GAAR and PPT with respect to transactions

Meyyappan Nagappan

Shweta Mallya

March 2025

Draft for discussion purposes only

Contents

- **Judicial anti-avoidance rule**
  - Colorable device and sham transactions; Shift to substance over form (1960s-2012)
  - SC rulings in *Raman & Co, McDowell*, *Azadi Bachao Andolan* and *Vodafone Intl*
  - Case studies on application of JAAR to transactions
- **Domestic GAAR**
  - Run up to GAAR (2012-2015)
  - GAAR under the Income Tax Act, 1961
  - Recent Telangana High Court ruling (first ruling to examine invocation of GAAR)
  - Case studies on application of GAAR to transactions
- **Treaty anti-abuse rules, MLI and PPT**
  - Limitation of benefits (**LoB**) and beneficial ownership clauses
  - Principal purpose test (**PPT**)
  - Recent CBDT guidance on applying the PPT
- **Interaction between GAAR and the PPT**
  - Conflicts in the interaction between domestic GAARs and the PPT
  - Case study: *Alta Energy* case

Case Studies / Transactions

1 *Transaction 1*: Classical 'round-tripping' structure through the Mauritius route

2 *Transaction 2*: Classical 'intermediary' or 'direct conduit' structure

3 *Transaction 3*: Restructuring in *Alta Energy* case

Application of JAAR, GAAR and PPT to the above transactions; and
Conflicts in the interaction of GAAR & PPT.

JUDICIAL ANTI-AVOIDANCE RULE

Judicial anti-avoidance rule (1960s-2012)

1. *Raman & Co*
Conventional view taken by the SC based on the *Duke of Westminster* principle. Justice Shah observed *"avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited."*

1967 | 1985 | 2003 | 2012

2. *McDowell & Co Ltd*
The SC held that substance was more critical than form and, in the process, colorable devices could be ignored to arrive at the substance of the transaction. It also observed that the time had come to depart from the *Westminster* principle, just as British Courts had done. Dismissed observations in *Raman & Co*.

3. *Azadi Bachao Andolan*
The SC's view was that *"the Westminster principle is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of Justice Shah in Raman & Co are very much relevant today."*

4. *Vodafone International Holdings BV*
Important observations by the SC on substance over form and JAAR:

i. No conflict between *McDowell* and *Azadi Bachao Andolan.*

ii. It cannot be said that all tax planning is illegal.

iii. In the application of the judicial anti-avoidance rule, the Revenue may invoke the 'substance over form' principle or 'piercing the corporate veil' test only after it is able to establish on the basis of facts surrounding the transaction that the impugned transaction is a sham or tax avoidant.

1. SC ruling in *Raman & Co.* (1967)

TRILEGAL

- *"The law does not oblige a trader to make the maximum profit that he can out of his trading transactions. Income which accrues to a trader is taxable in his hands: income which he could have, but has not earned, is not made taxable as income accrued to him. By adopting a device, if it is made to appear that income which belonged to the assessee had been earned by some other person, that income may be brought to tax in the hands of the assessee, and if the income has escaped tax in a previous assessment, a case for commencing a proceeding for reassessment under section 147(b) may be made out."*
- *"**Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited**. A taxpayer may **resort to a device to divert the income** before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, **but it may lawfully be circumvented**."*
- *If the goods were nominally transferred to the HUFs, the latter acting merely as benamidars for the assessees, and the profits were earned in truth by the assessees, income earned by sale of the goods by the HUFs might be held chargeable to tax as income which had escaped assessment to tax in the hands of the assessees. In the instant case, no such case was attempted to be made out in the affidavit filed by the ITO. It was, therefore, to be held that on the materials on the records, the ITO had no reason to believe that income chargeable to tax had escaped assessment, for the three years in question.*

(Emphasis supplied)

2. SC ruling in *McDowell & Co Ltd* (1985)

- Extracts of British rulings: Lord Tomlin echoing what Lord Sumner had said observed in IRC v. Duke of Westminster [1936] AC 1 as follows, typifying the prevalent attitude towards tax avoidance at that time:
- "*Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than if otherwise would be. If he succeeds in ordering them so as to secure this result, then, however, un-appreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.*"
- Extracts of British rulings: The march of the law against tax avoidance schemes continued and came a significant departure from the Westminster and the fisher executors principle. In W.T. Ramsay v. IRC [1982] AC 300, the House of Lords had to consider a scheme of tax avoidance which consisted of a series or a combination of transactions each of which was individually genuine but the result of all of which was an avoidance of tax. Lord Wilberforce, with great force, observed:

"Given that a document or transaction is genuine, the Court cannot go behind it to some supposed underlying substance. This is the well-known principle of IRC v. Duke of Westminster. This is a cardinal principle but it must not be overstated or overextended. While obliging the Court to accept documents or transactions, found to be genuine, as such, it does not compel the Court to look at a document or a transaction in linkers, isolated from any context to which it properly belongs……"

2. SC ruling in *McDowell & Co Ltd* (1985)

- *"Thus, the ghost of Westminster (in the words of Lord Roskill) has been exercised in England. Should it be allowed to rear its head in India?*
- *11. I have referred to the English cases at some length, only to show that in the very country of its birth, the **principle pf Westminster has been given a decent burial and in that very country** where the phrase 'tax avoidance' originated the judicial attitude towards tax avoidance has changed and the smile, cynical or even affectionate though it might have been at one time, has now frozen into a deep frown. **The courts are now concerning themselves not merely with the genuineness of a transaction, but with the intended effect of it for fiscal purposes. No one can now get away with a tax avoidance project with the mere statement that there is nothing illegal about it**."*
- *16. **We think that time has come for us to depart from the Westminster principle as emphatically as the British Courts have done and to dissociate ourselves from the observations of Shah, J. and similar observations made elsewhere. The evil consequences of tax avoidance are manifold. First there is substantial loss of much needed public revenue, particularly in a welfare state like ours. Next there is the serious disturbance caused to the economy of the country by the piling up of mountains of black money, directly causing inflation. Then there is 'the large hidden loss' to the community** (as pointed out by Master Wheatcroft in 18 Modern Law Review 209) by some of the best brains in the country being involved in the perpetual war waged between the tax-avoided and his expert team of advisers, lawyers and accountants on one side and the tax-gatherer and his perhaps not so skilful, advisers on the other side. Then again there is the 'sense of injustice and inequality which tax avoidance arouses in the breasts of those who are unwilling or unable to profit by it'. Last but not the least is the ethics (to be precise, the lack of it) of transferring the burden of tax liability to the shoulders of the guideless, good citizens from those of the 'artful dodgers'."*

(Emphasis supplied)

3. SC ruling in *Azadi Bachao Andolan* (2003)

- *"We see that even in the year 1988 the House of Lords emphasized the continued validity and application of the principle in Duke of Westminster's case (supra).*
- *132. While Chinnappa Reddy, J. took the view that W.T. Ramsay Ltd.'s case (supra), was an authoritative rejection of principle in the Duke of Westminster's case (supra), the House of Lords, in the year 2001, does not seem to consider it to be so, as seen from MacNiven (Inspector of Taxes) v. Westmoreland Investments Ltd.[2001] 1 All ER 865. Lord Hoffmann observes: My Lords, I venture to suggest that some of the difficulty which may have been felt in reconciling the Ramsay case with the Duke of Westminster's case arises out of an ambiguity in Lord Tomlin's statement that the courts cannot ignore 'the legal position' and have regard to 'the substance of the matter'. **If 'the legal position' is that the tax is imposed by reference to a legally defined concept,** such as stamp duty payable on a document which constitutes a conveyance on sale, **the court cannot tax a transaction which uses no such document on the ground that it achieves the same economic effect. On the other hand, if the legal position is that tax is imposed by reference to a commercial concept, then to have regard to the business 'substance' of the matter is not to ignore the legal position but to give effect to it**."*
- ***With respect, therefore, we are unable to agree with the view that Duke of Westminster's case (supra) is dead, or that its ghost has been exorcised in England. The House of Lords does not seem to think so, and we agree, with respect. In our view, the principle in Duke of Westminster's case (supra) is very much alive and kicking in the country of its birth. And as far as this country is concerned, the observations of Shah,J., in A. Raman &Co.'s case (supra) are very much relevant even today**.*

(Emphasis supplied)

3. SC ruling in *Azadi Bachao Andolan* (2003)

- *“Many developed countries tolerate or encourage treaty shopping, even if it is unintended, improper or unjustified, for other non-tax reasons, unless it leads to a significant loss of tax revenues. <u>Moreover, several of them allow the use of their treaty network to attract foreign enterprises and offshore activities.</u> Some of them favour treaty shopping for outbound investment to reduce the foreign taxes of their tax residents but dislike their own loss of tax revenues on inbound investment or trade of non-residents. <u>In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc.</u>*
- *123. Developing countries need foreign investments, and the treaty shopping opportunities can be an additional factor to attract them. The use of Cyprus as a treaty haven has helped capital inflows into eastern Europe. Madeira (Portugal) is attractive for investments into the European Union. Singapore is developing itself as a base for investments in South East Asia and China. Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant foreign funds through the "Mauritius conduit". Although the Indian economic reforms since 1991 permitted such capital transfers, the amount would have been much lower without the India-Mauritius tax treaty.*
- *124. <u>Overall, countries need to take, and do take, a holistic view. The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy. Many of them do not appear to be too concerned unless the revenue losses are significant compared to the other tax and non-tax benefits from the treaty, or the treaty shopping leads to other tax abuses.</u>*

(Emphasis supplied)

4. SC ruling in *Vodafone International Holdings BV* (2012)

TRILEGAL

- Correctness of Azadi Bachao case - Re: Tax Avoidance/Evasion

"Firstly, it was contended by the Revenue that Union of India v. Azadi Bachao Andolan [2003] 132 Taxman373 (SC) needs to be overruled insofar as it departs from McDowell & Co. Ltd. v. CTO [1985] 22 Taxman 11(SC). [Para 57]

The Westminster principle states that, "given that a document or transaction is genuine, the court cannot go behind it to some supposed underlying substance". The said principle has been reiterated in subsequent English Courts Judgments as "the cardinal principle". [Para 59]

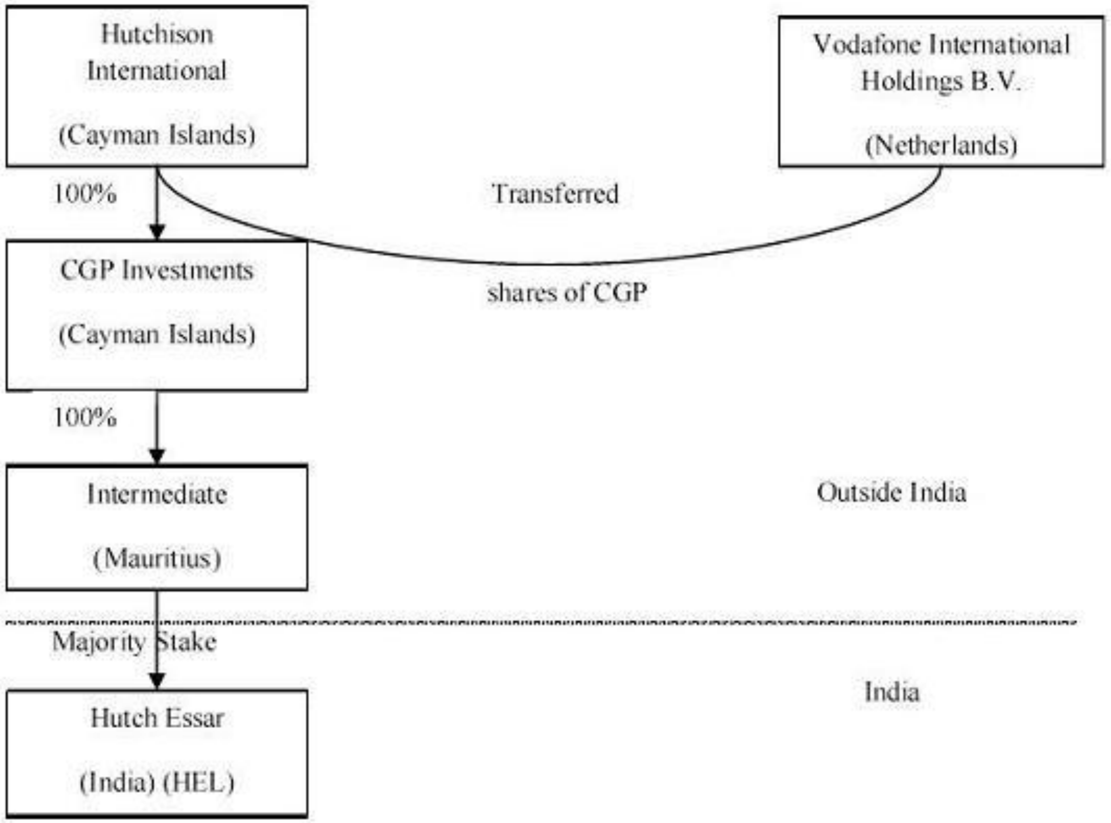
The majority judgment in McDowell & Co. Ltd. case (supra) held that "tax planning may be legitimate provided it is within the framework of law". In the latter part, it held that "colourable device cannot be a part of tax planning and it is wrong to encourage the belief that it is honourable to avoid payment of tax by resorting to dubious methods". It is the obligation of every citizen to pay the taxes without resorting to subterfuges.

Thus<u>, reading McDowell, in the manner indicated hereinabove, in cases of treaty shopping and/or tax avoidance, there is no conflict between McDowell and Azadi Bachao</u>. [Para 64]"

(Emphasis supplied)

- **Takeaway**: It cannot be said that all tax planning is illegal / illegitimate / impermissible.

4. SC ruling in *Vodafone International Holdings BV* (2012)



4. SC ruling in *Vodafone International Holdings BV* (2012)

Judicial anti-avoidance rule:

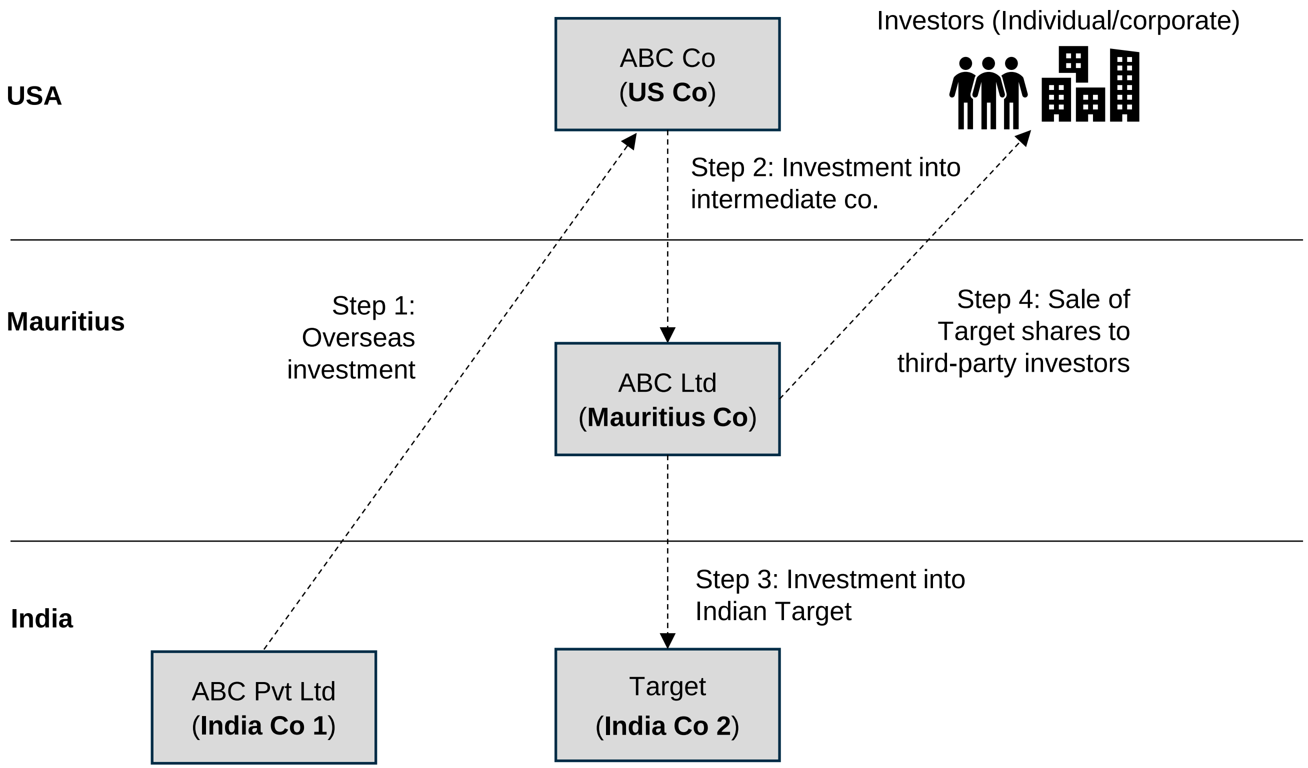
- *"In the application of a judicial anti-avoidance rule, the Revenue may **invoke the "substance over form" principle** or "piercing the corporate veil" test **only after itis able to establish on the basis of the facts and circumstances surrounding the transaction that** the impugned transaction is a **sham or tax avoidant**. To give an example, if a structure is used for **circular trading or roundtripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity.** Similarly, in a case where the Revenue finds that in a Holding Structure an entity which has no commercial/business substance has been interposed only to avoid tax then in such cases applying the test of fiscal nullity it would be open to the Revenue to discard such inter-positioning of that entity. However, this has to be done at the threshold.*

- *In this connection, one may reiterate the **"look at" principle** enunciated in W.T. Ramsay Ltd. case (supra) in which it was held that the Revenue or the Court must look at a document or a transaction in a **context to which it properly belongs** to. It is the task of the Revenue/Court to ascertain the legal **nature of the transaction and while doing so it has to look at the entire transaction as a whole and not to adopt a dissecting approach. The Revenue** cannot start with the question as to whether the impugned transaction is a tax deferment/saving device but that it **should apply the "look at "test to ascertain its true legal nature**.*

- ***Applying the above tests, 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 onus will be onthe Revenue to identify the scheme and its dominant purpose. **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**.*

Case studies: Application of the judicial anti-avoidance rule to transactions

Transaction 1: Classical ‘round-tripping’ structure through the Mauritius route



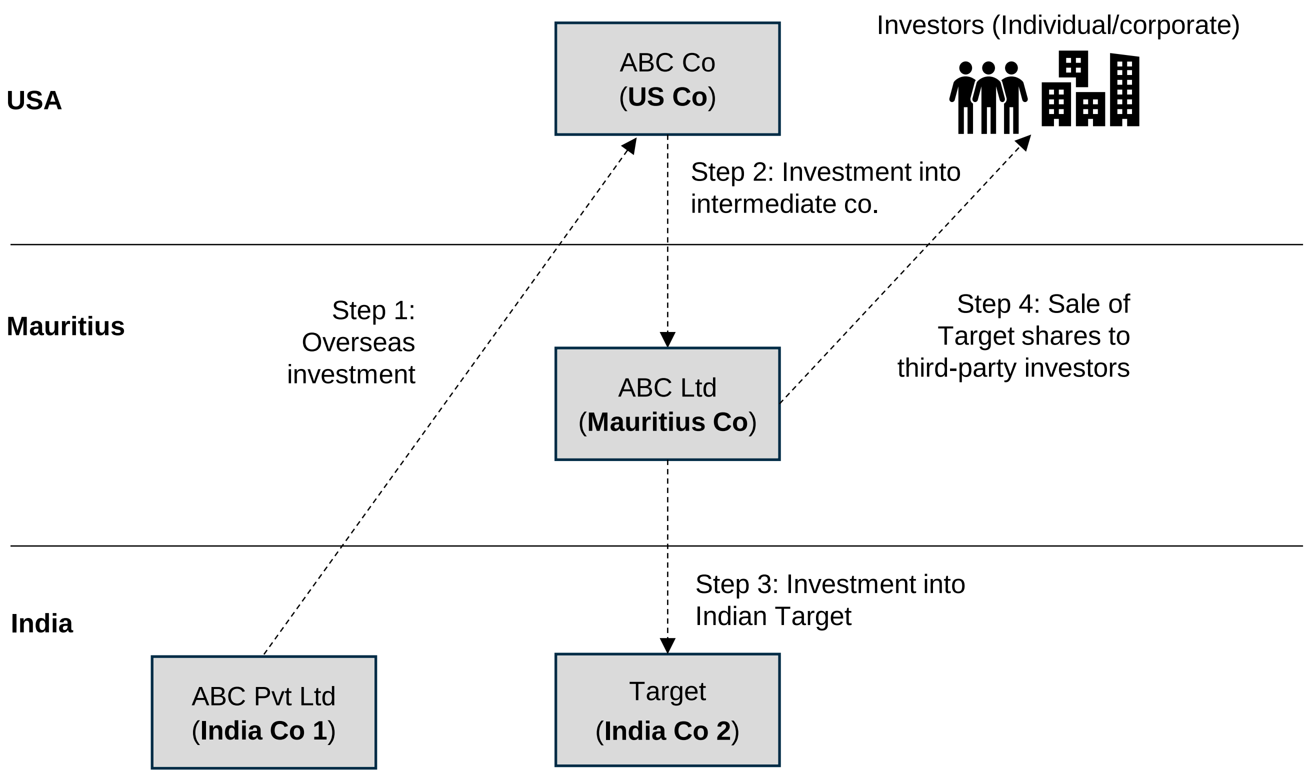
A ‘round-tripping’ structure typically entails the artificial shifting of income of a resident of a contracting state (i.e., India Co 1) to an entity interposed in the other contracting state (i.e., Mauritius Co), which is then transferred back to a resident of the first state (i.e., India Co 2).

Since the 1983 Mauritius-India tax treaty allocated exclusive taxing rights over capital gains to the alienator’s residence state (i.e., Mauritius, which did not levy a domestic capital gains tax), this structure generally resulted in:

(i) ‘double non-taxation’ of gains arising to Mauritius Co from a sale of shares of India Co 2; and

(ii) circumvention of capital gains tax that would otherwise have been payable on a domestic sale of shares of India Co 2 by India Co 1.

Transaction 1: Classical 'round-tripping' structure through the Mauritius route



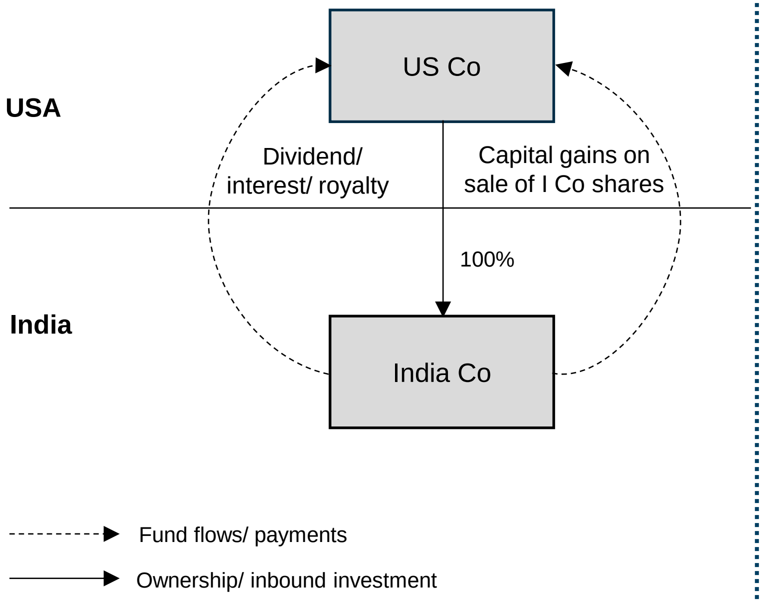
Application of JAAR to Transaction 1:

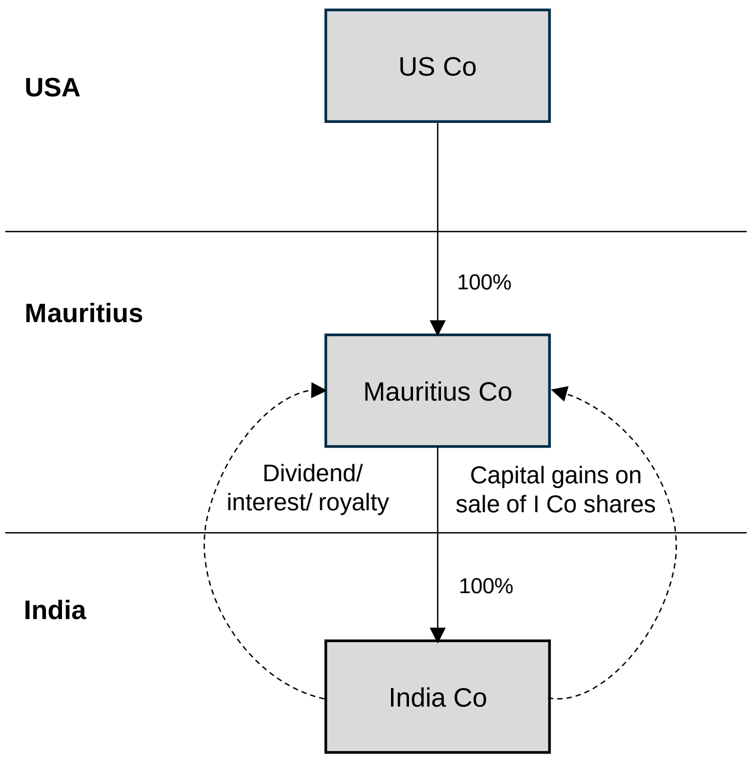
SC observations in ***Vodafone International Holdings BV* (2012)** on application of JAAR to round tripping structures:

- *"In the application of a judicial anti-avoidance rule, the Revenue may invoke the "substance over form" principle or "piercing the corporate veil" test only after itis able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant.*
- *To give an example, if a structure is used for circular trading or roundtripping or to pay bribes then such transactions, though having a legal form, should be discarded by applying the test of fiscal nullity. "*

(Emphasis supplied)

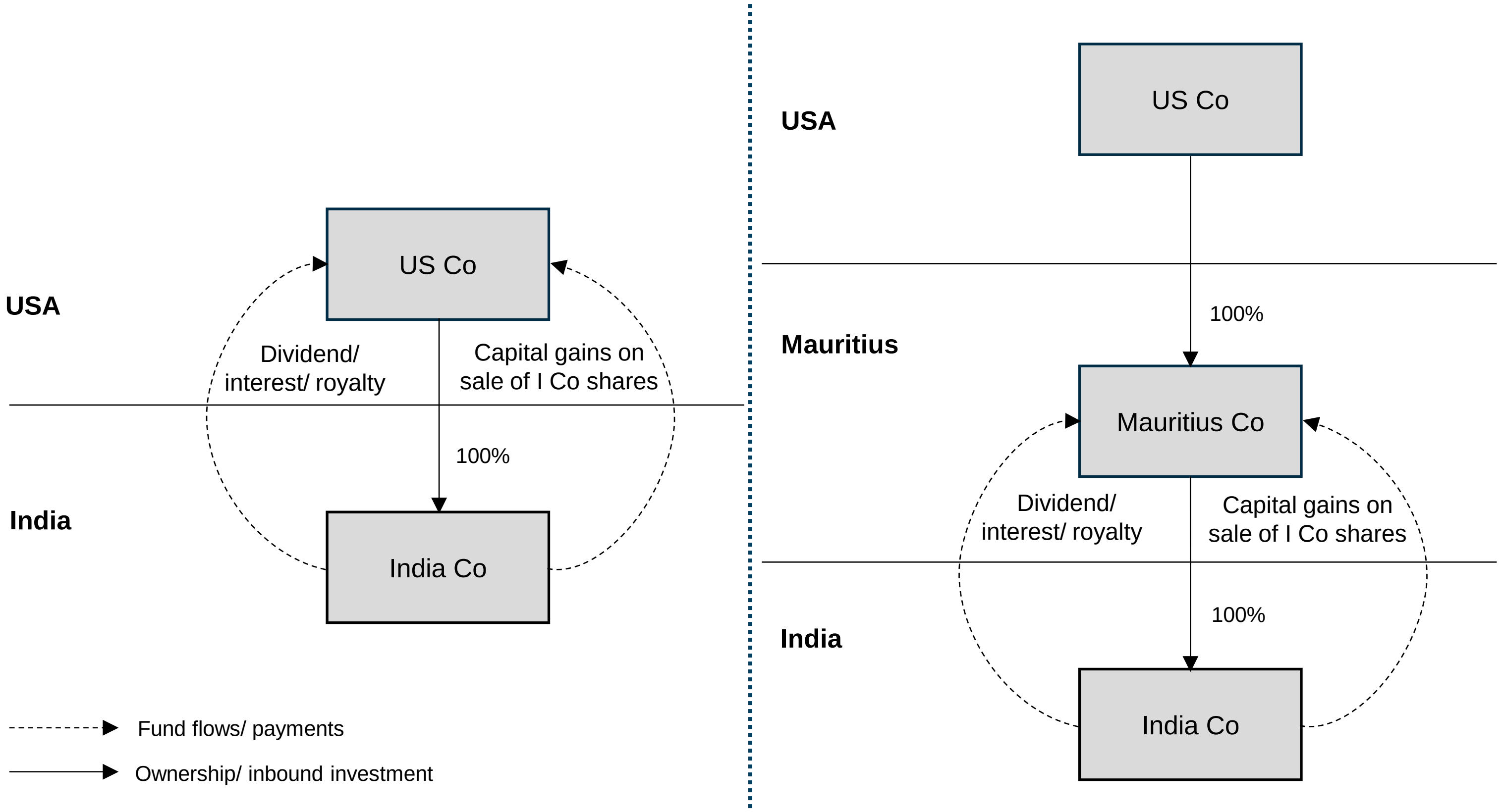
Transaction 2: Classical ‘intermediary’ or ‘direct conduit’ structure





- An ‘intermediary’ structure typically entails the interposition, by an enterprise in a third state (i.e., US Co), of a conduit company in an intermediary jurisdiction (i.e., Mauritius) that has a favourable treaty with the source state (i.e., India).
- This structure was *inter alia* used to avail reduced withholding tax rates in the source state or an otherwise unavailable capital gains tax exemption in the alienator’s residence state

Transaction 2: Classical 'intermediary' or 'direct conduit' structure



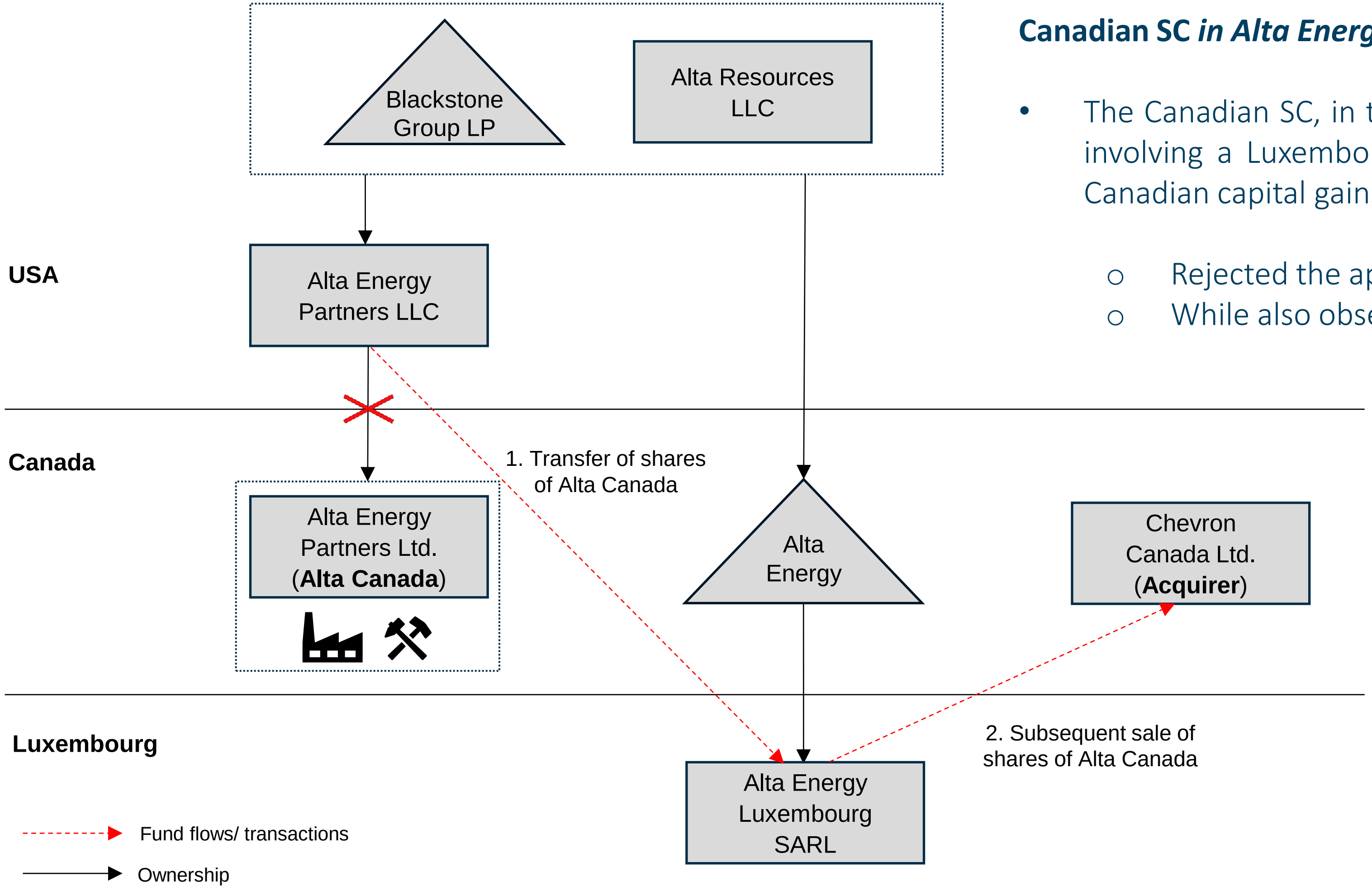
Application of JAAR to Transaction 2:

SC observations in ***Azadi Bachao Andolan (2003)*** on treaty shopping:

- *"In developing countries, treaty shopping is often regarded as a tax incentive to attract scarce foreign capital or technology. They are able to grant tax concessions exclusively to foreign investors over and above the domestic tax law provisions. In this respect, it does not differ much from other similar tax incentives given by them, such as tax holidays, grants, etc.*
- *Mauritius today provides a suitable treaty conduit for South Asia and South Africa. In recent years, India has been the beneficiary of significant foreign funds through the "Mauritius conduit".*
- *The developing countries allow treaty shopping to encourage capital and technology inflows, which developed countries are keen to provide to them. The loss of tax revenues could be insignificant compared to the other non-tax benefits to their economy."*

Based on the above observations by the SC in *Azadi Bachao Andolan* (paras 123-24), are all forms of treaty shopping such as a 'Mauritius conduit' structure necessarily abusive, even when specifically intended by the contracting states in line with their policy objectives (to attract foreign capital)?

Transaction 3: Restructuring in *Alta Energy* case



Canadian SC *in Alta Energy* on treaty shopping:

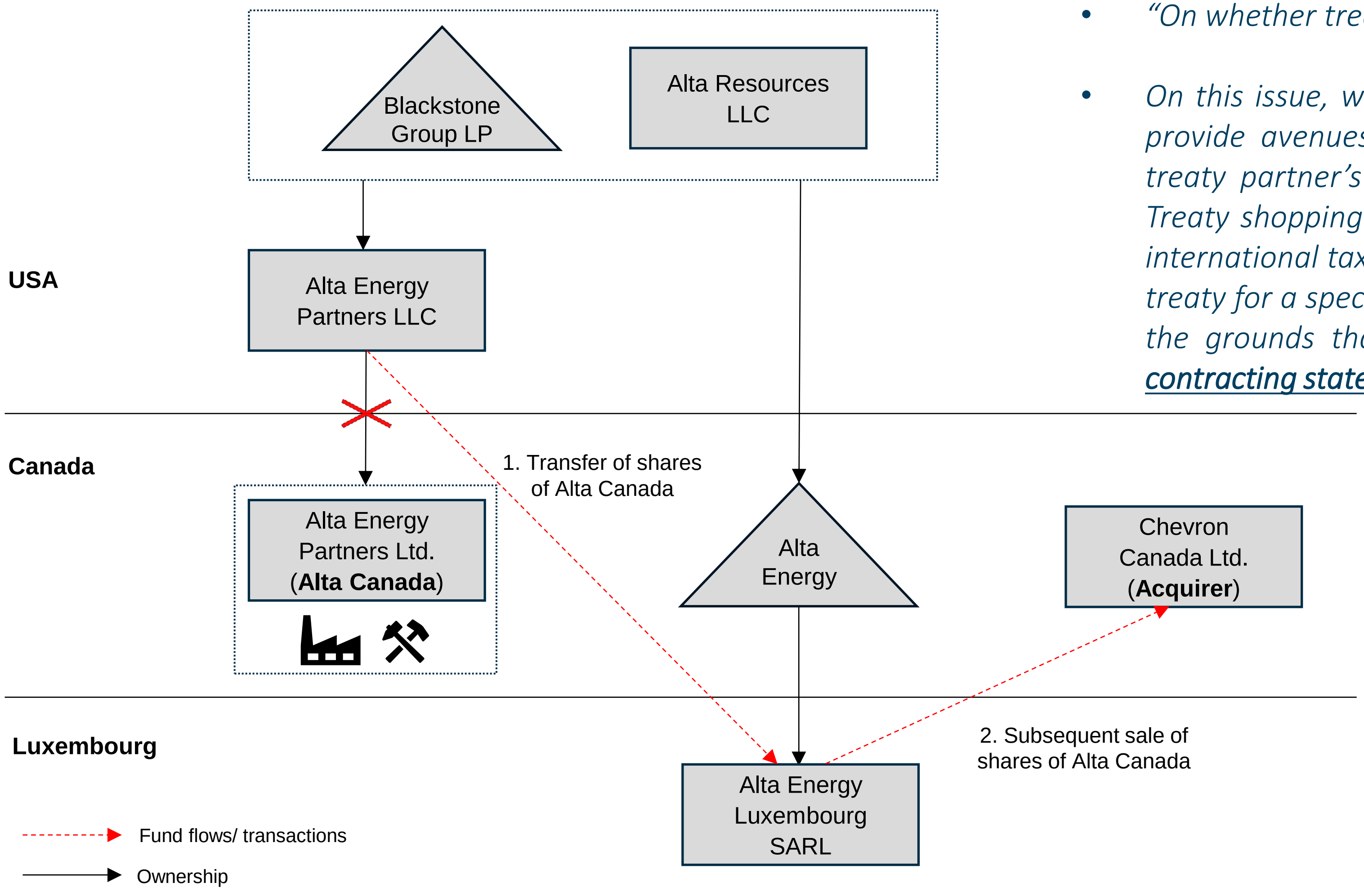
- The Canadian SC, in the Alta Energy case (2021), in the context of restructuring involving a Luxembourg taxpayer to obtain the benefit of an exemption from Canadian capital gains tax under the Canada-Luxembourg treaty:
  - Rejected the application of the Canadian GAAR to deny such treaty benefit
  - While also observing that treaty-shopping is not in and of itself abusive.

The diagram illustrates the restructuring whereby the taxpayer (i.e., Alta Energy Luxembourg S.A.R.L.):

(i) was incorporated in Luxembourg and its shares were issued to a newly formed Canadian partnership (i.e., Alta Energy);

(ii) purchased the entire shareholding of Alta Canada (i.e., a subsidiary of Alta Energy Partners LLC in the US that was set up to acquire/develop oil and natural gas properties), which it subsequently sold to a Canadian acquirer.

Transaction 3: Restructuring in *Alta Energy* case (contd.)



Canadian SC *in Alta Energy* on treaty shopping:

- *"On whether treaty shopping constitutes an improper use of tax treaties….*
- *On this issue, we agree with the Crown that the Treaty is not intended to provide avenues for residents of third-party states to benefit from their treaty partner's tax regime in the absence of genuine ties to that state. Treaty shopping connotes "a premeditated effort to take advantage of the international tax treaty network, and careful selection of the most favorable treaty for a specific purpose". Treaty shopping has notably been criticized on the grounds that it produces outcomes contrary to the intention of the contracting states, such as reduced taxation and non-taxation.*
- *Nevertheless, we agree with Alta Luxembourg that treaty shopping is not inherently abusive. There is nothing necessarily improper about minimizing tax liability by selecting a beneficial tax regime in making an investment in a foreign jurisdiction.*
- *Certain jurisdictions may provide tax incentives to attract businesses and investment; as such, taxpayers are entitled to avail themselves of such benefits to minimize tax. Thus, merely selecting a treaty to minimize tax, on its own, is not abusive. In fact, it may be consonant with one of the main purposes of tax treaties: encouraging trade and investment.*

GAAR

Run up to GAAR (2012-2015)

16 March 2012
GAAR was introduced in the Finance Bill 2012 (w.e.f. 1 April 2012)

16 March 2012
GAAR was deferred till 1 April 2014 on enactment of the Finance Bill 2012

28 June 2012
Draft GAAR guidelines were released by the government

13 July 2012
An expert committee was constituted to review and rework GAAR guidelines

1 Sept 2012
The expert committee report was published

14 Jan 2013
GAAR was postponed for another 2 years and was to become applicable from 1 April 2016

2015
Implementation of the Finance Bill 2015 deferred GAAR for 1 year. GAAR has been applicable w.e.f. 1 April 2017

GAAR framework under the Income Tax Act

Chapter X-A	• Sections 95 to 102 of the IT Act, primarily based on the South African model. • Investments made prior to 31 March 2017 (i.e., the date from which GAAR became effective) are exempt from the application of GAAR.
GAAR override (section 90(2A) of IT Act)	• **Section 90(2A)**: GAAR overrides the IT Act and tax treaties entered into with other countries. • *"90(2) <u>Where the Central Government has entered into an agreement</u> with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this <u>Act shall apply to the extent they are more beneficial to that assessee</u>.* • *90(2A) <u>Notwithstanding</u> anything contained in sub-section (2), <u>the provisions of Chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him</u>."*

GAAR framework under the Income Tax Act (contd.)

TRILEGAL

Impermissible avoidance agreement (sections 95 & 96)	• **Section 95 (Applicability of GAAR):** *Notwithstanding anything contained in the Act, an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement .* • **Section 96 (Impermissible avoidance agreement):** *(1) An impermissible avoidance arrangement means an arrangement, the main purpose 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, unless it is proved to the contrary by the assessee, 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.*
Arrangement deemed to lack commercial substance(section 97)	• **Section 97 (Arrangement deemed to lack commercial substance):** *An arrangement shall be deemed to lack commercial substance, if—* *(b) it involves or includes—(i) round trip financing; etc.*

GAAR elements

Main Purpose Test + **Tainted Elements Tests** = **IAA**

Main Purpose Test

Main purpose of the arrangement is to obtain a tax benefit.

OR

Main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit.

Tainted Elements Tests

The arrangement satisfies any of the following conditions:

1. creates rights, or obligations, which are not ordinarily created at arm's length
2. results, directly or indirectly, in the misuse, or abuse, of the provisions of the IT Act
3. lacks commercial substance or is deemed to lack commercial substance under sec. 97
4. is entered into, in a manner, which is not ordinarily employed for bona fide purposes

IAA

Consequences of IAA = Disregarded for tax purposes (including potential denial of treaty benefit, as per sec 98 of the IT Act)

Recent Telangana High Court ruling in *Ayodhya Rami Reddy* (first ruling to examine invocation of GAAR)

Key observations by the Telangana HC, while upholding the tax authorities' invocation of GAAR:

Non-obstante clause

"What next to be appreciated is the fact that chapter X-A begins with a ***non-obstante clause****, where inSection 95(1) dealing with the applicability of the GAAR….This in other words means that by virtue of the aforesaid non-obstante clause, the provisions of chapter X-A gets an* ***overriding effect over and above the other existing provisions*** *of law."*

SAAR v GAAR

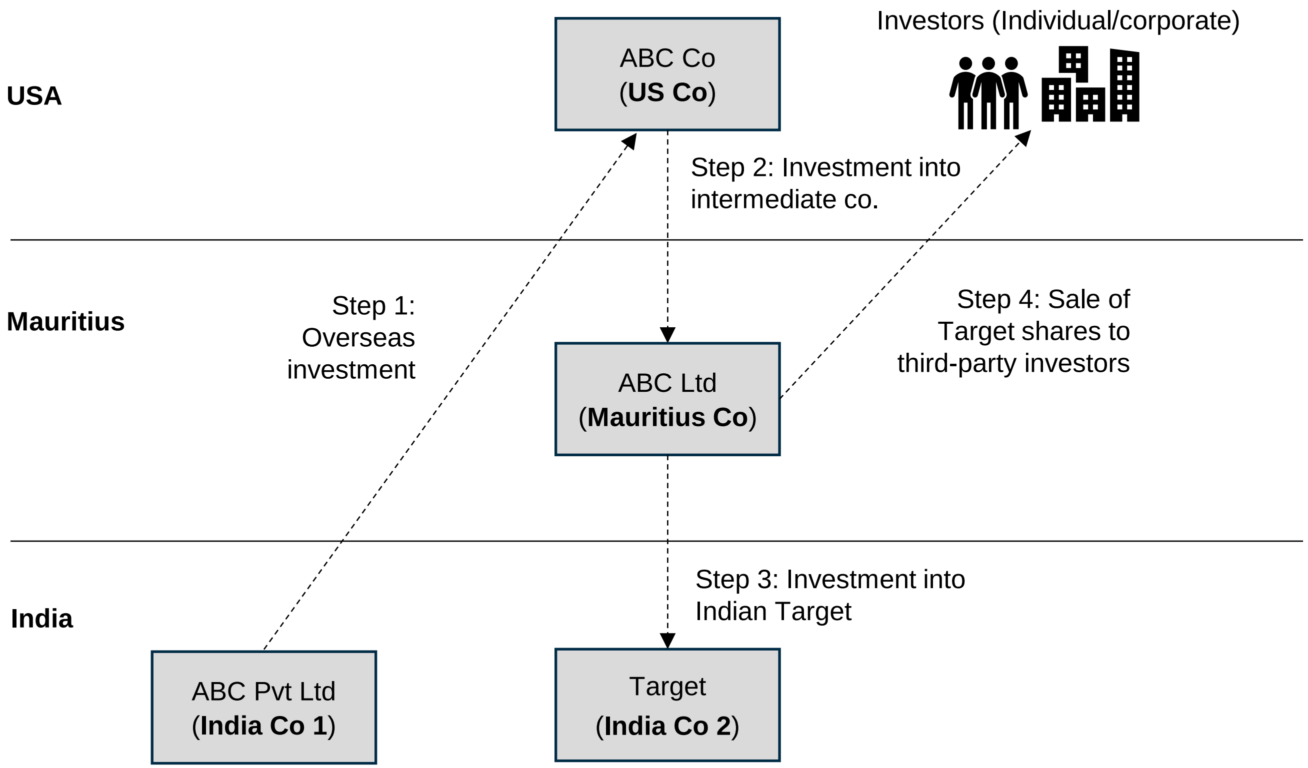
- Dismissed the argument that SAAR should take precedence over GAAR.
- It determined that the SAAR provisions in section 94(8) did not apply to the shares during the relevant period, which accordingly left GAAR as the applicable provision.

JAAR

- Citing the Supreme Court's judgement in ***McDowell & Co. Ltd***., the High Court reiterated that tax avoidance through dubious methods cannot be tolerated.

Case studies: Application of GAAR to transactions

Transaction 1: Classical 'round-tripping' structure through the Mauritius route



A 'round-tripping' structure typically entails the artificial shifting of income of a resident of a contracting state (i.e., India Co 1) to an entity interposed in the other contracting state (i.e., Mauritius Co), which is then transferred back to a resident of the first state (i.e., India Co 2).

Since the 1983 Mauritius-India tax treaty allocated exclusive taxing rights over capital gains to the alienator's residence state (i.e., Mauritius, which did not levy a domestic capital gains tax), this structure generally resulted in:

(i) 'double non-taxation' of gains arising to Mauritius Co from a sale of shares of India Co 2;28 and

(ii) circumvention of capital gains tax that would otherwise have been payable on a domestic sale of shares of India Co 2 by India Co 1.

Applicability of GAAR to Transaction 1

TRILEGAL

Main Purpose Test + Tainted Elements Tests = IAA

Main Purpose Test

- ✓ Main purpose of the arrangement is to obtain a tax benefit.

OR

Main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit.

Tainted Elements Tests

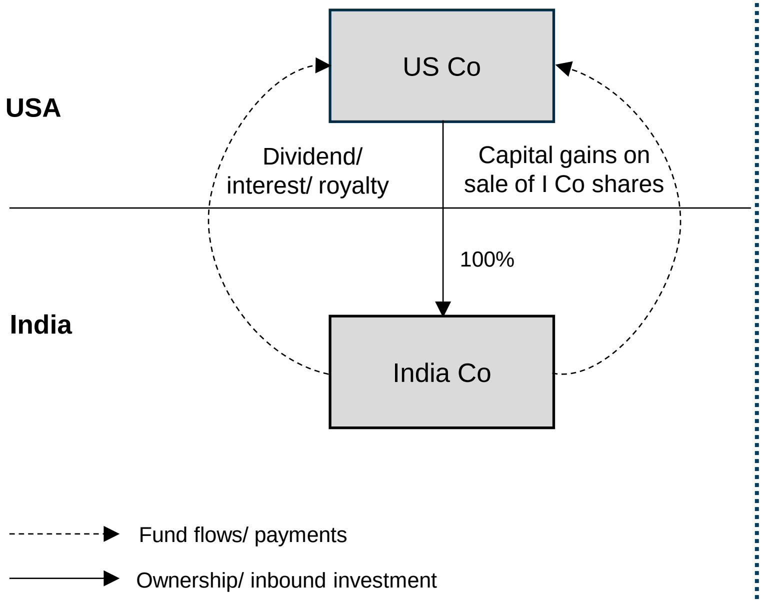
The arrangement satisfies any of the following conditions:

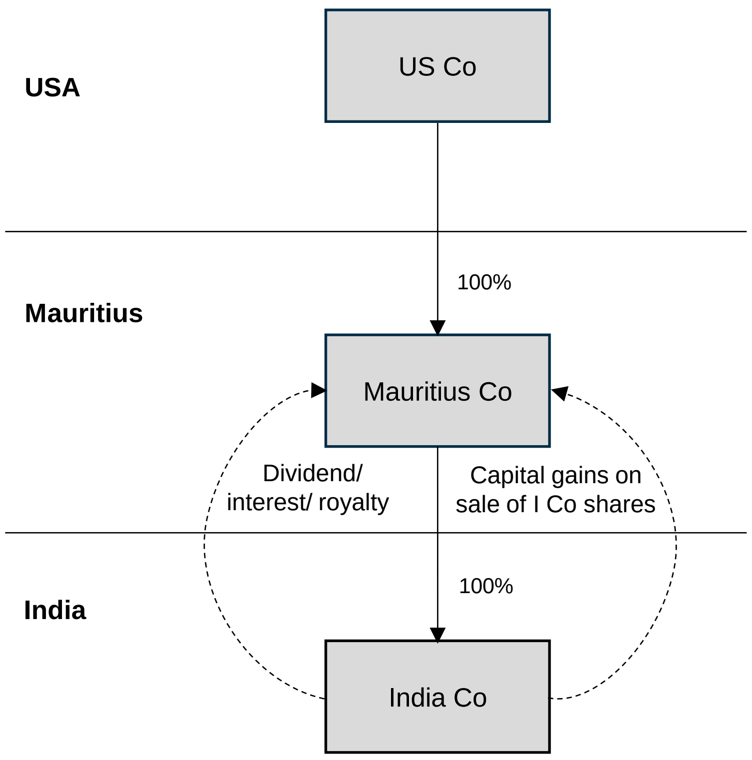
1. creates rights, or obligations, which are not ordinarily created at arm's length
2. results, directly or indirectly, in the misuse, or abuse, of the provisions of the IT Act
3. ✓ Round trip financing = <u>deemed to lack commercial substance under sec. 97</u>
4. is entered into, in a manner, which is not ordinarily employed for bona fide purposes

IAA

Consequences of IAA = Disregarded for tax purposes (including potential denial of treaty benefit, as per sec 98 of the IT Act)

Transaction 2: Classical 'intermediary' or 'direct conduit' structure





- An 'intermediary' structure typically entails the interposition, by an enterprise in a third state, of a conduit company in an intermediary jurisdiction (i.e., Mauritius) that has a favourable treaty with the source state (i.e., India).
- This structure was *inter alia* used to avail reduced withholding tax rates in the source state or an otherwise unavailable capital gains tax exemption in the alienator's residence state

Applicability of GAAR to Transaction 2

TRILEGAL

Main Purpose Test + Tainted Elements Tests = IAA

Main Purpose Test

- ✓ Main purpose of the arrangement is to obtain a tax benefit?

OR

Main purpose of a step in, or a part of, the arrangement is to obtain a tax benefit.

Tainted Elements Tests

The arrangement satisfies any of the following conditions:

1. creates rights, or obligations, which are not ordinarily created at arm's length
2. results, directly or indirectly, in the misuse, or abuse, of the provisions of the IT Act
3. ✓ lacks commercial substance or is deemed to lack commercial substance under sec. 97?
4. ✓ is entered into, in a manner, which is not ordinarily employed for *bona fide* purposes?

IAA

Consequences of IAA = Disregarded for tax purposes

TREATY ANTI-ABUSE RULES, MLI & PPT

BEPS, MLI & PPT (2015 onwards)

2015 | 2017 | June 2019 | Oct 2019

1. *BEPS Action 6 Final Report*

BEPS Action 6 on "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" was concluded as part of the final BEPS package released on 5 October 2015 by the OECD/G20.

2. *India signed the MLI*

India signed the Multilateral Instrument (**MLI**) on 7 June 2017,

3. *India deposited its instrument of ratification*

India deposited its instrument of ratification on 25 June 2019. India listed 93 out of its 96 bilateral tax treaties as covered tax agreements

4. *MLI entered into force in India*

The MLI entered into force for India on 1 October 2019. India listed 93 out of its 96 bilateral tax treaties as covered tax agreements, of which 54 treaties are in compliance with the minimum standards as of May 2023.

MLI Treaty Abuse Minimum Standards

India signed the MLI, which came into force in October 2019. In line with the 'minimum standards' under the BEPS Action 6 Report, India as a signatory to the MLI was required to implement the treaty abuse minimum standard by adopting one of the following three alternatives in its covered tax treaties:

PPT alone

Option 1: The PPT envisages denial of treaty benefits "*if it is reasonable to conclude*" that obtaining the benefit was "*one of the principal purposes*" of the arrangement. However, the PPT provision contains a carve-out that allows the person to whom the benefit would otherwise be denied the possibility of establishing that granting the benefit in the relevant circumstances "*would be in accordance with the object and purpose*" of the provisions of the treaty i.e., to provide benefits in respect of *bona fide* exchange of goods and services, and movement of capital and persons.

PPT + LoB

Option 2: The PPT along with the simplified limitation of benefits (**LOB**) provision.

Detailed LoB

Option 3: A detailed LOB provision along with provisions to address conduit financing structures.

MLI Treaty Abuse Minimum Standards

- In compliance with the treaty-shopping standards, India is implementing the preamble statement in article 6 of the MLI.

- Accordingly, while India's treaties earlier generally provided that such treaties were entered into "*for the avoidance of double taxation*" alongside other objectives such as "*encouragement of mutual trade and investment*", the new preamble would now include an explicit reference to "*avoidance, including through treaty-shopping*".

- India is also implementing the PPT and the simplified LoB, though it has expressed a statement that it accepts the PPT alone as an "interim measure" and intends to adopt an LoB through bilateral negotiations where possible.

PPT elements

The following paragraph 1 of Article 7 of the MLI applies to the provisions of this Agreement:

ARTICLE 7 OF THE MLI - PREVENTION OF TREATY ABUSE (Principal purposes test provision) (India-Singapore DTAA)

*Notwithstanding any provisions of the Agreement, **a benefit** under the Agreement **shall not be granted** in respect of an item of income **if it is reasonable to conclude**, having regard to all **relevant facts and circumstances**, **that obtaining that benefit was one of the principal purposes of any arrangement** or transaction that resulted directly or indirectly in that benefit, **unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose** of the relevant provisions of the Agreement.*

(Emphasis supplied)

LoB

ARTICLE 27A - LIMITATION OF BENEFITS (India-Mauritius DTAA)

1. *A resident of a Contracting State shall not be entitled to the benefits of Article 13(3B) of this Convention if its affairs were arranged with the primary purpose to take advantage of the benefits in Article 13(3B) of this Convention.*

2. *A **shell/conduit company** that claims it is a resident of a Contracting State **shall not be entitled to the benefits of Article 13(3B)** of this Convention. A shell/conduit company is any legal entity falling within the definition of resident with **negligible or nil business operations or with no real and continuous business activities** carried out in that Contracting State.*

3. *A resident of a Contracting State is **deemed to be a shell/conduit company** if its **expenditure on operations in that Contracting State is less than Mauritian Rs.1,500,000 or Indian Rs. 2,700,000 in the respective Contracting State** as the case may be, in the immediately **preceding period of 12 months** from the date the gains arise.*

4. *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 expenditure on operations in that Contracting State is equal to or more than MauritianRs.1,500,000 or Indian Rs.2,700,000 in the respective Contracting State as the case may be, in the immediately preceding period of 12 months from the date the gains arise.*

Explanation: The cases of legal entities not having bona fide business activities shall be covered by Article 27A(1) of the Convention.

LoB (contd.)

ARTICLE 13 - CAPITAL GAINS (India-Mauritius DTAA)

*3A. Gains from the alienation of **<u>shares acquired on or after 1st April 2017</u>** in a company which is resident of a Contracting State may be taxed in that State.*

*3B. However, the tax rate on the gains referred to in paragraph 3A of this Article and arising during the period beginning on **<u>1st April, 2017 and ending on 31st March, 2019</u>** shall **<u>not exceed 50% of the tax rate</u>** applicable on such gains in the State of residence of the company whose shares are being alienated.*

Recent CBDT guidance on applying the PPT

To provide clarity and certainty on the application of the PPT under India's tax treaties, the CBDT has issued the below welcomed clarifications.

<u>Period for which the PPT applies</u>:

i. **<u>For tax treaties where the PPT has been incorporated through bilateral processes</u>**:

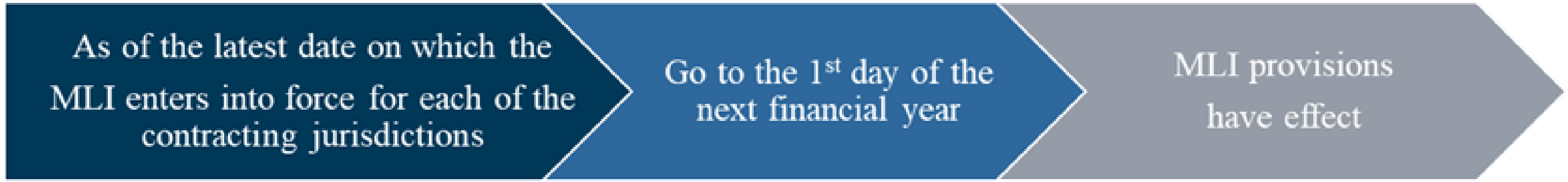
For tax treaties where the PPT has been incorporated through bilateral processes (such as Hong Kong, China, Chile, Iran, etc.), the PPT should apply from the date of entry into force of the tax treaty or the amending protocol incorporating the PPT.

i. **<u>For treaties where the PPT has been incorporated though the MLI</u>**:

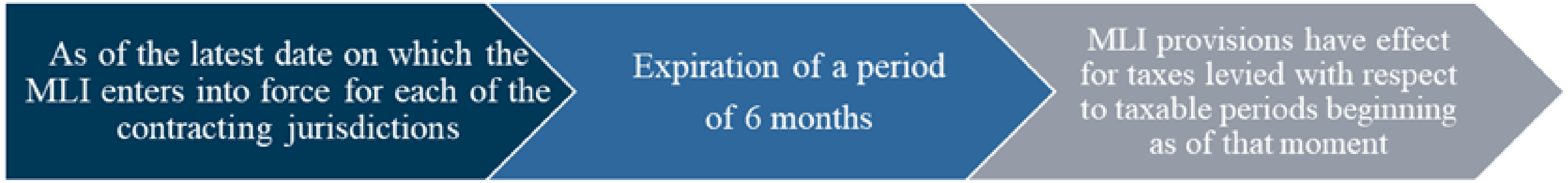
For treaties where the PPT has been incorporated though the MLI, the PPT should apply from the date of entry into effect of the MLI provisions with respect to the relevant tax treaty, as per article 35 of the MLI (illustrated below):

Recent CBDT guidance on applying the PPT (contd.)

With respect to taxes withheld at source:



With respect to all other taxes levied by a contracting jurisdiction:



- For India, the date of entry of force of the MLI is 1 October 2019. The date of entry into force of the MLI for the relevant treaty partner would need to be ascertained using the OECD's MLI Matching Database.
- For ease of reference, the dates of entry into effect of the PPT with respect to 'withholding taxes' (WHTs) and 'other taxes' for India and some of its key treaty partners are provided in Table 1 below

Recent CBDT guidance on applying the PPT (contd.)

Table 1: Entry into effect with respect to 'WHTs' and 'other taxes' for India and some of its key treaty partners						
Entry into force of the MLI for treaty partners[5]			Entry into effect of the PPT for India		Entry into effect of the PPT for treaty partner	
S. No.	Treaty partner	Entry into force of the MLI	WHTs (Taxable period beginning on or after)	Other taxes (Taxable period beginning on or after)	WHTs (Event giving rise to taxes begins on or after)	Other taxes (Taxable period begins on or after)
1.	Netherlands	1 July 2019[6]	1 October 2019[7]	1 April 2020[8]	1 January 2020[9]	1 April 2020[10]
2.	Luxembourg	1 August 2019	1 October 2019	1 April 2020	1 January 2020	1 April 2020
3.	Singapore	1 April 2019	1 October 2019	1 April 2020	1 January 2020	1 April 2020
4.	Cyprus	1 May 2020	1 May 2020	1 November 2020	1 January 2021	1 November 2020
5.	Australia	1 January 2019	1 October 2019	1 April 2020	1 January 2020	1 April 2020
6.	Belgium	1 October 2019	1 October 2019	1 April 2020	1 January 2020	1 April 2020
7.	Canada	1 December 2019	1 December 2019	1 June 2020	1 January 2020	1 June 2020
8.	United Arab Emirates	1 September 2019	1 October 2019	1 April 2020	1 January 2020	1 April 2020
9.	United Kingdom	1 October 2018	1 October 2019	1 April 2020	1 January 2020	1 April 2020

Recent CBDT guidance on applying the PPT (contd.)

Interaction between the PPT and certain treaty-specific bilateral commitments

i. India has made certain treaty-specific bilateral commitments in the form of grandfathering provisions under the India-Singapore tax treaty, India-Cyprus tax treaty as well as the India-Mauritius tax treaty. These provisions are not intended to interact with the PPT.

ii. Accordingly, the CBDT has clarified that the <u>grandfathering provisions under such tax treaties shall remain outside the purview of the PPT</u>. Please refer to Table 2 for an overview of the interaction between the PPT and certain treaty-specific bilateral commitments in certain illustrative scenarios.

Table 2:
Interaction between the PPT and certain treaty-specific bilateral commitments

S. No.	Tax treaties	Date of share acquisition	Date of share transfer	PPT applicability
1.	India-Singapore tax treaty	Prior to 1 April 2017	Irrespective of date of share transfer	Not applicable
		After 1 April 2017	Prior to 1 April 2020	Not applicable[11]
		After 1 April 2017	After 1 April 2020	PPT applicable.[12]
		<u>Note</u>: The benefit of the above grandfathering under the India-Singapore tax treaty is subject to the satisfaction of the LOB clause, which *inter alia* denies the capital gains tax benefit if the affairs are arranged with the "*primary purpose*" of obtaining the benefit.		
2.	India-Cyprus tax treaty	Prior to 1 April 2017	Irrespective of date of share transfer	Not applicable
		After 1 April 2017	Prior to 1 April 2021	Not applicable[13]
		After 1 April 2017	After 1 April 2021	PPT applicable[14]

Recent CBDT guidance on applying the PPT (contd.)

TRILEGAL

Supplementary sources of guidance

The guidance also clarifies that:

(i) the PPT provision is expected to be a context-specific and fact-based exercise, to be carried out on a case-by-case basis, keeping in view the objective facts and findings; and

(i) apart from the BEPS Action 6 Final Report, subject to India’s reservations wherever applicable, tax authorities may refer to the UN Model Tax Convention Commentary as additional / supplementary sources of guidance when deciding on the invocation of the PPT.

INTERACTION BETWEEN GAAR & THE PPT

Conflicts in the interaction of GAAR and PPT

- While the OECD's view is that conflicts do not arise in the interaction between the PPT and domestic GAARs "*in the vast majority of cases*" and that treaties do not preclude the application of domestic anti-abuse rules, a closer examination of the interaction between the PPT and the Indian GAAR reveals that such conflicts are likely to arise.

- **<u>On the one hand, such conflicts may arise in situations where the PPT applies but the Indian GAAR does not apply:</u>**

    - For instance, where the taxpayer is able to demonstrate that the transaction was primarily based on a commercial/economic rationale even though reduced taxation may be an additional result.
    - This is because the purpose test contained in the Indian GAAR uses "*the main purpose of which is to obtain a tax benefit* " unlike the PPT, which uses "*one of the main purposes*".
    - In such situations, an argument as to the non-application of the Indian GAAR may be made, though this may not preclude the application of the PPT.

- **<u>On the other hand, such conflicts may also arise in situations where the PPT does not apply but the Indian GAAR potentially applies:</u>**

    - For instance, if the transaction/arrangement falls within the purview of the PPT's '*bona fide escape clause*' on account of being in line with the object and purpose of the treaty.

Conflicts in the interaction of GAAR and PPT

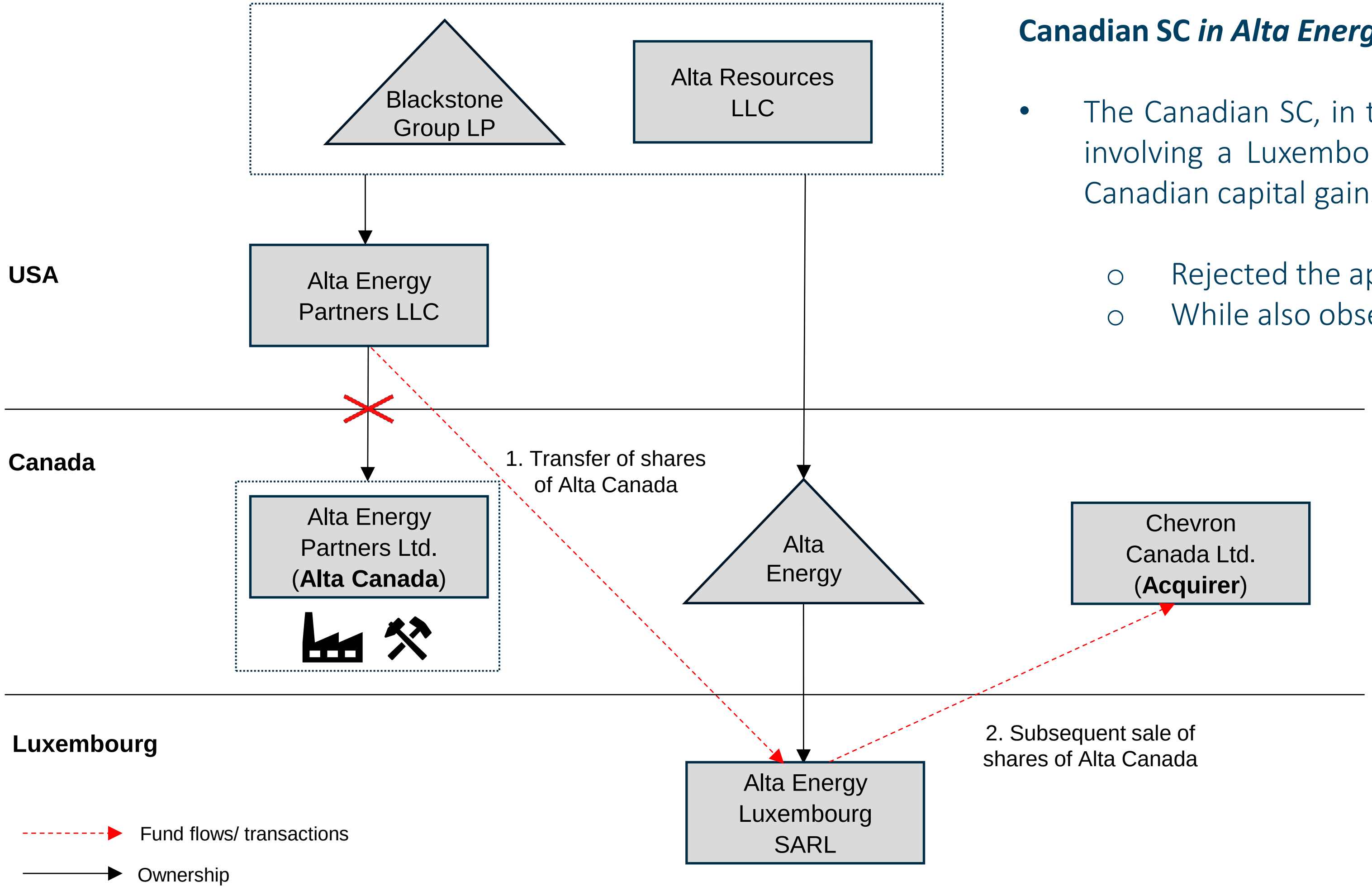
- Such risk of denial of treaty benefits on the basis of a domestic GAAR without considering the "*object and purpose*" of the treaty may be greater in jurisdictions where the domestic GAAR contains a main purpose test but, unlike the PPT, does not contain an escape clause (i.e., unless granting the benefit would be in line with the object and purpose, referred to as the 'objective component').

- For instance, the Indian GAAR does not contain a comparable escape clause, though its Canadian counterpart incorporates this element by requiring the following:

  (i) the existence of a tax benefit;
  (ii) an 'avoidance transaction'; and
  (iii) an abuse of the provisions relied on by the taxpayer such that "*it cannot be reasonably concluded that*" granting the benefit "*would be consistent with the object, spirit or purpose*" of such provisions.

Case studies: Application of GAAR and PPT to transactions

Transaction 3: Restructuring in *Alta Energy* case



Canadian SC *in Alta Energy* on treaty shopping:

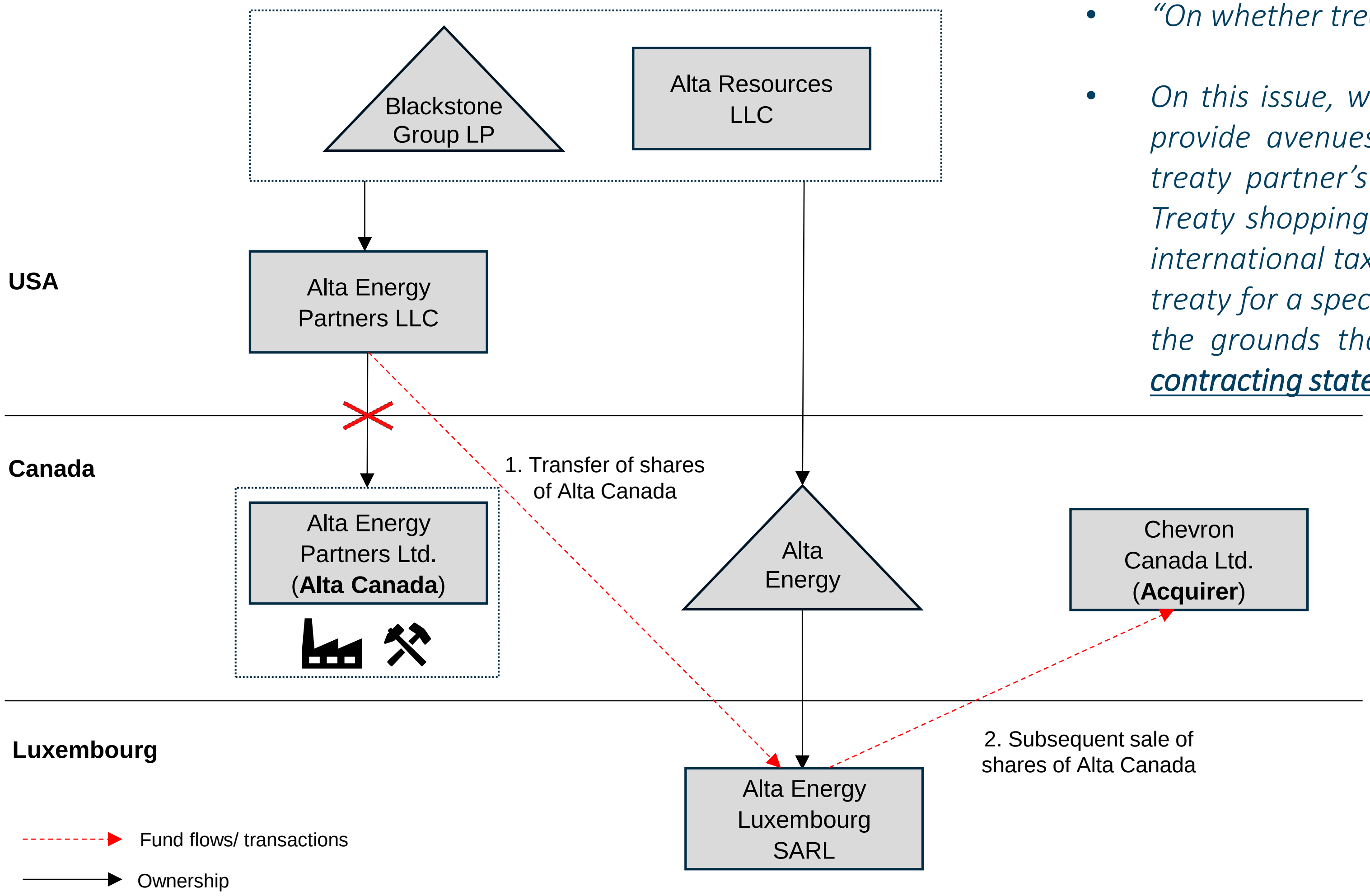
- The Canadian SC, in the Alta Energy case (2021), in the context of restructuring involving a Luxembourg taxpayer to obtain the benefit of an exemption from Canadian capital gains tax under the Canada-Luxembourg treaty:
  - Rejected the application of the Canadian GAAR to deny such treaty benefit
  - While also observing that treaty-shopping is not in and of itself abusive.

The diagram illustrates the restructuring whereby the taxpayer (i.e., Alta Energy Luxembourg S.A.R.L.):

(i) was incorporated in Luxembourg and its shares were issued to a newly formed Canadian partnership;

(ii) purchased the entire shareholding of Alta Canada (i.e., a subsidiary of Alta Energy Partners LLC in the US that was set up to acquire/develop oil and natural gas properties), which it subsequently sold to a Canadian acquirer.

Transaction 3: Restructuring in *Alta Energy* case (contd.)



Canadian SC *in Alta Energy* on treaty shopping:

- *"On whether treaty shopping constitutes an improper use of tax treaties….*
- *On this issue, we agree with the Crown that the Treaty is not intended to provide avenues for residents of third-party states to benefit from their treaty partner's tax regime in the absence of genuine ties to that state. Treaty shopping connotes "a premeditated effort to take advantage of the international tax treaty network, and careful selection of the most favorable treaty for a specific purpose". Treaty shopping has notably been criticized on the grounds that it produces outcomes contrary to the intention of the contracting states, such as reduced taxation and non-taxation.*
- *Nevertheless, we agree with Alta Luxembourg that treaty shopping is not inherently abusive. There is nothing necessarily improper about minimizing tax liability by selecting a beneficial tax regime in making an investment in a foreign jurisdiction.*
- *Certain jurisdictions may provide tax incentives to attract businesses and investment; as such, taxpayers are entitled to avail themselves of such benefits to minimize tax. Thus, merely selecting a treaty to minimize tax, on its own, is not abusive. In fact, it may be consonant with one of the main purposes of tax treaties: encouraging trade and investment.*

The information contained in this may address a specific requirement for the recipient and must not be construed as advertisement or solicitation in any form or manner.

For more information, please visit our website [WWW.TRILEGAL.COM](http://www.trilegal.com)