GAAR and PPT

- CA K Prasanna

Tax - Planning v. Avoidance v. Evasion

- ✓ There is a lot of debate over what constitutes tax planning v. avoidance v. evasion. Much clarity surrounding what constitutes tax planning and tax evasion.
- ✓ Over the years, the lines have blurred regarding the concept of tax avoidance. This leads to significant litigation and controversies.

Rulings	Observations
Duke of Westminster vs IRC (1936) AC 1 (HL); 19 TC 490	Every man entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be
CIT Vs A. Raman & Co (1967) 67 ITR 11 SC	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 arises or accrues to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act.
McDowell & Co. Ltd [154 ITR 148 (SC)]	Tax planning may be legitimate provided it is within the framework of law
Walfort Shares & Stock Borkers [(2010) 326 ITR 1	The assessee had made use of the said provision of the Act. That such use cannot be called "abuse of law". Even assuming that the transaction was pre-planned there is nothing to impeach the genuineness of the transaction
Vodafone International 341 ITR 1	Revenue cannot tax a subject without a statute to support and every taxpayer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury

Scope of GAAR

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- **Sec 95(1):** **Notwithstanding** anything contained in the Act**, an arrangement** **entered into** by an assessee **may be declared to be an IAA** and the consequence **in relation to** **tax** arising therefrom may be determined subject to the provisions of this Chapter

- **Sec 96(1):** An IAA 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**

Exclusions from GAAR

- **Rule 10U(1)(d) :** GAAR not to apply to **any income** accruing or arising to, or deemed to accrue or arise to, or received or deemed to be received by, any person **from transfer of** **investments made before 1 April, 2017** by such person.

- **Rule 10U(2):** **Without prejudice to** the provisions of sub-rule (1)(d), the provisions of Chapter X-A shall apply to any arrangement, **irrespective of the date on which it has been entered into**, in respect of the **tax benefit obtained from the arrangement on or after 1 April, 2017**

- **Rule 10U(1)(a) – GAAR** an arrangement where the tax benefit **in the relevant assessment year** arising, in **aggregate, to all the parties** to the arrangement **does not exceed Rs 3 crores**

Critical elements in GAAR

Arrangement

Sec 102(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

Notification

Sec 102(10): "tax benefit" includes,—

(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; or

(f) an increase in loss,

in the relevant previous year or any other previous year;

Lack commercial substance

Sec 97(1): An arrangement shall be deemed to lack commercial substance, if—

(a) Substance over form theory - 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) Locational Benefits - 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 for a party; or

(d) No significant Business Risk or Cash Flow - it does not have a significant effect upon the business risks or net cash flows of any party to the arrangement apart from any effect attributable to the tax benefit that would be obtained

Consequences under GAAR

Treat equity as debt and vice versa

Disregard/combine/re-characterize any steps or parts

Treat as if IAA is not entered

Recharacterize expenditure, deduction, relief or rebate

Disregard/look through any corporate structures

Disregard/treaty any parties as same person/deem any connected person as one

Treat revenue item as capital and vice versa

Treat place of residence, situs of asset/transactions at different place

Reallocation of income/expense/relief

Consequences mentioned above are inclusive and not exhaustive

Takeaway from the Shome Committee Report

Suggestions implemented

- Arrangements with the main purpose of obtaining tax benefit to be covered
- Introduction of Section 97(4) to understand the relevance of transactions that has a commercial substance
- Approving panel with one chairperson and two members has been provided in the law as per section 144BA.
- Any income accruing or arising to or deemed to accrue or arise to that are received before 1.04.2017 is not covered by GAAR provisions
- Monitory threshold of 3 crore of tax benefit
- If only a part of arrangement is impermissible, the tax consequences shall be with reference to such part only
- Detailed reasoning of the Assessing officer in the show cause notice

Suggestions not implemented

- Where treaty itself has anti avoidance provisions GAAR should not be invoked
- Tax mitigation should be distinguished from tax avoidance
- GAAR should not be invoked in intragroup transactions which may result in tax benefit to one person, but overall tax revenue is not affected either by actual loss or deferral of revenue.
- Where SAAR is applicable to a particular aspect /element, then GAAR should not be invoked to look into the same (also refer CBDT's circular 7/2017)

CBDT's Circular – 7/2017

Particulars	CBDT's Response
GAAR vs SAAR	GAAR and SAAR can co-exist, if SAAR has not sufficiently addressing all situation of abuse
Choice Principles	GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction
Jurisdiction	If jurisdiction is finalized based on non-tax commercial considerations and main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply
Grandfathering	Grandfathering available to investments made before 1 April 2017 in respect of compulsorily convertible from one form to another, split of consolidation, bonus issue. Lease contracts and loan arrangement are by themselves not 'investments' and hence grandfathering is not available
Scheme of arrangement	If court has explicitly and adequately considered the tax implications, then GAAR may not apply
Corresponding adjustment	No corresponding adjustment in the hands of other party
Limit of INR 3 Crores	3 Crore limit is to be applied on the arrangement cannot be read in respect of Single Party

GAAR vs Treaty – Interplay

- **Section 90(2) of IT Act -** Where the Central Government has entered into an agreement 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 Act shall apply to the extent they are more beneficial to that assessee.

- **Section 90(2A) of the IT Act -** Notwithstanding anything contained in sub-section (2), the provisions of Chapter X-A of the Act shall apply to the assessee even if such provisions are not beneficial to him.

- **Conflict with Article 26 of Vienna Convention** which lays down the principles of pacta sunt servanda, i.e., every treaty in force is binding upon the parties to it and must be performed by them in good faith

- **Para 77 of Commentary on Article 1 of OECD Model Convention 2017**, inter alia, provides that there exists no conflict between the provisions of tax treaty and domestic GAAR if the provisions of domestic GAAR are formulated in line with the principle of PPT

- Some tax treaties [Singapore, Malta, Indonesia, Luxembourg, Malaysia, Colombia, Spain (through Protocol)] specifically provide for application of domestic anti-abuse provisions over the beneficial provisions of tax treaties

BEPS – Action Plan 6 – Treaty abuse approach

1. Title and Preamble	2. Limitation of Benefit	3. PPT Rule
Statement from the contracting states intend to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance. Including through treaty shopping arrangement	Objective criteria rules like legal nature, ownership in, general activities of contracting states (i) simplified or (ii) detailed	General anti-abuse rule based on the principal purpose of transactions or arrangements to address other forms of abuse not covered by LOB

Mandates inclusion of preamble as a minimum standard

Options – (i) PPT, (ii) PPT + LOB (Detailed or Simplified), (iii) Detailed LOB + Anti abuse rule

Article 6 - Preamble to Tax Treaty

- ✓ **Minimum Standard – Title to Preamble**
  "Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions),"

- ✓ **Additional Language**
  "Desiring to further develop their economic relationship and to enhance their co-operation in tax matters.

- ✓ **India's Position**
  India is silent on the Article – being a minimum standard, the countries, who subscribes to MLI, unless otherwise notified, be presumed to have agreed to the change.

  Impact of additional language – This is optional, hence subject to the position of other treaty countries

- ✓ **Impact of CTA**
  Singapore, France, UK, Netherlands etc., - Preamble is modified
  Russia has opted for optional language – Hence India-Russia treaty will include additional language

Significance of Preamble in interpretation of tax treaty

- **Article 31 of Vienna Convention –** "The context for the purpose of the interpretation of tax treaty shall comprise the text, **preamble** and annexes"

  Although India is not a signatory to Vienna Convention, Indian Courts have embraced the principles of VCLT while interpreting tax matters – UOI vs Ram Jethmalani (2011) 8 SCC1; Engineering Analysis Centre of Excellence Pvt Ltd – CA 8733-8744 of 2018

- **Para 23 of MLI Explanatory statement –** CTA to be interpreted inline with the Preamble Language

- **Para 73 of AP 6 –** will be relevant to the interpretation and application of provisions of the tax treaty

- **Azadi Bachaon Andolan [263 ITR 706] (SC)** – In the context of India-Mauritius, the SC upheld that treating shopping is valid by interpreting the preamble which included "**encouragement of mutual trade and investment"**

- **India had amended Section 90(1) to resonate preamble under Art 6 of MLI**

- **Whether SC ruling in AZA holds valid in the era of MLI? –** Whether SC ruling holds good from India-Mauritius DTAA perspective, as Mauritius has not included India as CTA.

- **Impact of the amended preamble on grandfathered investments – for e.g. India-Singapore**

Article 7 – India's position

Principal Purpose Test	Limitation of Benefit	Simplified LOB
Being a Minimum standard, PPT shall be mandatory part of CTA	Where possible, it is intended to adopt detailed LOB, in addition to or in replacement of PPT with anti conduit rules	Apply simplified LOB with a combination of PPT – subject to opting by treaty partner (including Symmetric/Asymmetric options)
To be applied as Interim measure	**India can bilaterally negotiate treaty to include detailed LOB + anti conduit rules**	**India has opted to adopt SLOB + PPT**

Article 7 – Principal Purpose Test

"Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital 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 – **Reasonable Purpose Test**

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 Covered Tax Agreement – **Object and Purpose Test**

PPT have overriding impact on benefit under a treaty	Benefit could be denied if one of the principal purpose is to obtain treaty benefit	PPT is applied on transaction or arrangement – not entity specific	Object and Purpose to be established by taxpayers
Arrangement vs Transaction – includes series of transactions	Benefits – direct and indirect covered – includes all limitation on taxation provided under CTA	Can have Retroactive application	Powers under PPT is limited compared to GAAR

Article 7 – Select examples provided in AP

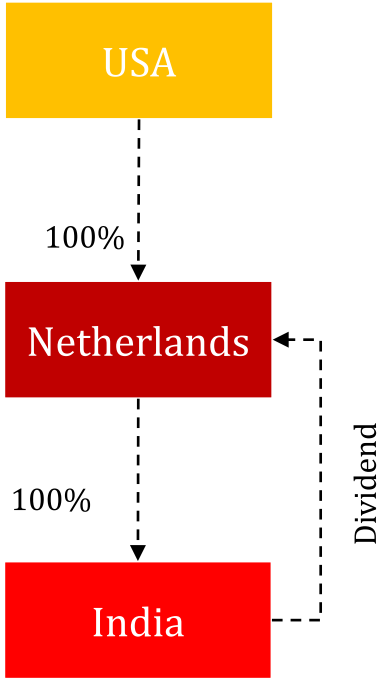
#	Example A	Example C	Example E	Example G
Facts	• T Co owns shares of S Co. In absence of T-S treaty, dividend by S Co to T Co is subject to WHT of 25% under domestic law of State S. • T Co assigns right to receive dividends declared but not yet paid by S Co, to R Co, an independent financial institution in State R • Under R-S treaty, there is no WHT on dividends paid by S Co to R Co.	• R Co is in the business of manufacturing electronic devices proposing to set up plant in developing country to benefit from lower manufacturing cost • After preliminary review, 3 potential locations were shortlisted based on political and economic comparability • R Co decided to set up plant in State S, as this is only country with which State R has tax treaty	• R Co has, for the last 5 years, held 24% shares of S Co. • Following the entry-into-force of R-S treaty, R Co decides to increase its ownership to 25% shares of S Co. • Decision to increase ownership by 1% is primarily to obtain treaty benefit of Article 10(2)(a)	Establishing intra-group service company in a jurisdiction with skilled labour force, reliable legal system, business friendly environment, political stability, sophisticated banking system and comprehensive treaty network
Comments	In absence of other facts, PPT is applicable because: 'Reasonable purpose test' not satisfied; and 'object and purpose test' also not satisfied.	• Objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention	• Though increase in investment is for one of the principal purpose of obtaining treaty benefit, it meets the "object and purpose" of the relevant dividend article of treaty • PPT trigger is not warranted	Not reasonable to deny treaty benefits to R Co which conducts real business, using real assets, assumes real risks, and performs multitude economic functions through its own personnel located in State R

Article 7 – Simplified LOB

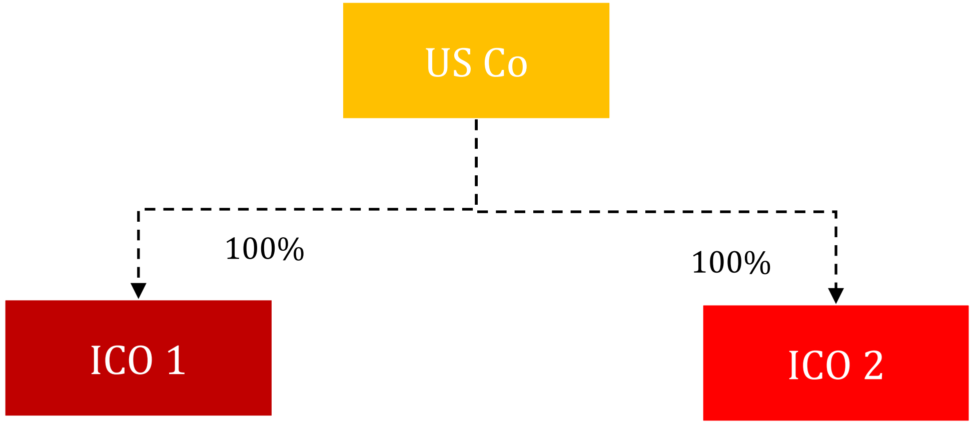
Conditions	Description
Resident should be a Qualified person (Para 9)	Qualified persons to include Individuals, Government and Government bodies, publicly traded companies/ entities, not-for profit organizations, persons satisfying certain ownership tests, etc.)
Resident should be carrying on active trade or business in the CoR (Para 10)	• Income is derived by person engaged in active conduct of trade or business in CoR • Income derived from/emanates from or is incidental to such business • Exceptions provided as to when person is not engaged in active conduct of business (illustratively- holding company, providing group financing, providing overall supervision/ management of a group)
Derivative Benefits Rule (Para 11)	If, on at least half of the days of any 12-month period, atleast 75% of beneficial interest in resident enterprise is directly or indirectly owned by certain persons entitled to equivalent benefits (Equivalent Beneficiaries defined as a person entitled to equivalent/ more favourable benefit under domestic law, CTA or any other instrument)
Competent Authority (Para 12)	If a resident of contracting jurisdiction is neither a qualified pursuant para 9 nor entitled to benefits under para 10 or para 11, then CA can nevertheless grant the benefits of the CTA

Only 14 countries including India had opted for application of SLOB. In this CTA between India-Greece is an example where Greece chose asymmetric application of SLOB i.e. India can apply PPT + SLOB, whereas Greece will apply only PPT

Case Studies

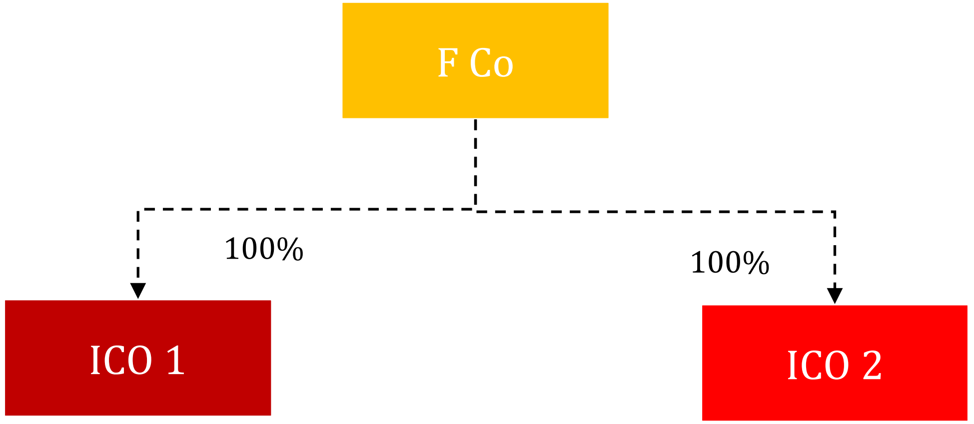


- Netherland structure was put in place during DDT regime to take benefit of Capital Gains
- Post change in classical system, India Co declared dividend to Netherlands
- Whether PPT or GAAR can be invoked to deny treaty

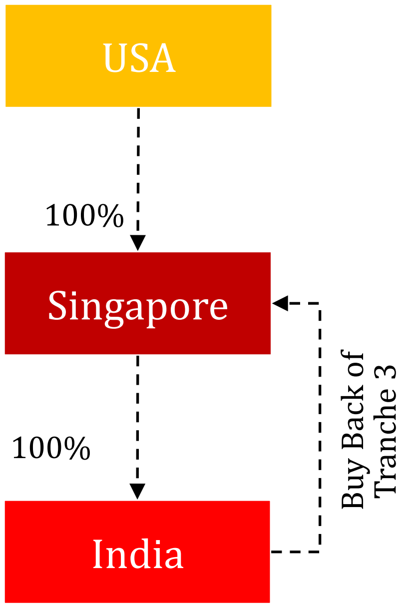


- US Co transfer shares of ICO 1 to its wholly owned subsidiary i.e., ICO 2 and claimed exemption under 47(iv)
- Post share transfer ICO 1 became WOS of ICO 2.
- ICo 1 had merged with ICO 2 post share transfer.
- Whether GAAR/PPT can be invoked to deny exemption under 47(iv) of the Act

Case Studies



- ICO 1 is loss making entity engaged in the business of manufacturing automobile components. I Co 1 has significant business loss and unabsorbed depreciation
- ICo 2 is a profit-making entity and pays significant taxes.
- F Co decide to merge ICO 1 with ICO 2, so that there is optimization of resources as well as tax cost.
- Whether GAAR can be invoked?



Tranches	FV	Premium	Total
Tranche 1	100	5	105
Tranche 2	100	10	110
Tranche 3	100	80	180

Thank You

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