

GAAR-legitimate tax planning?

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Substance over form

In ***Duke of Westminster vs IRC (1936) AC 1 (HL); 19 TC 490***

Lord Tomlin observed that

“Every man is 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. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of “the substance” seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.”

In ***W.T. Ramsay v. IRC [1982] AC 300*** the House of lords merely looked at whether schemes resulting in reduction of tax were indeed genuine and compelled stakeholders to look at the “substance” of the matter to give effect to the true legal position.

Substance over form

- Pendulum swings towards 'substance' and 'form' before the Courts of law.
- Substance over form- does it mean 'form' has no value at all?
- In other words, whether the 'form' is accepted or restricted to a particular extent?
- Whether that means 'form' coupled with 'substance' is agreed as legitimate?
- Whether commercial substance co-relates with present conditions or it could be of future relevance
- What is the barometer to decide relevance of 'form' and its legitimacy.
- If the structure/form crosses the acceptance limit then it is abuse of law, if so, that is where GAAR would apply?

Abuse of Law

➤ Whether abuse occurs when tax payer does not meet the spirit of law?

In the case of ***Canada Trustco Mortgage Co. Vs The Queen (2005) SCC 54***, the Supreme Court of Canada established that a finding of abuse is possible in the following situations:

- the taxpayer uses specific provisions of tax laws in order to achieve an outcome that those specific provisions seek to prevent
- a transaction defeats the underlying rationale of the provisions that are relied upon
- an arrangement circumvents the application of certain provisions, such as anti-avoidance rules in a manner that frustrates or defeats the 'object, spirit or purpose' of those provisions.
- Abuse is not established if it is reasonable to conclude that an avoidance transaction was within the 'object, spirit or purpose' of the provisions that confer the tax benefit.
- Economic substance must be considered in light of the specific provisions being examined

..... *in favour of taxpayer*

Abuse of Law

- In the case of ***Capthorne Holdings Ltd. v. Canada 2011 SCC 63***, the Supreme Court of Canada observed that the GAAR requires three questions to be decided as follows:
 - was there a tax benefit;
 - was the transaction giving rise to tax benefit, an avoidance transaction; and
 - was the avoidance transaction giving rise to the tax benefit abusive
- Abusive tax avoidance arises where the above criteria is met, which is same as in the case of Canada Trustco's case.
- Further, these considerations are not independent of one another and may overlap

..... *in favour of revenue*

Abuse of Law

➤ In the case of *Honk Land Trustees Ltd v Commissioner of Inland Revenue CA327/2016 [2017] NZCA 54*, The **Court of Appeal of New Zealand** upheld decision of the High Court confirming the Commissioner of Inland Revenue's disallowance of a \$1,116,000 towards management fee for income tax purposes.

The Court of Appeal dismissed Honk Land Trustees Limited's ("HLT") appeal on the following alternative grounds:

- there was no satisfactory evidence to show that management services were in fact provided;
- there was no sufficient nexus shown; and
- in the event the management fees were deductible, they were nevertheless part of a void **tax avoidance arrangement**.

The Court also confirmed that the Commissioner had correctly imposed a shortfall penalty on the taxpayer for taking an abusive tax position.

..... *in favour of revenue*

Indian GAAR

Inclusion of GAAR Provisions in Direct Tax Code Bill 2010.

Finance Bill – 2012 introduced GAAR provisions

Constitution of Dr. Shome Committee

Indian GAAR

Dr. Shome Committee suggestions **accepted**:

Arrangements with the main purpose of obtaining tax benefit to be covered

Introduction of Section 97(4) to understand the criteria that are relevant but not sufficient to determine 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, are received or deemed to be received before 1.04.2017 is not covered by GAAR provisions

Monetary 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

Indian GAAR

Dr. Shome Committee suggestions **yet to be accepted:**



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.

Four Tainted Elements

- Sec. 96 of the Income Tax Act has introduced 4 tainted elements which are identical to South African GAAR provisions.

- The 4 tainted elements are as follows:
 1. Arrangement creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;
 2. Arrangement results, directly or indirectly, in the misuse, or abuse, of the provisions of this Act;
 3. Arrangement lacks commercial substance or is deemed to lack commercial substance under section 97, in whole or in part; or
 4. Arrangement is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes.

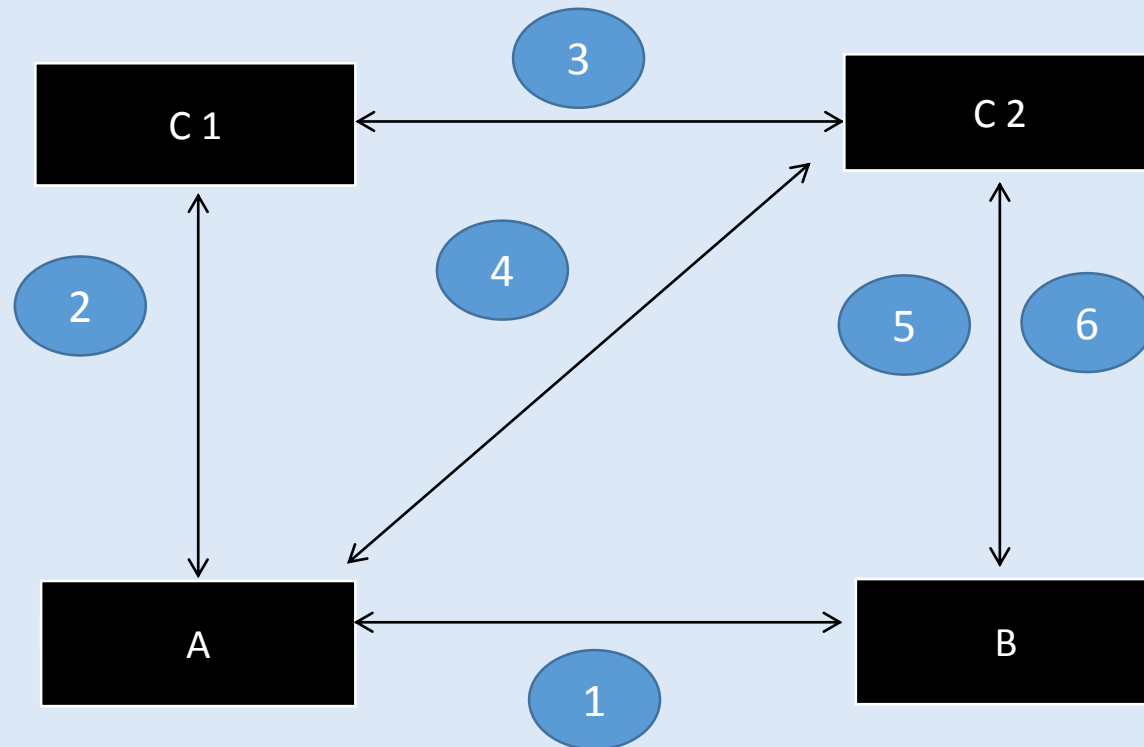
The four tainted element tests which are listed above are to be read as “either or “ approach and not to be taken as cumulative in nature.

Four Tainted Elements

- Abuse of law is critical – Other three tainted elements are shades of Abuse of Law.
- For the Assessing Officer to invoke GAAR , one of the 4 tainted elements must exist and the main purpose of such arrangement shall be to obtain tax benefit.
- To understand the above four tainted elements, let us discuss case studies in the following slides

Four Tainted Elements

- Case Study 1:

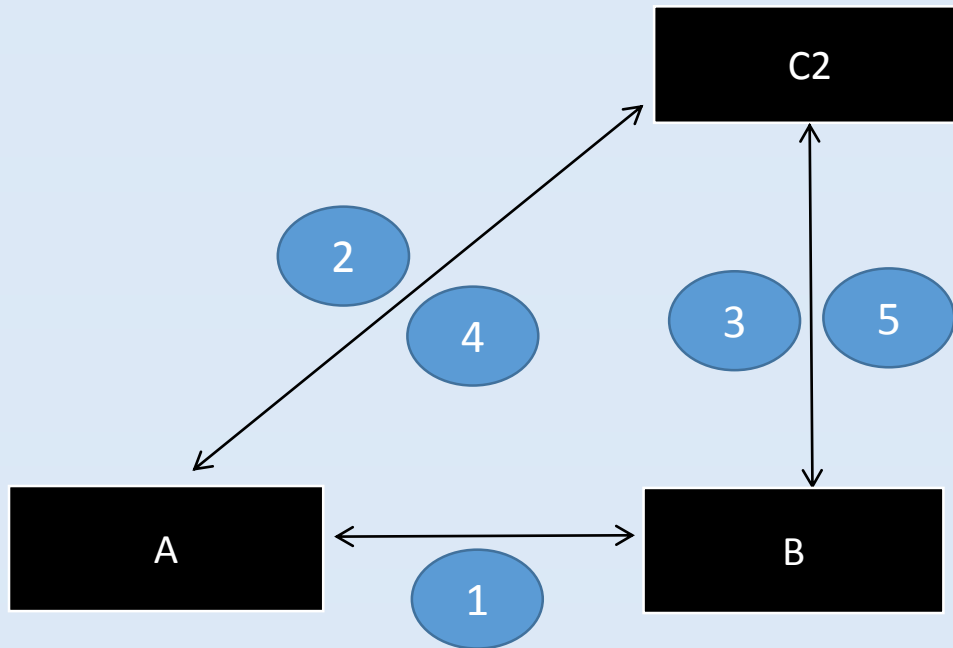


1. 'B' is subsidiary of 'A'
2. 'A' proposes to setup a subsidiary 'C1' in Singapore.
3. 'C1' proposes to setup a subsidiary 'C2' in Singapore.
4. 'A' sells IPR to 'C2' at market price
5. Making 'B' as subsidiary to 'C2'
6. 'B' provides software development services to 'C2' on cost plus basis
7. Later 'C1' sells 'C2' to third party for which Capital Gain will arise for 'C1' which is exempt from tax in Singapore.

❖ It can be questioned that the 'C1' is acting as conduit without proper commercial substance.

Four Tainted Elements

- Case Study 2:



1. 'B' is subsidiary of 'A'
2. 'A' proposes to setup a subsidiary 'C2' in Singapore.
3. Making 'B' as subsidiary to 'C2'
4. 'A' sells IPR to 'C2' at market price
5. 'B' provides software development services to 'C2' on cost plus basis
6. Later 'A' sells 'C2' to third party for which Capital Gain will arise in India in the hands of 'A'.

Four Tainted Elements

Case Study- 2

➤ Assessing Officer argues :

- that the first (a) tainted element exists- rights and obligations not at Arms length.
- that the fourth (d) tainted element exists- in a manner which are not employed for *bona fide* purposes.
- that there is a lack of commercial substance as it is a round trip financing as per third (c) tainted element.

➤ Taxpayer argues :

- No abuse of law as the taxpayer pays taxes in India on selling C2.
- There is commercial substance in setting up C2 in Singapore for branding the group internationally.
- Tainted elements (a) & (d) would not trigger as there is commercial substance.
- There is no abuse of law

- Hence GAAR cannot be invoked

Judicial Precedents in India

- In the case of ***CIT Vs Bank of Chettinad Ltd [1940] 8 ITR 522 (PC)*** , the Hon'ble Privy Council held that *“Their Lordships think it necessary once more to protest against the suggestion that in revenue cases “the substance of the matter” may be regarded as distinguished from the strict legal position.”*
- In the case of ***Meenakshi Mills Ltd (63 ITR 209)*** the Apex Court held that the Court has power to disregard the corporate entity if it is used for tax evasion or to circumvent tax obligation.
- In the case of ***CIT Vs A. Raman & Co (1967) 67 ITR 11 SC*** the Hon'ble Justice Shah has observed that *“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. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may be lawfully circumvented.”*
- In the case of ***McDowell & Co. Ltd Vs. CTO (1985) 154 ITR 148*** it was 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.

Judicial Precedents in India

➤ In the case of ***Azadi Bachao Andolan 263 ITR 706 (SC)*** the Hon'ble Supreme Court observed that

“With respect, therefore, we are unable to agree with the view that the Duke of Westminster 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 of the Duke of Westminster 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 CIT V Raman are very much relevant today.”

➤ In the in the landmark judgment of ***Vodafone International Holdings BV (2013) 341 ITR 1 (SC)*** Justice Kapadia observed as follows:

- All the tax planning cannot be treated as illegal, impermissible or illegitimate.
- The observations of justice Chinnapareddy in Mc Dowell's case on the need to depart from Westminster principle were only in the context of an artificial or colorable device.
- Justice Chinnapareddy had agreed that tax planning within the framework of the law was permissible.
- There is no conflict between Mc Dowell's case and Azadi bachao's case

Memorandum to Finance Bill-2012

The relevant portion of Memorandum to Finance Bill-2012 is extracted below:

“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, therefore, important that Indian taxation law also incorporate a statutory General Anti Avoidance Provisions **to deal with aggressive tax planning.**”*

CBDT Circular- Clarifications on GAAR

- CBDT vide its circular No. 7 of 2017 dt. 24/01/2017 provided clarifications on implementation of GAAR provisions
- The relevant questions addressed by CBDT in its clarifications are as follows:

Q.no	Questions	Clarification by CBDT
3	Will GAAR interplay with the right of taxpayer to select or chose method of implementing a transaction?	GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.
10	How will it be ensured that GAAR will be invoked in rare cases to deal with highly aggressive and artificially pre-ordained schemes and based on cogent evidence and not on the basis of interpretation difference?	The proposal to declare an arrangement as an impermissible avoidance arrangement under GAAR will be vetted first by the Principal Commissioner / Commissioner and at the second stage by an Approving Panel, headed by judge of a High Court. Thus, adequate safeguards are in place to ensure that GAAR is invoked only in deserving cases.

- ❖ Therefore it can be understood that the Revenue's intention of legislating GAAR provisions is to target abusive/aggressive tax planning but not the legitimate tax planning.

Legitimate Tax planning survives?

- Memorandum to Finance Bill - 2012 clearly provides that GAAR provisions target aggressive tax planning.
- Circular of CBDT clarifies that it does not restrict any tax payer of his right to structure/method of implementing a transaction.
- It also mentions that GAAR would be invoked only in deserving cases with proper checks and balances.
- This clearly leads us to take a view legitimate/ legal tax planning is not under GAAR scanner.
- Aggressive tax planning which results in unintended tax benefits is the clear target of GAAR which is against the spirit of law.
- Can we conclude that GAAR applies where there is abuse of law by tax payer?

Hence legitimate tax planning survives?

Thank
You!