Exposure Draft on Framework of Indian GAAR

The Institute of Cost Accountants of India

(Statutory body under an Act of Parliament)

Delhi Office:- CMA Bhawan, 3, Institutional Area, Lodhi Road, New Delhi – 110003

Head Office:- HQ: 12, Sudder Street, Kolkata-700 016

Website: www.icmai.in

Index

	Page No.
1. Introduction	
1.1. Tackling avoidance “squeezing the balloon”	2
1.2. The “New Realism”	2
2. Current Scenario with Specific Anti Avoidance Rules	**5**
3. Analysis of GAAR Provisions	**7**
3.1. Impermissible Avoidance Agreement	7
3.2. Agreement to lack Commercial Substance	9
3.3. Consequences of Impermissible Avoidance Agreements	11
3.4. Treatment of Connected Persons & Accommodating Party	13
3.5. Application of Chapter	14
3.6. Framing Guidelines	14
3.7. Definitions	14
3.8. Reference to Commissioner in certain cases	16
4. Interplay of GAAR with Treaty provisions	**19**
5. Recommendations	**21**
6. GAAR in other countries	**23**

Tax Transplants and Local Culture:

Exposure Draft on Framework of Indian GAAR

The transplantation of tax laws from one country to another commonly occurs around the world. It may range from the wholesale adoption of entire systems of tax law to the importation of a single rule. Income tax law transplantation, globally, has largely been rule-specific. Examples are the transfer pricing rules, the controlled foreign corporation (CFC) rules and thin capitalization rules. Such cross country tax transplantation happens across legal cultures. Even among the Organization for Economic Cooperation & Development (OECD) countries, there is a mix of civil law traditions, Anglo-Saxon common law traditions, and Asian legal traditions. Such cross-cultural transplantation raises interesting questions about the **"actual function of apparently similar rules in countries with different institutional and cultural backgrounds".**

> The best-known example of a systematic transplantation is perhaps the adoption of the European value-added tax (VAT) by over 100 countries.

Accordingly, each country, should apply such rules after giving due considerations to its legal, political and economical factors. Rules should be reasonably be amended as per above factoral requirements.

A general anti-avoidance rule has been introduced in a number of countries, including Australia, Canada, Hong Kong SAR, Italy, Germany, New Zealand and South Africa, to combat a growing problem of tax avoidance. It generally applies when an avoidance transaction technically complies with the provision of a tax statute, but "offends the legislative intent or purpose".

In India, there are specific anti-avoidance provisions in the domestic tax laws as well as 'limitation of benefits' clauses in some tax treaties. Additionally, the Government has introduced General Anti Avoidance Rule (GAAR) provisions through the Finance Act, 2012 which are overriding in nature as far as tax treaties are concerned to which India is a signatory.

The purpose of this Exposure draft is to provide analysis to the proposed GAAR provisions and recommendations thereof for better implementation.

1. Introduction

Indian tax law is specifically targeted rather than purposive in tackling the exploitation of loopholes in the law, governments have legislated against individual avoidance schemes as and when these have come to light.

1.1 Tackling avoidance – "squeezing the balloon"

The traditional approach in this country to counter tax avoidance has been to introduce legislation to prevent individual tax-planning schemes exploiting loopholes in the law, once their operation has come to light. A common response from the tax avoidance industry to new legislation has been to introduce new schemes to circumvent its effect – so that the history of tax avoidance has been characterised as *"one of squeezing the balloon in one area only to see a new bulge emerge in another."*

1.2 The "New Realism"

Tax avoidance became big business and schemes were commercially marketed. A characteristic scheme was directed at transactions that had already taken place. It was therefore too late for conventional tax planning but the scheme aimed to manufacture a loss, which could be used to offset the tax liability. It was important that the loss should not be a real loss; otherwise there would be no advantage to the taxpayer. The "new realism" describes the approach adopted by the Courts to curb these complex and artificial tax avoidance schemes. There is still no judicial doctrine that allows the Revenue departments to tax on the basis of the economic substance of transactions. The Courts have, however, emphasized the legal substance and nature of transactions over their form.

The new realism first gained acceptance in *W. T. Ramsay v IRC* ***(1982 A.C. 300)***, when the Law Lords struck down a scheme as a fiscal nullity The case demonstrated an example of a circular scheme in which transactions were entered into, money changed hands and documents were

> Lord Templeman vividly described the artificiality of it all [at page 128]: *"The facts demonstrate yet another circular game in which the taxpayer and a few hired performers act out a play; nothing happens save that the Houdini taxpayer appears to escape from the manacles of tax ... the play is devised and scripted prior to performance. The object of the performance is to create the illusion that something did happen, that Hamlet has been killed and that Bottom did don an ass' head so that tax advantages can be claimed as if something had happened."*

executed with legal effect. At the end of the day, however, everyone was back where he or she started apart from payment of a fee to the promoter of the scheme.

In the House of Lords the Inland Revenue argued successfully that the taxpayer had made no real financial loss and could not claim a loss for tax purposes. In a series or combination of transactions, intended to operate as such, it was the legal nature of the series that mattered. There was no requirement that each step had to be considered separately. The intermediate steps could be struck out.

The effect of this was underlined by Lord Diplock in *IRC v Burmah Oil* ***(1982 S.T.C 30)***. He said that the approach taken in Ramsay marked [at page 214] *"a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable."*

The development of the doctrine continued in *Furniss v Dawson* ***(1984 A.C. 474)***. The taxpayer wished to sell shares to an independent third party. Here the scheme, which involved making the sale of shares via an offshore intermediate company, was not circular but linear. By routing the transaction in this way, the taxpayer hoped to defer indefinitely the liability to capital gains tax that would have accrued on a direct sale of the shares.

The House of Lords extended the Ramsay fiscal nullity doctrine to redefine what the taxpayer had done. There was a single composite transaction consisting of a preordained series of transactions, into which steps had been inserted with no commercial purpose beyond the avoidance of tax. Where these conditions were present the Court would ignore the inserted steps and look to the end result to determine the tax consequences. Effectively, the exchange was not of a type that the courts would recognise as falling within the provisions allowing tax to be deferred.

The new realism also embraces a new willingness to examine very carefully the actual legal effect of transactions, or a series of transactions, to decide precisely what are the true legal rights and obligations to which they give rise. The Courts are not bound by the labels which the parties themselves give to their transactions or by their form if the legal effect is something different.

Above interpretation has been applied in India too in several cases, the more recent among them being the *Azadi Bachao Andolan case* ***(263 ITR 706)*** and the *Vodafone case* ***(Civil Appeal No.722 of 2012)***. The Supreme Court in the *McDowell case* ***(3 SCC 230)*** frowned only upon the use of colourable devices and resort to dubious methods and subterfuges, and, as clarified by the Supreme Court in the Vodafone case, not on all tax planning in general.

However, this long standing principle has faced legislative reversal with the introduction of GAAR in the Finance Bill 2012, which seeks to incorporate the *'substance over form'* doctrine in Indian tax law. Broadly speaking, GAAR will be applicable to arrangements/transactions which are regarded as *'impermissible avoidance arrangements'* and will enable tax authorities, among other things, to re-characterise such arrangements/transactions so as to deny tax benefits.

On 12 August, 2009, the Indian Government released the draft Direct Taxes Code Bill (DTC 2009) and discussion paper for public debate. Subsequently, a Revised Discussion Paper was released in June 2010. A formal Bill to enact a law known as the Direct Taxes Code, 2010 (the Code) tabled in the Parliament on 30 August, 2010, was an outcome of this process.

Further, Finance Act, 2012 contains a number of far reaching proposals to amend the Indian Tax Laws substantially. On January 14th 2013, in deference to various representations and Expert Committee (2012) recommendation, Finance Minister P. Chidambaram said, ***"Having considered all the circumstances and relevant factors, the government has decided that provisions of Chapter 10A of the Income Tax Act (dealing with GAAR) will come into force from April 1, 2016 as against April 1, 2014"***. One of the main reasons for deferral, as clarified by Finance Minister in Supplement to *Memorandum* pertaining to Finance Act 2012, was to provide more time to tax payers and tax administrators to address all related issues.

2. Current scenario with Specific Anti Avoidance Rules

It is not that anti-abuse provisions do not already exist in the law. The Indian tax law has several anti-avoidance provisions, introduced over the years. These are, however, specific rules to cover specific classes of structures / transactions. For instance, there are rules to prevent unaccounted money being received as share capital or loans, interest, dividend and bonus stripping transactions, understatement of consideration for transfers of immovable property, excessive payments to related parties, expenditure in cash, transfer pricing for international transactions, etc.

Situations governed	Section under the Act
Deeming certain payments by closely held companies by way of loans and advances to specified shareholders/other specified entities as dividends	2(22)(e)
Provision targeting transfer of income without transfer of assets	60
Provision in respect of revocable transfer of assets	61
Provisions relating to clubbing of income which prevent shifting of income from one person to another for tax reasons.	64
Provisions targeting avoidance of income-tax by transactions resulting in transfer of income to non-residents.	93
Provisions targeting avoidance of tax by certain transactions in securities, such as dividend stripping	94
Provision authorizing the AO to determine actual cost to the assessee in case of	Explanation 3 to section 43(1)

transfer of assets with a view to claim higher depreciation at an enhanced cost	
Provisions meant to curb tax avoidance in case of sale and lease back transactions.	Explanation 4A to section 43(1)
Provision to curb tax avoidance by transferring property at nil or inadequate consideration.	56(2)(vii), 56(2)(viia)
Disallowance of excessive or unreasonable payments to an associated person	40A(2)

3. Analysis of GAAR provisions

For the first time the introduction of a GAAR into the Income-tax law of India has been made by inserting related provisions in Finance Act 2012 (hereinafter referred as the Act). Though, initially, provisions were incorporated under Direct Tax Code (DTC) 2009 but such provisions were not made as practical machinery due to hardships of both taxpayer and authorities.

Here we will discuss the provisions relating to GAAR sequentially as provided by the Act. (Section 95 to 99 with discussion as these are substantive provisions and Section 100 to 102 & 144BA without analysis as these are combination of procedural provisions and definitions.)

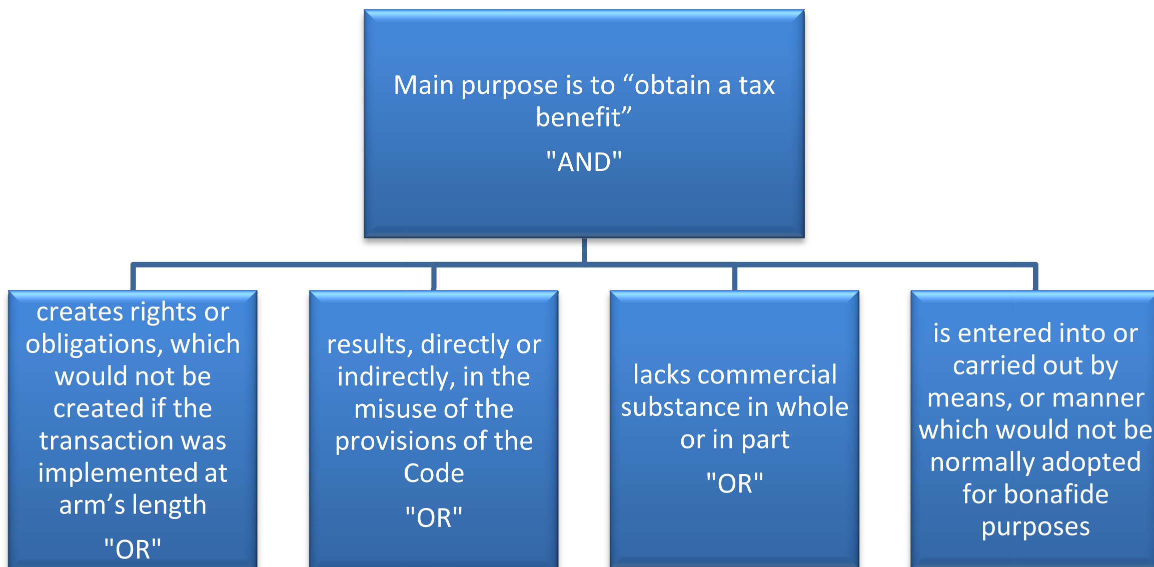
3.1 Section 96 "Impermissible Avoidance Agreement"

1. *An impermissible avoidance arrangement means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and it—*
   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 a manner, which are not ordinarily employed for* bona fide *purposes.*
2. *An arrangement shall be presumed to have been entered into, or carried out, for the main purpose of obtaining a tax benefit, if the main purpose of a step in, or 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.*

Under the GAAR provisions, as specified above, an arrangement (including a step in or a part) shall be considered to be an impermissible tax avoidance arrangement, if it is undertaken with the main purpose of "obtaining a tax benefit" and it:

1. creates rights or obligations, which would not be created if the transaction was implemented at arm's length; or
2. results, directly or indirectly, in the misuse of the provisions of the Code; or
3. lacks commercial substance in whole or in part; or
4. is entered into or carried out by means, or manner which would not be normally adopted for bonafide purposes.

Briefly



3.2 Section 97 “Agreement to Lack Commercial Substance”

1. *An arrangement shall be deemed to lack commercial substance if—*
    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.*
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.*

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.*

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.*

Lacks commercial substance

The lack of commercial substance, in the context of an arrangement, shall be determined by the following indicators:

i. The arrangement results in a significant tax benefit for a party but does not have a significant effect upon either the business risks or the net cash flows of that party other than the effect attributable to the tax benefit.
ii. The substance or effect of the arrangement as a whole differs from the legal form of its individual steps.
iii. The arrangement includes or involves:
    a. round trip financing;
    b. an 'accommodating party', as defined;
    c. elements that have the effect of offsetting or cancelling each other;
    d. a transaction which is conducted through one or more persons and disguises the nature, location, source, ownership or control of funds; or
    e. an expectation of pre-tax profit which is insignificant in comparison to the amount of the expected tax benefit.

3.3 Section 98 "Consequences of Impermissible Avoidance Agreement"

1. *If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences, in relation to tax, of the arrangement, including denial of tax benefit or a benefit under a tax treaty, shall be determined, in such manner as is deemed appropriate, in the circumstances of the case, including by way of but not limited to the following, namely:—*
    a. *disregarding, combining or recharacterising 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.*
2. *For the purposes of sub-section (1),—*
    a. *any equity may be treated as debt or* vice versa;
    b. *any accrual, or receipt, of a capital nature may be treated as of revenue nature or* vice versa; *or*
    c. *any expenditure, deduction, relief or rebate may be recharacterised*

Once the arrangement is charecterised as "impermissible", following could be the consequences thereof :

i. disregard, combine, or re-characterize any steps in, or parts of, the impermissible avoidance arrangement;

ii. disregard any accommodating party or treat any accommodating party and any other party as one and the same person;
iii. deem persons who are connected persons in relation to each other to be one and the same person for purposes of determining the tax treatment of any amount;
iv. re-allocate any gross income, receipt or accrual of a capital nature, expenditure or rebate amongst the parties;
v. re-characterize any gross income, receipt or accrual of a capital nature or expenditure;
vi. re-characterize any multi-party financing transaction, whether in the nature of debt or equity, as a transaction directly among two or more such parties;
vii. re-characterize any debt financing transaction as an equity financing transaction or any equity financing transaction as a debt financing transaction;
viii. treat the impermissible avoidance arrangement as if it had not been entered into or carried out or in such other manner as the Commissioner in the circumstances may deem appropriate for the prevention or diminution of the relevant tax benefit; or
ix. disregard the provisions of any agreement entered into by India with any other country.

3.4 Section 99 "Treatment of Connected Person & Accommodating Party""

For the purposes of this Chapter, 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.*

So as to test whether a "tax benefit" exists or not, connected persons or accommodating party, as the case may be, may be treated as one and the same person. Further any corporate arrangement may be disregarded for this purpose.

3.5 Section 100 "Application of Chapter"

100. *The provisions of this Chapter shall apply in addition to, or in lieu of, any other basis for determination of tax liability.*

3.6 Section 101 "Framing Guidelines"

101. *The provisions of this Chapter shall be applied in accordance with such guidelines and subject to such conditions and the manner as may be prescribed.*

3.7 Section 102 "Definitions"

102. *In this Chapter, unless the context otherwise requires,—*

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;*
2) *"asset" includes property, or right, of any kind;*
3) *"associated person", in relation to a person, means—*
   a. *any relative of the person, if the person is an individual;*
   b. *any director of the company or any relative of such director, if the person is a company;*
   c. *any partner or member of a firm or association of persons or body of individuals or any relative of such partner or member if the person is a firm or association of persons or body of individuals;*
   d. *any member of the Hindu undivided family or any relative of such member, if the person is a Hindu undivided family;*
   e. *any individual who has a substantial interest in the business of the person or any relative of such individual;*
   f. *a company, firm or an association of persons or a body of individuals, whether incorporated or not, or a Hindu undivided family having a substantial interest in the business of the person or any director, partner, or member of the company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member;*

- **g.** *a company, firm or association of persons or body of individuals, whether incorporated or not, or a Hindu undivided family, whose director, partner, or member have a substantial interest in the business of the person, or family or any relative of such director, partner or member;*
- **h.** *any other person who carries on a business, if—*
  - **i.** *the person being an individual, or any relative of such person, has a substantial interest in the business of that other person; or*
  - **ii.** *the person being a company, firm, association of persons, body of individuals, whether incorporated or not, or a Hindu undivided family, or any director, partner or member of such company, firm or association of persons or body of individuals or family, or any relative of such director, partner or member, has a substantial interest in the business of that other person;*

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

5) *"connected person" means any person who is connected directly or indirectly to another person and includes associated person;*

6) *"fund" includes—*

- **a.** *any cash;*
- **b.** *cash equivalents; and*
- **c.** *any right, or obligation, to receive, or pay, the cash or cash equivalent;*

7) *"party" means any person including a permanent establishment which participates or takes part in an arrangement;*

8) *"relative" shall have the meaning assigned to it in the* Explanation *to clause (*vi*) of sub-section (2) of section 56;*

9) *a person shall be deemed to have a substantial interest in the business, if—*

- **a.** *in a case where the business is carried on by a company, such person is, at any time during the financial year, the beneficial owner of equity shares carrying twenty per cent or more, of the voting power; or*
- **b.** *in any other case, such person is, at any time during the financial year, beneficially entitled to twenty per cent or more, of the profits of such business;*

10) *"step" includes a measure or an action, particularly one of a series taken in order to deal with or achieve a particular thing or object in the arrangement;*

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.

12) *"tax treaty" means an agreement referred to in sub-section (1) of section 90 or sub-section (1) of section 90A.*

3.7 Section 144BA "Reference to Commissioner in certain cases"

1. *If, the Assessing Officer, at any stage of the assessment or reassessment proceedings before him having regard to the material and evidence available, considers that it is necessary to declare an arrangement as an impermissible avoidance arrangement and to determine the consequence of such an arrangement within the meaning of Chapter X-A, then, he may make a reference to the Commissioner in this regard.*
2. *The Commissioner shall, on receipt of a reference under sub-section (1), if he is of the opinion that the provisions of Chapter X-A are required to be invoked, issue a notice to the assessee, setting out the reasons and basis of such an opinion, for submitting objections, if any, and providing an opportunity of being heard to the assessee within such period, not exceeding sixty days, as may be specified in the notice.*
3. *If the assessee does not furnish any objection to the notice within the time specified in the notice issued under sub-section (2), the Commissioner shall issue such directions as it deems fit in respect of declaration of the arrangement to be an impermissible avoidance arrangement.*
4. *In case the assessee objects to the proposed action, and the Commissioner, after hearing the assessee in the matter, is not satisfied by the explanation of the assessee, then, he shall make a reference in the matter to the Approving Panel for the purpose of declaration of the arrangement as an impermissible avoidance arrangement.*
5. *If the Commissioner is satisfied, after having heard the assessee that the provisions of Chapter X-A are not to be invoked, he shall by an order in writing communicate the same to the Assessing Officer with a copy to the assessee.*

6. *The Approving Panel, on receipt of reference from the Commissioner under sub-section (4) shall issue such directions, as it deems fit, in respect of the declaration of the arrangement as an impermissible avoidance arrangement in accordance with the provisions of Chapter X-A including specifying the previous year or years to which such declaration of an arrangement as an impermissible avoidance arrangement shall apply.*
7. *No direction under sub-section (6) shall be issued unless an opportunity of being heard is given to the assessee and the Assessing Officer on such directions which are prejudicial to the interest of the assessee or the interest of the revenue, as the case may be.*
8. *The Approving Panel may, before issuing any direction under sub-section (6),—*
   a. *if it is of the opinion that any further inquiry in the matter is necessary, direct the Commissioner to make such further inquiry or cause to make such further inquiry to be made by any other income-tax authority and furnish a report containing the results of such inquiry to it; or*
   b. *call for and examine such records related to the matter as it deems fit; or*
   c. *require the assessee to furnish such document and evidence as it may so direct.*
9. *If the members of the Approving Panel differ in opinion on any point, the point shall be decided according to the opinion of the majority of the members.*
10. *Every direction, issued by the Approving Panel under sub-section (6) or the Commissioner under sub-section (3), shall be binding on the Assessing Officer and the Assessing Officer on receipt of the directions shall proceed to complete the proceedings referred to in sub-section (1) in accordance with the directions and provisions of Chapter X-A.*
11. *If any direction issued under sub-section (6) specifies that declaration of the arrangement as impermissible avoidance arrangement is applicable for any previous year to which the proceeding referred to in sub-section (1) pertains, then, the Assessing Officer while completing any assessment or reassessment proceedings of the assessment year relevant to such other previous year shall do so in accordance with such directions and the provisions of Chapter X-A and it shall not be necessary for him to seek fresh direction on the issue for the relevant assessment year.*
12. *No order of assessment or reassessment shall be passed by the Assessing Officer without the prior approval of the Commissioner if any tax consequences have been determined in the order under the provisions of Chapter X-A pursuant to a direction issued under sub-section (6) or sub-section (3) declaring the arrangement as impermissible avoidance arrangement.*
13. *No direction under sub-section (6) shall be issued after a period of six months from the end of the month in which the reference under sub-section (4) was received by the Approving Panel.*

14. *The Board shall, for the purposes of this section constitute an Approving Panel consisting of not less than three members, being—*
    a. *income-tax authorities not below the rank of Commissioner; and*
    b. *an officer of the Indian Legal Service not below the rank of Joint Secretary to the Government of India.*
15. *The Board may make rules for the purposes of the efficient functioning of the Approving Panel and expeditious disposal of the references received under sub-section (4).*

4. Interplay of GAAR with Treaty provisions

GAAR provisions brought in picture by Finance Act 2012 are overriding in nature. Its not the case that these provisions shall get applied to every transaction seeking or sought applicability of any Treaty provision rather its applicable to a transactions the "main purpose" of which is tax avoidance. This holds good keeping in mind the following provisions of Vienna and OECD conventions :

Vienna Convention

- ***Existing domestic law v. existing treaty*** - The principle of "pacta sunt servanda" incorporated in Article 26 of the Vienna Convention suggests that in case of conflict between the provisions of tax treaties and those of domestic law, the provisions of the tax treaties must prevail. A conjoint and proper construction of Article 18, Article 26 and Article 31 of the Vienna Convention suggests that circumstances or situations like "tax abuse" may amount to abuse of the Convention itself and therefore such abusive transactions should be disregarded while granting benefits under the treaty.

- ***Existing treaty v. subsequent domestic law changes*** - Under the Vienna Convention, technically, any unilateral act on the part of a country to override existing tax treaties, through the later insertion of provisions in domestic tax laws, may be in conflict with Articles 18 and 26 of the Convention, which cast an obligation on the parties to respect the Convention. Further, Article 27 of the Convention provides that a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This means that a party may not invoke its domestic legislation that was enacted after a treaty agreement was concluded. A treaty is generally understood to be a contract and has the effect of binding the two contracting States to that agreement. Any domestic law subsequently enacted to combat tax avoidance may not override such a binding legal agreement. An alternative argument advanced against this principle is that such anti abuse measures are inherent in the application of treaty, relying on the principles of 'good faith' and 'not to defeat the object and purpose of a treaty'.

OECD Model Convention

The 2010 Commentary (Commentary) to Article 1 of the OECD MC discusses the relationship between domestic antiavoidance rules and treaty and whether treaties benefits would be available with respect to abusive transactions. It clarifies that apart from the principal purpose of tax treaties which is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons, ***prevention of tax avoidance and evasion*** is also a purpose.

This practice is universally accepted and Institute is in favor of application of GAAR with this approach.

5. Recommendations

Though after several representations by stakeholders and smooth implementation of GAAR following amendments in the previous provisions of GAAR has been made by Finance Act, 2012 :

- The burden of application of GAAR rests with the tax authority.
- Assessing Officer (AO) can invoke GAAR only after obtaining the approval of the Approving Panel.
- An option for Advance Ruling has been provided for.
- The Approving Panel will have an 'Independent Member'.
- AO can pass Order only after the approval of the Commissioner.
- Taxpayer can avail the facility of the Advance Ruling on GAAR.

But still some ambiguities are still existing which requires either clarifications or amendments. Appended are the provisions require further consideration :

- The Indian Approving Panel neither is an advisory in nature, nor is mandated to assist the AO on the application of GAAR. Neither the clause 144BA elaborate, nor the 'explanatory notes to the Finance Bill' explain the role of the Approving Panel. This ambiguity can create different expectations among taxpayers as it has happened in the case of the 'Dispute Resolution Panel' (DRP). Elaboration of Panel's role will help all in its functioning

- The Parliamentary Standing Committee has recommended that the Departmental body should not review application of GAAR but an independent body should review it. The Committee has suggested that the Chief Commissioner should head the reviewing body and it should have two independent technical members. However, the Government has decided to form a Panel consisting of the senior Tax Officers and an Officer of Indian Legal Service as against the arguments for having non-Governmental independent members. Now the composition of the Panel appears to be more balanced than what was previously proposed, although taxpayers would have preferred to have non-Governmental independent member on the Approving Panel.

  The Australian GAAR Panel consists of senior tax officers, businessmen and professional experts. The Panel is headed by a senior Tax Officer. UK's Advisory Panel is proposed to be to be chaired by an independent person and will

have a tax officer and an independent member having experience in area relevant to the activity involved in the arrangement. Whereas, the Canadian GAAR Committee consists of the representatives from the different departments of the Government such as Department of Legislative Policy, Tax Avoidance and Income-tax Rulings. The Committee also has lawyers and representatives from the Department of Finance of the Government.

Presence of the non-governmental independent members on the Approving Panel gives more confidence to taxpayers in its decisions. Taxpayers perceive such a panel to be fair and unbiased. It also results in external review of the Departments' work on GAAR and makes the Department somewhat accountable to external systems.

- Monetary limits for implications of GAAR provisions should be specified until unless GAAR is going to implemented with Direct Tax Code. This way Government may be able to bring a kind of Mini GAAR with current system which can bring some specified transactions in its ambit. This will provide a way to implement GAAR provisions at its best in the near future without any risk of any kind of possibility of failure of GAAR proposed provisions.

- Its scope of operation should be limited to transactions which, judged as a whole, have tax avoidance as a main purpose or, in the case of multi-step transactions, when a particular step in the transaction has tax avoidance as its sole purpose.

- It should exclude transactions that are consistent with the intention of Parliament, as appears from the legislation taken as a whole.

- There should be a provision enabling Central Government to exempt certain transactions even if these transactions do attract GAAR in legal sense but apparently these are genuine transactions. For example Buy back of shares by company to save Dividend Distribution Tax. Though transaction is genuine but GAAR provisions shall get attracted by virtue of Section 96(2) of the Act.

- No law is perfect since beginning, it has to be made better at every stage. But for betterment, first it requires implementation. Implementing GAAR provisions in totality with Direct Tax Code or deferring it to 1st April 2016 may cause potential loss to revenue. There is a strong recommendation to implement GAAR provisions, after incorporating above suggestions, at the earliest so as to pay a way ahead for a much better legislation in the form of Direct Tax Code.

6. GAAR in other countries

United States

As ever in tax matters, the most complicated answer to the question is provided by the US. US courts have, over the years, developed four anti-abuse doctrines: substance over form, which can be traced back to the Supreme Court decision of *Gregory v Helvering* **(1935)**; **"**step transaction**"**, under which inserted steps can be disregarded (a doctrine applied by the UK judiciary, albeit more narrowly, in *Furniss v Dawson* **(1984)** – though the degree of factual recharacterisation required by that case might not find favour with the UK courts today); **"sham transactions"**; and the **"economic substance"** doctrine. Indeed, the complexity is such that the number and classification of the doctrines is not entirely clearcut and the Internal Revenue Service may well cite all four principles if it is attempting to recharacterise a transaction for tax purposes.

The **"economic substance"** judicial doctrine is probably the most important, and it is certainly the first to have been codified in any form. In 2010, section 7701(o) was added to the Internal Revenue Code. This states that if the economic substance doctrine is relevant to a transaction, that transaction is to be treated as having economic substance only if, ignoring tax, it *"changes in a meaningful way … the taxpayer's economic position" and "the taxpayer has a substantial purpose … for entering into"* the transaction. But the codification is not complete, as the provision goes on to say that determining whether the doctrine is relevant *"shall be made in the same manner as if [section 7701(o)] had never been enacted"*. It has yet to be determined quite what this means.

Canada

The Canadian GAAR became effective in 1988 and appears in section 245 of the Income Tax Act. For the GAAR to operate, three requirements must be met: a **"tax benefit"** is obtained from the transaction; it is not the case that the transaction *"may reasonably be considered to have been arranged or undertaken primarily for bona fide purposes other than to obtain the tax benefit"*; and the transaction must be shown to result in a "misuse" or an "abuse" of Canadian tax laws.

Copthorne Holdings Ltd v Canada **(2011)** is a recent example of the application of the GAAR by the Canadian Supreme Court. Under the Canadian tax code, a payment made on redemption of shares was classified as dividend income (and so potentially subject to withholding) to the extent that it exceeded the "paid-up capital" in the shares. The rule

at the centre of the case concerned the treatment of such capital on the amalgamation of two companies: the resulting entity would inherit the paid-up capital from both of them if they were sister companies, but not if one was a subsidiary of the other.

The essential facts were as follows. The taxpayer group wanted to amalgamate two companies that were parent (A) and subsidiary (B). To avoid losing the paid- up capital in B, A first transferred to its own parent company the shares in B. Six months later, A and B amalgamated. A year after that, the group entered into a series of transactions designed to avoid the effect of an unrelated change in the tax code. This culminated in the redemption of shares by a third Canadian company which, unless the GAAR applied, would benefit from the paid-up capital originally attributable to both A and B.

The court held that the GAAR did indeed apply. This required a finding that the redemption was a transaction "completed in contemplation of" the "series" of transactions constituted by the transfer and amalgamation implemented a year or more previously – a surprising interpretation of the words "in contemplation of" (but in line with an earlier case called *Trustco*). The conclusion on the central issue of misuse/abuse is also surprising, given the simplicity and obviousness of the step in question (the intra-group transfer).

Ireland

Ireland adopted its GAAR only a year later, as section 86 Finance Act 1989. This was inspired by the Canadian model, though there are material differences.

The conservative approach to the interpretation of tax legislation evident in the *Duke of Westminster* case appears to have survived rather longer in Ireland than in the UK. Indeed the *Ramsay* principle was expressly rejected by the Irish courts in a case called *McGrath v McDermott* (1988), on the grounds that it went beyond the proper exercise of the judicial function. Perhaps because of that, the GAAR did not come up for consideration by the Irish Supreme Court until 2011, in the shape of *Revenue Commissioners v O'Flynn Construction*.

The case concerned an Export Sales Relief Scheme established by Ireland in 1958. A company earned profits from activities which qualified under the Scheme. They were therefore not subject to corporation tax and could also be distributed tax- free. However, the company was apparently not in a position to make a distribution. It therefore entered into a complicated series of transactions which allowed an unrelated group to use the profits to frank its own dividends.

The Supreme Court held, by a 3-2 majority, that this was, in the words of the critical statutory provision, "a misuse of the Scheme or an abuse of the Scheme having regard to

the purposes for which it was provided". The alternative view, expressed in trenchant terms, was that the profits in question derived from activities of the kind that the Scheme sought to encourage, so the result of the transactions (tax-free dividends) was consistent with "the purposes for which the Scheme was provided". It is clear, though, that there was also a wider difference of opinion between the judges over the extent to which the traditional approach to statutory construction still held good.

Australia

Australia has had a GAAR in some form for nearly 100 years (and New Zealand for even longer). But the experience has not been an entirely happy one, either for taxpayers or for the Australian Tax Office. (the "ATO"). Frustrated by the courts' approach, the ATO has on several occasions persuaded the Government to extend the reach of the GAAR.

According to an explanatory memorandum issued on one of those occasions, it was (as redrafted, in 1981) designed to catch tax avoidance measures which were "blatant, artificial or contrived". But these terms do not appear in the statutory provision itself, which is very long but asks in essence whether the taxpayer has entered into a "scheme" with the sole or "dominant" purpose of obtaining a "tax benefit"?

Yet another change is now in the offing, following a taxpayer victory in the case *RCI Pty Ltd v Commissioner of Taxation* (2011). The Australian Government has announced plans to redefine the concept of "tax benefit" so as to prevent taxpayers from arguing that, but for the scheme, they would have avoided entering into a taxable arrangement by doing nothing, deferring the arrangements indefinitely or undertaking another scheme that also avoided tax.

Jamaica

Jamaica has had a GAAR since 1939. It applies if the tax authority "is of the opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious".

This test was considered by the Privy Council in early 2012, in *Commissioner v Cigarette Company of Jamaica Ltd*. Over the period in dispute, the Jamaican taxpayer company was a subsidiary (but not quite a wholly- owned subsidiary) of Carreras Group Ltd. (Carreras is also a Jamaican company and in fact gave its name to another Privy Council decision, in 2004, in which the *Ramsay* principle was applied to defeat a rather transparent stamp duty saving scheme.) The taxpayer was very profitable, but paid very low dividends. Instead it transferred almost all of its profits to Carreras by way of loans that were interest-free, unsecured and recorded only as book-entries.

Before the Privy Council, the sole question was whether the loans were "artificial" transactions. The court held that they were not: informal loans of this kind were

common in group structures and the existence of very small outside shareholdings should not change the analysis.

The court's explanation of its approach to the term "artificial" is noteworthy:

"We consider that in this context a transaction is 'artificial' if it has, as compared with normal transactions of an ostensibly similar type, features which are abnormal and appear to be part of a plan. They are the sort of features of which a well- informed bystander might say, 'This simply would not happen in the real world'."

As will be apparent from the discussion towards the end of this chapter, the author believes that, in light of this judgment, the term "artificial" would be a useful addition to the UK's proposed GAAR.

Hong Kong

The same "fictitious or artificial" test has also been part of the Hong Kong tax code for many years. But in 1986 a second GAAR was added, as section 61A of the Inland Revenue Ordinance. This follows the Australian model; so the central question is whether, having regard to specified matters, it is right to conclude that the relevant transaction was entered into for the "sole or dominant purpose" of enabling a person to obtain a "tax benefit".

Section 61A was the subject of two cases heard together by Hong Kong's Court of Final Appeal in 2007, *Tai Hing Cotton Mill* and *Hong Kong International Terminals Ltd*. Lord Hoffmann, giving the leading judgments, held that section 61A applied in both cases.

In *Tai Hing*, it was conceded that the transaction had a proper commercial purpose. But the legislation allowed an assessment of liability as if the transaction had not been carried out, or "in such other manner as the assistant commissioner considers appropriate to counteract the tax benefit which would otherwise be obtained". Lord Hoffmann concluded that the commissioner could "assess the taxpayer on the hypothesis that there was a transaction which created income, but without the features which conferred the tax benefit" (and noted that this was also possible under the Australian GAAR, but not New Zealand's GAAR). In determining purpose, therefore, "the appropriate question is the purpose of the parties in adopting the specific terms which had the effect of conferring a tax benefit". If the question could indeed be put in that way, the taxpayer's cause was clearly lost.

The critical reasoning in the second case was similar. It was possible to assess purpose by reference to features that had been inserted into a circular funding structure– specifically, the introduction of a BVI member of the group as the holder of notes issued by a Hong Kong member of the group. The purpose of those features was plainly to

allow the generation of net funding deductions in Hong Kong and that was a "tax benefit".

France

The French GAAR is based on the civil law doctrine of abuse of rights ("*abus de droit*"). Pursuant to Article L64 of the Tax Procedure Code, tax authorities may reconstruct a transaction that constitutes an abuse of law on the basis that: (i) the commercial steps taken meet the literal terms of a statute or decision but are motivated solely by a desire to reduce tax, or (ii) the transaction is "fictitious". This is a high threshold – frustratingly so for the French Revenue.

Germany

Germany's GAAR appears in section 42 of the Fiscal Code. An abuse is deemed to exist "where an inappropriate legal option is selected which, in comparison with an appropriate legal option, leads to tax advantages unintended by law". But there is no abuse if the taxpayer can show material non-tax reasons for selecting the option.

The Federal Fiscal Court has taken a restrictive view of the rule and in practice it rarely applies.

European Union

The anti-avoidance principle in European Court of Justice (ECJ) jurisprudence is also based on abuse of rights. The *locus classicus* is a VAT case, *Halifax plc v Commissioners of Customs and Excise* (2006). This established a two-pronged test: whether the "transactions concerned ... resulted in the accrual of a tax advantage, the grant of which would be contrary to the purpose of [the] provisions"; and whether "the essential aim of the transactions concerned was to obtain a tax advantage".

It is interesting to compare this with the approach taken by the ECJ a year later when considering the UK's CFC rules in the *Cadbury Schweppes* case. The ECJ stated that the restriction on freedom of establishment which resulted from these rules would be justified only if its effect was "to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due".

Three points emerge from this survey. First, the test applied in civil law jurisdictions is narrower than the typical common law GAAR. Second, uncertainty is indeed the result of the latter approach, as witness the controversial judgments delivered most recently by the Supreme Courts of Canada (*Copthorne Holdings*) and Ireland (*O'Flynn Construction*). Third, producing the perfect GAAR is a tricky business.