENT AND SECTION 97: ARRANGEMENT TO LACK COMMERCIAL SUBSTANCE

1. An arrangement is an "impermissible avoidance arrangement" (IAA) if the following twin conditions are satisfied:

Primary Condition		Tainted element presence test
Main purpose is to obtain **tax benefit**	+	Creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length **(Test 1)**
		Or
		results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act **(Test 2)**
		Or
		Lacks commercial substance or is deemed to lack commercial substance in whole or in part **(Test 3)**
		Or
		Is entered into or carried out by means or in a manner which are not ordinarily employed for bonafide purposes **(Test 4)**

Thus, an **arrangement** would qualify to be termed as an **IAA** if it satisfies the **primary condition and any one of tainted element presence test.**

2. PRESUMPTION OF PURPOSE

An arrangement is presumed to have been entered into for main purpose of obtaining tax benefit even if:

- Main purpose of whole arrangement is not to obtain a tax benefit; but
- Main purpose of step in, or a part of, the arrangement is to obtain tax benefit.

3. ANALYSIS OF EACH OF THE TAINTED ELEMENT PRESENCE TESTS

I. Test 1: Arrangement creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length

♦ ANALYSIS OF TEST 1 ♦

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 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 Transfer Pricing regulations** and where the main purpose of the arrangement is to obtain tax benefit.

Illustration:

Facts:

Yamaha Inc. is a company resident of Germany. 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) USD 10 million for design of power plant outside India (payment for which is taxable at 10% on gross basis)

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

(iii) USD 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 (instead of USD 10 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.

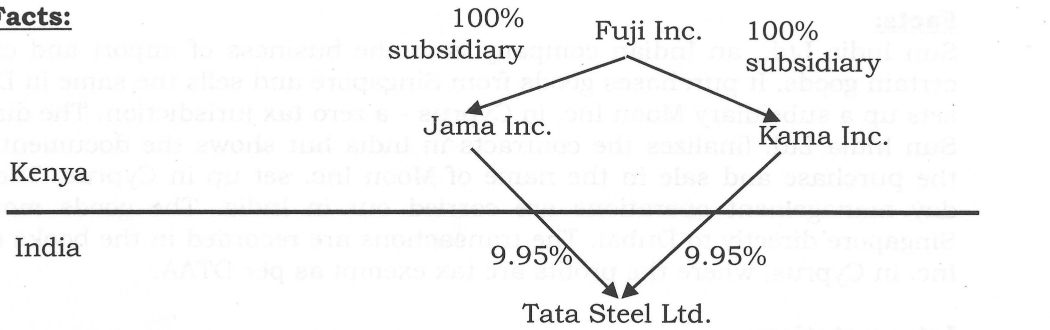
II. Test 2: Arrangement results, directly or indirectly, in the misuse or abuse, of the provisions of this Act

♦ ANALYSIS OF TEST 2 ♦

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.

Illustration:

Facts:



Under the provision of DTAA between India and Kenya, any capital gains arising from the sale of shares of Tata Steel Ltd., an Indian company would be taxable only in Kenya if the transferor is a resident of Kenya and holds not more than 10% equity capital of Indian company. However, where the transferor holds more than 10% interest in the capital stock of Indian company, then such capital gains shall be taxable in India.

A company, Fuji Inc., being resident in Kenya, makes an investment in Tata Steel Ltd. through two wholly owned subsidiaries (Jama Inc. and Kama Inc.) located in Kenya. Each subsidiary holds 9.95% shareholding in Tata Steel, the total adding to 19.9% of equity of Tata Steel. The subsidiaries sell the shares of Tata Steel and no tax is payable in India as per DTAA as each is holding less than 10% equity shares in Tata Steel Ltd. Can GAAR be invoked to deny DTAA benefit?

Interpretation:

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the DTAA. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor Fuji Inc. 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 IAA by invoking GAAR. Consequently, DTAA benefit would be denied by ignoring Jama Inc. and Kama Inc., the two subsidiaries. By treating Jama Inc. and Kama Inc. as one and the same company for tax computation purposes, the profits from sale of shares shall be taxable in India.

III. **Test 3: This test covers the following situations:**

a) Arrangements that lack commercial substance; and

b) Arrangements that are deemed to lack commercial substance under section 97 of the Act

in whole or in part.

♦ ANALYSIS OF TEST 3(a) ♦

As regards the first limb, the term **"commercial substance"** has not been defined and has **to be understood in common parlance.**

Illustration:

Facts:

Sun India Ltd., an Indian company is in the business of import and export of certain goods. It purchases goods from Singapore and sells the same in Dubai. It sets up a subsidiary Moon Inc. in Cyprus - a zero tax jurisdiction. The director of Sun India Ltd. finalizes the contracts in India but shows the documentation of the purchase and sale in the name of Moon Inc. set up in Cyprus. The day to day management operations are carried out in India. The goods move from Singapore directly to Dubai. The transactions are recorded in the books of Moon Inc. in Cyprus, where the profits are tax exempt as per DTAA.

Interpretation:

The company is camouflaging the sale and purchase transactions as Cyprus based transactions. By this arrangement, Sun India Ltd. has obtained a tax benefit. There was no need to set up the subsidiary Moon Inc. in Cyprus. The arrangement lacks commercial substance. The DTAA with Cyprus shall be ignored and the profits of Moon Inc. shall be taxable in India applying GAAR.

Thus, an arrangement is likely to be lacking commercial substance if it has not been undertaken for a bonafide purpose and does not have a significant effect upon the business of the party, apart from the tax benefit.

♦ ANALYSIS OF TEST 3(b) ♦

As regards the second limb, there are other factors provided under **section 97**, which have the effect of deeming the arrangement to be lacking in commercial substance. The **presence of any one of these following factors will be sufficient for the test to be satisfied:**

(a) **Where the substance/ effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part**

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.

For example, a company forms a partnership firm with one of its director. Company holds 99% share and the director holds 1% share in the partnership firm. Company invests ₹10 crores in the firm and the firm further invests in shares. The firm earns long term capital gains taxable under section 112A. In such a case, GAAR would be applicable as the company has made investments through the partnership firm to avoid MAT liability @ 15%.

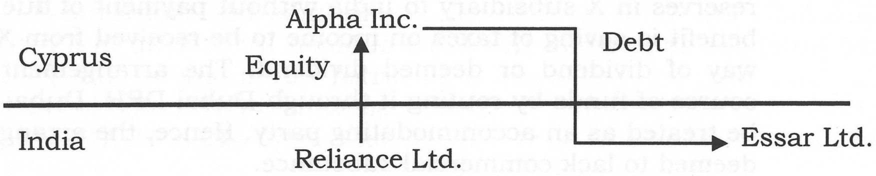
(b) When the arrangement involves/ includes any of these:

(b)(i) Round Trip Financing

Illustration on (b)(i):

<u>Facts:</u>

Reliance Ltd., an Indian Company, incorporates a subsidiary company Alpha Inc. in Cyprus (No Tax Jurisdiction) with equity of USD100 million. Alpha Inc. gives a loan of USD100 million to another Indian company (Essar Ltd.) at the rate of 10% p.a. Essar Ltd. claims deduction of interest payable to Alpha Inc. from the profit of business. There is no other activity in Alpha Inc. Can GAAR be invoked in such a case?



<u>Interpretation:</u>

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

Consequently, in the case of Reliance Ltd., Alpha Inc. may be disregarded and the interest income will be taxed in the hands of Reliance Ltd.

(b)(ii) An accommodating party

(b)(iii) Elements that have effect of offsetting or cancelling each other

(b)(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

This factor is intended to cover situations where **transactions are undertaken by persons through others**, so as to disguise their identities, location, source, value etc.

Illustration on (b)(iv):

<u>Facts:</u>

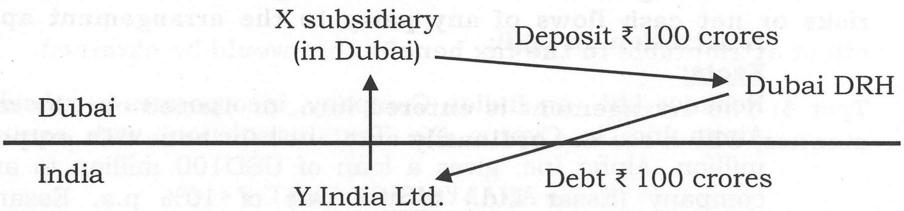
(i) Dubai DRH is a banking institution in Dubai (No Tax Jurisdiction);

(ii) There is a closely held company X in Dubai which is a wholly owned subsidiary of another closely held Indian company Y;

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

(iv) X makes a term deposit with Dubai DRH and Dubai DRH, on the basis of this security, provides a back to back loan to Y.

India-Dubai DTAA provides that interest payment to a Dubai banking company is not taxable in India. Can this be examined under GAAR?



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

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

In the case of Dubai DRH, exemption from tax on interest under the DTAA may not be allowed as Dubai DRH is not a beneficial owner of the interest. GAAR may be invoked to deny DTAA benefit as arrangement will be perceived as an attempt to hide the source of funds of X subsidiary.

(c) When the arrangement 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 for a party.

Illustration on (c):
Facts:
Beta Inc. is incorporated in Mauritius as a wholly owned subsidiary of company Gama GmbH, a resident of Germany. Say, the India-Mauritius DTAA provides for non-taxation of capital gains in India (the source country) and Mauritius charges no capital gains tax in its domestic law. Some shares of Alpha Ltd., an Indian company, are acquired by Beta Inc. in the year after date of coming into force of GAAR provisions. The entire funding for investment by Beta Inc. in Alpha Ltd. was done by Gama GmbH. These shares are subsequently disposed of by Beta Inc. after 5 years. This result in capital gains which Beta Inc. claims as not being taxable in India by virtue of the India-Mauritius DTAA. Beta Inc. 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 Gama GmbH in setting up Beta Inc. It should be immaterial here whether Beta Inc. has office, employee etc. in Mauritius. Both the purpose test and tainted element tests are satisfied for the purpose of invoking GAAR.

(d) When the arrangement 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.

IV. Test 4: The arrangement is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for bona fide purposes

♦ ANALYSIS OF TEST 4 ♦

This test deals with the manner in which the arrangement is entered into or carried out. **For example**, if an arrangement could be carried out in a simpler/ direct way and the parties adopt a different route, the same may fall under the ambit of this test.

SECTION 98: CONSEQUENCES OF IMPERMISSIBLE AVOIDANCE ARRANGEMENT

(1) If an arrangement is declared to be an IAA, then, the consequences, in relation to tax, of the arrangement, **including denial of tax benefit or a benefit under a tax treaty,** shall be determined by:

(a) **disregarding any step** in, or a part or whole of, the IAA

(b) treating the IAA 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 nature 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.

(2) For the purposes of sub-section (1),—
(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.

SECTION 144BA: ASSESSMENT PROCEDURE FOR GAAR INVOCATION

If at any stage of Assessment or Reassessment proceedings, Assessing Officer, on the basis of material & evidence available considers necessary to declare an arrangement as IAA & to determine its consequences

↓

Assessing Officer may make a reference to CIT

↓

CIT, on framing the opinion to invoke GAAR provisions, shall issue notice to assessee to submit his objections and providing an opportunity of being heard within a period not exceeding 60 days

No Objection filed by Assessee

↓

CIT to issue directions to Assessing Officer to declare arrangement as IAA

↓

AO to complete assessment proceedings in accordance with such directions and provisions of GAAR.

↓

Prior approval of the CIT required for passing assessment order, if any tax consequences determined as per the provisions of GAAR.

Objection filed by Assessee

(a) CIT is not satisfied with the explanation

↓

CIT to make reference to Approving Panel ("AP") to declare arrangement as IAA

↓

- AP to give an opportunity of being heard to assessee & AO.
- AP may direct CIT to make further inquiry and furnish report.
- AP may call for & examine records.
- AP may require assessee to furnish documents & evidences.

↓

AP to issue directions to Assessing Officer for declaration of arrangement as an IAA and specifying the Previous Year(s) in respect of which it is so declared within 6 months (excluding period provided under the Explanation) from the end of the month of receipt of reference from CIT.

→ AO to complete assessment proceedings in accordance with such directions and provisions of GAAR.

↓

- Directions issued by AP binding on the assessee, CIT/subordinate authorities;
- No appeal shall lie against such directions.

(b) CIT is satisfied with the explanation

↓

CIT to communicate it to the Assessing Officer by order in writing with a copy to the assessee

↓

Assessing Officer to complete assessment without invoking GAAR

NOTE: **An appeal shall lie to ITAT against the order of Assessing Officer passed under section 143(3)/ 144/ 147 where Approving Panel has declared the arrangement to be IAA.**

CLARIFICATIONS ON CERTAIN QUERIES ABOUT IMPLEMENTATION OF GAAR

Question no. 1: Will GAAR provisions apply to (i) any securities issued by way of bonus issuances so long as the original securities are acquired prior to 01 April, 2017 (ii) shares issued post 31 March, 2017, on conversion of Compulsorily Convertible Debentures, Compulsorily Convertible Preference Shares (CCPS), Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs), acquired prior to 01 April, 2017; (iii) shares which are issued consequent to split up or consolidation of such grandfathered shareholding?

Answer: Grandfathering under Rule 10U(1)(d) will be available to investments made before 1st April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments. Shares brought into existence by way of split or consolidation of holdings, or by bonus issuances in respect of shares acquired prior to 1st April 2017 in the hands of the same investor would also be eligible for grandfathering under Rule 10U(1)(d) of the Income Tax Rules.

Question no. 2: The expression "investments" can cover investment in all forms of instrument - whether in an Indian Company or in a foreign company, so long as the disposal thereof may give rise to income chargeable to tax. Grandfathering should extend to all forms of investments including lease contracts (say, air craft leases) and loan arrangements, etc.

Answer: Grandfathering is available in respect of income from transfer of investments made before 1st April, 2017. As per Accounting Standards, 'investments' are assets held by an enterprise for earning income by way of dividends, interest, rentals and for capital appreciation. Lease contracts and loan arrangements are, by themselves, not 'investments' and hence grandfathering is not available.

Question no. 3: Will GAAR be invoked if arrangement is sanctioned by an authority such as the Court, National Company Law Tribunal or is in accordance with judicial precedents etc.?

Answer: Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.

Question no. 4: Will a Fund claiming tax treaty benefits in one year and opting to be governed by the provisions of the Act in another year attract GAAR provisions? An example would be where a Fund claims treaty benefits in respect of gains from derivatives in one year and in another year sets-off losses from derivatives transactions against gains from shares under the Act.

Answer: GAAR provisions are applicable to impermissible avoidance arrangements as under section 96. In so far as the admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR provisions.