Indian Jurisprudence on Tax Avoidance, GAAR and Principal Purpose Test

December 03, 2023

What is Tax Avoidance?

- ‘Tax avoidance’ is essentially a ‘reaction’ to the ‘action’ of levying tax, and ‘anti avoidance’ provisions are the ‘reaction’ to the ‘action’ of adopting tax avoidance steps
- It is the legal utilization of tax regime to one’s own advantage, to reduce the amount of tax that is payable by means that are within the four corners of law
- ‘Tax avoidance’ - not defined under the Act or earlier legislations in India. Courts around the world have repeatedly interpreted and differentiated the terms ‘ tax planning’, ‘tax avoidance’, and ‘tax evasion’
- Thin line exists between tax planning and tax avoidance; each country needs to protect its tax base and collect its rightfully due taxes
- It has been judicially accepted that tax planning, within the four corners of law whereas tax evasion has no place in law.
- There has been established jurisprudence - both Indian and foreign - discussing the treatment of tax avoidance. Some landmark cases include the **Westminster’s case** it was held that “*every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be*”. In **IRC v WT Ramsay Ltd** , the House of Lords held that the principle of the Westminster’s case must not be overextended.

What is Tax Avoidance?

- In **McDowell & Co. Ltd. case** 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.
- A study on the evolution of the concept of 'tax avoidance' in India is perhaps incomplete without the mention of two significant milestones, the 2003 ruling of the Supreme Court of India in the **Union of India v Azadi Bachao Andolan** case (Azadi case) and the enactment of GAAR, effective 1 April 2017
- Azadi case upheld sanctity of TRC and marked the victory of the legal form of the transaction over its substance and the Court eloquently concluded that:

  "The court must deal with what is tangible in an objective manner and cannot afford to chase a will-o'-the-wisp….We are unable to agree with the submissions that an act which is otherwise valid in law can be treated as non-est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interests"

(In)Famous Vodafone case

- *There is a conceptual difference between preordained transaction which is created for tax avoidance purposes, on the one hand, and a transaction which evidences investment to participate in India. In order to find out whether a given transaction evidences a preordained transaction in the sense indicated above or investment to participate, one has to take into account the factors, namely, duration of time during which the holding structure existed, the period of business operations in India, generation of taxable revenue in India during the period of business operations in India, the timing of the exit, the continuity of business on such exit, etc.*
- *Tax avoidance is a problem faced by almost all countries following civil and common law systems and all share the common broad aim, that is to combat it. Many countries are taking various legislative measures to increase the scrutiny of transactions conducted by non-resident enterprises. [Para 54]*
- *Direct Tax Code Bill (DTC) 2010, proposed in India, envisages creation of an economically efficient, effective direct tax system, proposing GAAR. GAAR intends to prevent tax avoidance, what is inequitable and undesirable. Clause 5(4)(g) provides that the income from transfer, outside India of a share in a foreign company shall be deemed to arise in if the FMV of assets in India owned by the foreign company is at least 50 per cent of its total assets*

Judicial anti-avoidance doctrines

Bird eye view of the principles developed in the Pre-GAAR era

Lifting of the corporate veil

- Disregarding separate legal identity of a company and consequently taxing the shareholder

Telco vs State of Bihar, Ansaldo Energia SPA vs ITAT

Sham transaction

- Transaction not carried out or is not intended to be carried out or is a cover up for another transaction or relationship;
- Essentially conceals true nature or reality of transaction, legal form retained but underlying substance is not genuine

McDowell case, Meenakshi Mills case

Economic substance test

- Economic substance of transactions is to be determined by looking at both objective and subjective factors;
- To see if there is any potential for profit other than tax savings or if there is any meaningful change in the economic position of the taxpayer

Business purpose test

- Requires justification of transaction from commercial point of view
- Mere tax advantage cannot be sole or main business purpose

Gergory vs Helvering, Star TV Amalgamation AAR case

Label Doctrine

Use of incorrect labels to classify or characterize a transaction or relationship for tax purposes

Ridge Securities v. IRC, 1964

Step transaction doctrine

Intermediate steps of a transaction disregarded, several transactions treated as single composite transaction

Furniss vs Dawson, Ramsay case

Colorable Device

Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods

McDowell and Co Ltd vs Commercial Tax Officer

Applicability of GAAR

Tax planning	Tax evasion	Tax avoidance
Arrangement of affairs in order to minimize tax liability *Legal – not in the ambit of GAAR*	Use of illegal means to reduce tax liability Illegal – GAAR not applicable	Legal exploitation of tax laws to one's own advantage **GAAR applicable**

Gamut of anti-avoidance rules

Specific anti-avoidance rules

TP Regulations; thin capitalization norms; Deemed dividend; Indirect transfer; Transfer of income without transfer of asset etc

- **Judicial GAAR** - Principles that are not codified in legislation but are developed by the judicial precedents (*refer next slide*)
- **Statutory GAAR** - Statute based GAAR is extended and codified version of Judicial GAAR. It codifies and gives legal recognition to principles laid by Judicial GAAR

Memorandum to GAAR

- *The questions of substance over form has consistently arisen in the implantation of taxation laws. In the Indian context, judicial decisions have varied. While some courts in certain circumstances had held that legal form of transactions can be dispensed with and the real substance of the transaction can be considered while applying the taxation laws, others have held that the form is to be given sanctity. The existence of anti-avoidance principles in India is based on various judicial pronouncements. There are some specific anti-avoidance provisions but general anti-avoidance has been only dealt with through judicial decisions in specific cases.*
- *In an environment of moderate rates of tax, it is necessary that the correct tax base be subject to tax in the face of aggressive tax planning and use of opaque low tax jurisdictions for residence as well as for sourcing of capital. Most countries have codified a "substance over form" doctrine in the form of General Anti Avoidance Rules (GAAR).*
- *In the above background and keeping in view the aggressive tax planning with the use of sophisticated structures, there is a need for statutory provisions so as to codify the doctrine of "substance over form" where the real intention of the parties and effect of transactions and purpose of an arrangement is taken into account for determining the tax consequences, irrespective of the legal structure that has been superimposed to camouflage the real intent and purpose. (…).*
- *It is accordingly proposed to provide General Anti Avoidance Rule in the Income-Tax Act to deal with aggressive tax planning*

GAAR provisions (1/3)

Conditions for qualifying as an IAA

Arrangement - Main purpose* to obtain tax benefit

AND

- creates rights/ obligations not ordinarily created between persons dealing at arm's length

(and/ or)

- results, directly or indirectly, in misuse/ abuse of provisions of the Act

(and/ or)

- lacks commercial substance or is deemed to lack commercial substance, in whole or in part

(and/ or)

- carried out, by means or in a manner, which are not ordinarily employed for bona fide purpose

Tax benefit includes

- reduction or avoidance or deferral of tax or other amount
- increase in refund of tax
- reduction or avoidance or deferral of tax or other amount as a result of tax treaty
- increase in refund of tax or other amount as a result of a tax treaty
- reduction in total income
- an increase in loss

**Arrangement presumed to have been entered/ carried out for the main purpose of obtaining tax benefit, if the main/ part purpose of a step is to obtain tax benefit, unless proved contrary by the assessee*

GAAR provisions (2/3)

Arrangement deemed to lack commercial substance

- 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;
- It involves or includes:
  - round trip financing;
  - an accommodating party*;
  - elements that have effect of offsetting or cancelling each other; and
  - a transaction conducted through one or more person and disguises the value, location, source, ownership or control of funds
- Involves the location of an asset or of a transaction or the place of residence of any party, which does not have a substantial commercial purpose other than obtaining a tax benefit;
- Does not have significant business risk or net cash flow other than that attributable to the tax benefit that would be obtained

Factors for determining lack of commercial substance

Period or time for which the arrangement exists

Payment of taxes, directly or indirectly, under the arrangement

Exit route provided by the arrangement

Relevant but not sufficient factors

Reporting of GAAR under tax audit report – A taxpayer is required to specify whether it has entered into an IAA along with the nature and the quantum of tax benefit obtained by the IAA – CBDT has deferred these reporting requirements to March 31, 2020

*A party to an arrangement shall be an accommodating party, if the main purpose of direct/ indirect participation of the party (in whole or part) is to obtain, directly or indirectly, a tax benefit for the taxpayer (whether or not the party is a connected person in relation to any party to the arrangement)

GAAR provisions (3/3)

Consequences of IAA

Disregarding the corporate structure or any step of arrangement

Treating the arrangement as if it had not been entered into or carried out

Re-assign place of residence/ situs of asset or transaction

Re-characterize equity-debt, income, expenses, relief etc

Disregard accommodating party/ treating accommodating part as one and the same person

Reallocating income/ expense/ relief/ rebate, etc amongst the parties

Deeming connected persons as one and the same

Situations in which GAAR shall not apply

- Where tax benefit (in aggregate to all parties of IAA) is not > INR 3 crores;
- FII who has invested in accordance with SEBI Regulations and is an assesse under the Act and does not take tax treaty benefit;
- A non-resident, in relation to investment made by him by way of offshore derivate instrument in a FII;
- 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 the April 1, 2017 by such person*

**GAAR shall apply to an IAA, irrespective of the date on which it has been entered into, in respect of the tax benefit obtained from the arrangement on or after the April 1, 2017*

Refer annexure for CBDT clarifications

GAAR and interplay with tax treaties (1/5)

- Tax treaties ensure proper application of domestic tax laws through equitable allocation of taxation rights between partners with an intent to eliminate double taxation and prevention of fiscal evasion
- The international tax community is trying to combat the issue of double non-taxation on account of availing benefits under the tax treaty and erosion of tax base; one of the objectives of the birth of the OECD BEPS project is to tackle this issue
- Globally, several countries are taking measures to prevent the erosion of their tax bases through tax avoidance

Recent modifications in tax treaties

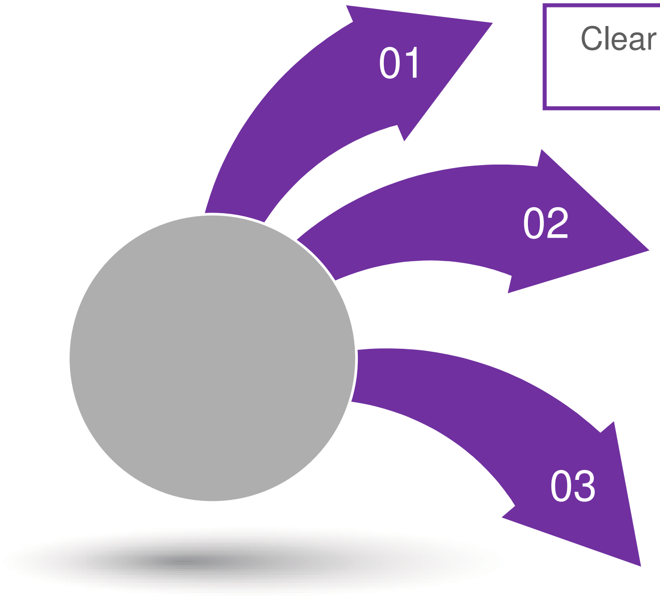
1. **GAAR like rules prevalent in Indian DTAAs with UK, Poland, Norway, UAE**
2. **Indian DTAAs with Singapore, Cyprus, Mauritius modified to include the LoB clause**
3. **DTAA clause allowing domestic GAAR to override DTAA provisions- Indian DTAA with Luxembourg, Malaysia**

Refer annexure for recent amendments in Indian tax treaties with Mauritius, Singapore and Cyprus

GAAR and interplay with tax treaties (2/5)

Action Plan 6 and MLI

- Action Plan 6 of the OECD BEPS Project recognizes treaty abuse as an important source of BEPS concern
- MLI has been developed to modify existing bilateral tax treaties to swiftly implement tax treaty measures developed in course of the BEPS Project
- As a minimum standard, jurisdictions should implement one of the following three:
  - PPT;
  - Detailed LOB rule plus anti-conduit arrangement rules;
  - PPT plus LOB rule – LOB can be either simplified or detailed
- India has chosen to apply PPT along with simplified LOB rule



Clear statement of intent in tax treaties to avoid creation of opportunities for non-taxation or reduced taxation through tax evasion or avoidance

Limitation of Benefit ('LoB')

- Specific anti-abuse rule like the LoB rule, limits availability of treaty benefits to entities meeting certain conditions (*based on legal nature, ownership etc.*) – ensuring entitlement of treaty benefits to cases having sufficient substance

Principle Purpose Test ('PPT')

Treaty benefits shall be denied if one of the principal purposes of any transaction is to obtain treaty benefits – thereby ensuring that there is sufficient commercial rationale for undertaking a transaction

GAAR and interplay with tax treaties (3/5)

India's position under MLI

- India has chosen to apply PPT along with simplified LOB rule
- PPT rule seems to be wider than GAAR in most circumstances

Particulars	PPT	GAAR
Scope	Possible to invoke even if **one of the principle purpose** is to avail tax benefit	Can be invoked only if the **main purpose** is to obtain tax benefit
Additional test	Nothing prescribed	One of the other tainted elements need to be satisfied
Safeguards	No safeguards in place, hence the ITA can deny tax treaty benefit by invoking PPT	Procedural safeguards in place
Exclusions	Nothing prescribed	Exhaustive list provided
Grandfathering	Nothing prescribed; hence, impacts structures already in existence	Income arising from transfer of investment made prior to April 1, 2017

CBDT Clarification:

- Adoption of anti-abuse rules in tax treaties may not be sufficient to address all tax avoidance strategies and the same are required to be tackled through domestic anti-avoidance rules;
- If a case of avoidance is sufficiently addressed by LOB in the treaty, there shall not be an occasion to invoke GAAR

GAAR and interplay with tax treaties (4/5)

GAAR overriding the tax treaties

- Provisions of ITA provide that GAAR would apply even in case it is not more beneficial to the taxpayer; thereby, overriding the tax treaties
- Interplay of the PPT and LoB rule under the tax treaties with GAAR

Treaty without LoB

- GAAR would apply in case a transaction is construed as a IAA

Treaty with LoB rule

- Like India-Mauritius tax treaty
- GAAR would apply where the case of avoidance is not sufficiently addressed by the LoB clause

Treaty with LoB & PPT

- Like India-Singapore tax treaty
- PPT rule to apply – considering it is wider in scope and application
- Can GAAR be invoked even on satisfaction of PPT?

GAAR and interplay with tax treaties (5/5)

Impact of MLI on some select jurisdictions

Particulars	Mauritius	Netherlands	Singapore	Cyprus
Prior to MLI				
Existence of LoB rule	Yes (Applicable for transitory relief)	No	Yes (Applicable for grandfathering and transitory relief)	No
Existence of PPT rule	Yes (Applicable only for transitory relief)	No	Yes (Applicable for grandfathering and transitory relief)	No
Post MLI				
Definitive list announced	No	Yes	Yes	No
Whether notified as CTA?	No	Yes	Yes	Yes
CSI included in the preamble?	NA	Yes	Yes	Yes
Applicability of PPT rule under Article 7 of MLI	NA	PPT rule to apply	PPT rule to apply	PPT rule to apply

MUMBAI

93 B, Mittal Court, Nariman Point
Mumbai 400 021, India

Tel +91 22 6669 5000

SILICON VALLEY

220 S California Ave., Suite 201
Palo Alto, California 94306, USA

Tel +1 650 325 7100

BANGALORE

Prestige Loka, G01, 7/1 Brunton Rd
Bangalore 560 025, India

Tel +91 80 6693 5000

SINGAPORE

Level 24, CapitaGreen
138 Market St
Singapore 048 946

Tel +65 6550 9855

NEW DELHI

13-H, Hansalaya Building, 15
Barakhamba Road, Connaught
Place
New Delhi 110 001, India

Tel +91 11 4906 5000

MUNICH / AMSTERDAM

Maximilianstraße 13
80539 Munich, Germany

Tel +49 89 203 006 268

NEW YORK

1185 6th Avenue, Suite 326
New York, NY 10036, USA

Tel +1 212 464 7050

GIFT CITY

408, 4th Floor, Pragya Towers
GIFT City, Gandhinagar

Gujarat 382 355, India