CHAPTER 11

TAX PLANNING, TAX AVOIDANCE AND TAX EVASION

LEARNING OUTCOMES

After studying this chapter, you would be able to -

- **distinguish** between tax planning, tax avoidance and tax evasion;
- **analyse** whether a specified activity resulting in reduction of tax liability would be considered as tax planning, tax avoidance or tax evasion;
- **examine** the doctrine of form and substance in the context of tax planning;
- **analyse** the provisions of General Anti-avoidance Rules (GAAR)
- **examine** the applicability of General Anti-avoidance Rules (GAAR) *vis-a-vis* Specific Anti-avoidance Rules (SAAR)

CHAPTER OVERVIEW

Tax Planning, Tax Avoidance and Tax Evasion

General Anti-Avoidance Rules (GAAR)

11.1 TAX PLANNING, TAX AVOIDANCE AND TAX EVASION – AN OVERVIEW

Tax planning involves an intelligent application of the various provisions of the direct tax laws to practical situations in such a manner as to reduce the tax impact on the assessee to the minimum. A thorough understanding of the principles, practices and procedures of tax laws and the ability to apply such knowledge to various practical situations is expected at the final level.

A thorough up-to-date knowledge of tax laws is a pre-requisite for a successful study of tax planning techniques. Not only an up-to-date knowledge of the statute is necessary, but one must also be aware of the contents of the various circulars issued by the CBDT and also of case laws in the form of various decisions of the Courts. One of the best methods to study tax planning in action is to analyze the case laws. In view of this position, students should realise the importance and usefulness of keeping track of the judgments of the Supreme Court and of various High Courts reported in tax law journals from time to time. Students should make it a point to go through the relevant cases and understand the issues involved and the rationale of the judgments. Of course, tax planning in any particular case would depend on the facts and circumstances of that particular case.

Apart from the above, students are advised to go through the articles on tax laws published in tax journals and financial papers. With this brief introduction, let us go into the basic concepts of tax planning.

(1) **Concept of tax planning**: Before entering into a transaction or before starting a business, one normally considers its profitability and other aspects. Amongst other aspects, the tax implications of the transactions of the business have to be thought out before actually embarking on the deal. Otherwise, one may be caught unwittingly in huge tax liability. Planning from the point of view of taxation helps in generating greater savings of investible surplus.

Tax planning may be defined as an arrangement of one's financial affairs in such a way that, without violating in any way the legal provisions, full advantage is taken of all tax exemptions, deductions, concessions, rebates, allowances and other reliefs or benefits permitted under the Act so that the burden of taxation on the assessee is reduced to the minimum.

It involves arranging one's financial affairs by intelligently anticipating the effects which the tax laws will have on the arrangements now being adopted. As such it is a very stimulating intellectual exercise.

Any tax planning scheme should be a natural one and should not give an appearance of an artificial arrangement on the face of it. The tax planner or the tax adviser should exercise great care and caution in designing any tax planning scheme as its failure will result in great difficulties and heavy burden of tax on the assessee for whom the scheme is evolved.

In relation to income-tax, the following may be noted as illustrative instances of tax-planning measures:

(a) Varying the residential status taking into consideration the number of days of stay in India to be a resident, in case of an individual.

(b) Choosing the suitable form of assessable entity (Individual, HUF, Firm, Co-operative society, Association of persons, Company, Trust, etc. to obtain optimal tax concessions).

(c) Exercising the option to shift out of default regime under section 115BAC and paying tax as per the normal provisions of Income-tax law in case of Individual, HUF, AOPs or BOI.

(d) Exercising the option to pay tax as per concessional tax regimes under section 115BAA or 115BAB in case of corporate assessee subject to satisfaction of certain conditions and non-allowability of certain exemptions or deductions.

(c) Choosing suitable forms of investment (share capital, loan capital, lease, mortgages, tax exempt investments, priority sector, etc.), considering deductions available in respect of interest or dividend etc.

(d) Programmed replacement of assets to take advantage of the provisions governing depreciation.

(e) Programmed sale of capital assets depending upon the period of holding and deductions specifically available for assets held for long term.

(f) Diversification of the business activities (hotel industry, agro-based industry etc.) considering the various profit-linked and investment-linked benefits available under the provisions of the Act.

(g) The use of the concept of commercial expediency to claim deduction in respect of expenditure, in computing business income.

(2) Tax planning, tax evasion and tax avoidance: Three methods of reducing taxes have been developed in most countries of the world over a period of time.

Methods of reducing taxes	• Tax planning • Tax evasion • Tax avoidance

The dividing line between tax evasion and tax avoidance is very thin. The Direct Taxes Enquiry Committee (Wanchoo Committee) has tried to draw a distinction between the two items in the following words.

"The distinction between 'evasion' and 'avoidance', therefore, is largely dependent on the difference in methods of escape resorted to.

Tax Planning

- Availing tax exemptions or tax privileges offered by the Government, strictly in accordance with law.

Tax evasion

- Manoeuvre involving an element of deceit, misrepresentation of facts, falsification of accounting calculations or downright fraud. In simple terms, tax evasion refers to any attempt to avoid payment of taxes by using illegal means.

Tax avoidance

- Between two extremes i.e., tax planning and tax evasion, a vast domain for selecting a variety of methods which, though technically satisfying the requirements of law, in fact, circumvent it with a view to eliminate or reduce tax burden.

Common forms of tax evasion

- Misrepresentation or suppression of facts;
- Failure to record investments in books of account;
- Claim of expenditure not substantiated by any evidence;
- Recording of any false entry in books of account;
- Failure to record any receipt in books of account having a bearing on total income; and
- Failure to report any international transaction or deemed international transaction or specified domestic transaction under Chapter X.

These constitute misreporting of income attracting penalty@200% under section 270A.

(3) Judicial thinking—A brief study: The judicial attitude towards tax avoidance schemes is very strict and the landmark judgment of the Supreme Court in *M/s. Mc Dowell and Co. Ltd. vs. Commercial Tax Officer (1985) 154 ITR.148 (SC)* is proof of the same. Though this decision was rendered in the context of A.P. General Sales Tax Act, the principles emerging out of this decision will have relevance to direct taxes also.

Before discussing the relevant observations of the Supreme Court in relation to tax avoidance scheme it will be instructive to have an idea of the development in judicial thinking in England since our own judicial thinking on the subject has been largely derived from English thinking.

English Scene: In *Inland Revenue Commissioner vs. Duke of Westminster 1936 AC 1* it was held "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. 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."

After the World War II and the consequent huge profiteering and racketeering the attitude of the courts towards the avoidance of tax perceptibly changed and hardened. Commenting on a tax avoidance scheme, the court observed that it scarcely lies in the mouth of the taxpayer who plays with fire to complain of burnt fingers.

It was felt that there must be some limit to the devices which courts can put up with in order to defeat the fiscal intentions of the legislature. A very significant departure from the Westminster Principle was made in *Ramsay vs. Inland Revenue Commissioners (1982) AC 300*. It was felt in that case that even though the doctrine that courts could not go behind a given genuine document or transaction to some supposed underlying substance was a cardinal principle, it must not be overstated or over-extended. While obliging the courts to accept documents or transactions, found to be genuine, as such, the doctrine did not compel the court to look at the document or transaction in blinkers isolated from any context to which it properly belonged. If it could be seen that a document or transaction was intended to have effect as a part of a nexus or series of transactions or as an ingredient of a wider transaction intended as a whole, there was nothing in the doctrine to prevent it being so regarded. To do so was not to prefer form to substance or substance to form. It was the task of the court to ascertain the legal nature of any transaction to which it was sought to attach a tax consequence and if that emerged from a series or combination of transactions, intended, apart as such, as was that series or combination which might be regarded.

Thus, two points were established. The first was a significant change in the approach adopted by the court with regard to its judicial role towards tax avoidance scheme. The second was that it was crucial when considering any such scheme to take the analysis far enough to determine where the profit, gain or loss was really to be found. It was also stated that the fact that the court accepted that each step in a transaction was a genuine step producing its intended legal results did not confine the court to consider each step in isolation for the purpose of assessing the fiscal results. Thus, we can say that the true principle of the decision in Ramsey was that the fiscal consequence of a preordained series of transactions intended to operate as such, are generally to be ascertained by considering the result of the series as a whole and not by dissecting the scheme and considering each transaction separately.

In *I.R.C. vs. Burmah Shell Co. Ltd. (1982) STC 30 (Burmah)* and *Furniss (Inspector of Taxes) vs. Dawson (1984) 1 All E.R.530*, it was held that where tax avoidance was targeted through a series of transactions with no commercial or substantial value but with the only aim of avoiding tax, the Courts have to ignore the transactions and the tax liability has to be determined as if these transactions never took place.

Indian Scenario: In *CIT vs. A. Raman & Co. 1 SCR 10,* the Supreme Court followed the dictum of the Westminster's case. It observed that avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. The taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon consideration of morality but on the operation of the Income-tax Act, 1961. Legislative injunction in taxing statutes may not, except on pain of penalty, be violated but it may lawfully be circumvented. The same view was expressed in *CIT vs. Kharwar (1969) 72 ITR 603 (SC)* as follows:

"The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction, if the parties have chosen to conceal by a device the legal relation, it is open for the taxing authorities to unravel the device and to determine the true character of relationship. The legal effect of a transaction, however, cannot be displaced by probing into the substance of the transaction."

However, the Supreme Court in *Mc Dowell's* case clearly departed from the above views and expressly disassociated itself with the earlier observations of the Supreme Court echoing the sentiments of Westminster principle. The court enumerated the evil consequences of tax avoidance as follows:

(1) Substantial loss of much needed public revenue.

(2) Serious disturbance caused to the economy of the country by the piling up mountains of black money, directly causing inflation.

(3) Large hidden loss to the community by some of the best brains of the country involved in perpetual litigation.

(4) Sense of injustice and inequality which tax avoidance arouses in the minds of those who are unwilling or unable to profit from it.

(5) The unethical practice of transferring the burden of tax liability to the shoulders of the guileless, good citizens from those of the 'artful dodgers'.

The court felt that there was as much moral sanction behind taxation laws as behind any other welfare legislation and avoidance of taxation was not ethical.

In the view of the Court, the proper way to construe a taxing statute while considering a device to avoid tax was not to ask whether the provisions should be construed literally or liberally, nor whether the transaction was not unreal and not prohibited by the statute, but whether the transaction was as device to avoid tax and whether the transaction was such that the judicial process might record its approval to it.

The court felt that it was neither fair nor desirable to expect the legislature to intervene and take care of every device to avoid taxation. It was up to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and consider whether the situation created by the devices could be related to the existing legislation with the aid of emerging techniques of interpretation as was done in Ramsey's case to expose the devices for what they are really worth and to refuse to give judicial benediction.

The Supreme Court emphasised that tax planning may be legitimate provided it is within the framework of law and colorable devices cannot be part of tax planning. It is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. The Supreme Court also recommended that it is the obligation of every citizen to pay the taxes honestly without resorting to subterfuge.

Tax planning may be legitimate provided it is within the framework of law

Another significant case decided by the Supreme Court, though involving a dispute relating to payment of bonus, is worthy of reference at this stage as it also reflects the same thinking as in *Mc Dowell's* case. In *Associated Rubber Industries case (1986) 157 ITR 77(SC)*, a new wholly owned subsidiary company was created with no asset of its own except investments transferred by the holding company with no business income, except receiving dividend from the transferred investments. The Supreme Court held that on facts, the purpose of such a transfer of investments was nothing but to reduce the gross profits of the holding company and thereby to reduce the payment of bonus. There was no direct evidence that the subsidiary was formed as a device to reduce the gross profits of the principal company for whatever purpose. But Justice Chinnappa Reddy in passing his judgment was following the principles earlier laid down by him in *Mc Dowell's* case and was of the opinion that the transfer of shares was nothing but a device like tax evasion to avoid a welfare legislation like the Payment of Bonus Act. It was observed that it is the duty of the Court in every case where ingenuity is expended to avoid liability to taxation and welfare legislation, to get behind the smoke screen and discover the true state of affairs.

The above decision seems to have introduced a new doctrine that it is upto the court to take stock, weigh out sophisticated legal devices and expose the devices for what they really are. The fact that this new doctrine has started gaining ground very fast is seen from a quick succession of decisions, after *Mc Dowell* in *Kartikeya vs. Sarabhai* and in *Associated Rubber's* case. The above change in the trend of judicial thinking clearly shows that the line of demarcation between Tax Planning and Tax avoidance.

In order to curb tax avoidance, provisions such as

- applicability of transfer pricing provisions in respect of specified domestic transactions,
- treating any transaction with the person located in the notified jurisdiction areas to be treated as international transaction,
- General Anti-avoidance Rules,
- provisions relating to furnishing of Tax Residency Certificate for claiming benefit of double tax avoidance agreements

have been introduced.

The decision in *Mc Dowell's* case and the subsequent developments have evoked lot of debate in all legal and tax circles.

The Gujarat High Court in *CIT vs. Smt. Minal Rameshchandra (1987) 61 CTR (Guj) 80* had occasion to consider the impact of *Mc Dowell's* case. The following propositions appear to emerge from the same.

(i) *Mc Dowell's* case and observations therein cannot be ignored and these are binding on all courts.

(ii) *Mc Dowell's* case and observation therein should be understood in the context of questioning the legitimacy of the use of artificial and transparent device and sham practices to circumvent the law.

(iii) Where the arrangement cannot be dismissed as an artificial tax device (and not as a legitimate transaction), the subject can be taxed only having "regard to strict letter of the law and not merely to the spirit of the statute or the substance of the law" and had been consistently laid down earlier. In this sense there is no radical departure from law, prior to Mc Dowell case.

In *CWT. vs. Arvind Narottam [1988] 173 ITR 479 (SC)* Judge Sabyasachi Mukharji J. made the following significant observations:

(i) Where the language of the deed of settlement is plain and admits no ambiguity there is no scope for considerations of tax avoidance.

(ii) One would wish as noted by Chinnappa Reddy in Mc Dowell's case that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary taxpayers very often in a country of shortages (with ostentatious consumption and deprivation for the large masses) ask is does he with taxes buy civilization or does he facilitate the waste and ostentation of the few. Unless waste and ostentation in government spending are avoided or eschewed no amount of moral sermons would change people's attitude to tax avoidance.

(iii) Where the true effect on the construction of the deeds is clear, appeal to discourage tax avoidance is not a relevant consideration".

In the light of the above development, we have to ascribe a proper meaning to the concept of tax-planning. We can take a cue from the structure of our tax laws.

Our tax laws tend to serve a dual purpose of collecting revenue and of achieving certain social objectives. There are in-built tax incentives which promote savings and investments in new enterprises and facilitate the development of backward areas. A lot of exemptions and incentives are provided in all the direct taxes. If an assessee takes maximum advantage of these incentives, exemptions etc. and enlarges the scope of his disposable resources, there can be no objection because the legislature wants the optimum utilisation of these incentives to promote economic activity in the country. The complexity of our tax-laws makes it impossible for even an intelligent assessee to comprehend them properly and avail all the reliefs which may be genuinely provided by such laws. Moreover, the interaction of other laws such as MRTP Act, FERA, Companies Act etc. make the exercise much more complicated. It requires, therefore, meticulous planning to bring down the tax commitments keeping in view not only the statutes but also the judge-made law. We may say that the above area properly belongs to tax-planning. In this sense there is nothing unethical about tax-planning.

Due to constant changes in the law and new court decisions, it is always necessary to have a continuous review in relation to all matters of tax planning so that appropriate changes are introduced without delay.

(4) Doctrine of form and substance: One of the reasons which prompts a taxpayer to resort to tax planning is the existence of the doctrine of form and substance. The principle involved in this doctrine is simple. How far Court may stretch the wording of a Statute to cover a particular set of facts, where those facts have clearly been created by a tax payer in order to avoid or minimise his tax and the literal interpretation of the Statute is not, at first sight apt to cover them? Is it possible to ignore the form of a transaction and determine the substance thereof?

Landmark Judgments wherein the doctrine of form and substance played a major role in decision making:

(i) In *Commissioner of Income tax vs. Motor and General Stores (P) Ltd. (1967) 66 ITR 692,* the Supreme Court had observed that in the absence of any suggestion of bad faith or fraud the true principle is that the taxing statute has to be applied in accordance with the legal rights of the parties to the transaction. According to the court, when the transaction is embodied in a document the liability to tax depends upon the meaning and content of the language used in accordance with the ordinary rules of construction. The House of Lords in *Duke of Westminster vs. ICR (1936) 19 ATC 498* held that in considering the substance of the transaction, the legal form cannot be disregarded.

(ii) It was held in *CIT vs. B.M. Kharwar (1969) 72 ITR 603 (SC)* that the taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by device the legal relation, it is open to the taxing authority to unravel the device and to determine the true character of the relationship. However, the legal effect of a transaction cannot be displaced by probing into 'the substance of the transaction'. This principle applies alike to cases in which the legal relation is recorded in a formal document and to cases where it has to be gathered from the evidence - oral and documentary - and the conduct of the parties to the transaction. However, this view of the Supreme Court has now been expressly disapproved by the Supreme Court in *Mc Dowell & Co. Ltd.'s case.*

(iii) Justice Shah, in *Ram Laxman Sugar Mills vs. CIT (1967) 66 ITR 613, 617 (SC),* has stated that to ascertain the legal effect of a transaction, the court seeks, in the first instance, to determine the intention of the parties and if ambiguous expressions are used, the court may normally adopt such interpretation consistent with the parties thereto having acted on the assumption of its validity. Thus, any claim made by a taxpayer will be scrutinized from the point of view of his intention and if there was any intention to defraud the revenue, the court will consider the transaction or the claim as fraud.

Thus, we can say that unless there is clear evidence of *malafide* intention resulting in a form which is a "colorable device" or "mere legal facade" or "non-genuine" form the tax authorities are not justified in disregarding the legal form and probing into the substance of the transaction.

Principles governing the form and substance: Theory of interpretation of a taxing statute:

(i) It is well settled that when a transaction is arranged in one form known to law, it will attract tax liability while, if it is entered into in another form which is equally lawful, it may not. In considering, whether a transaction attracts tax or not, the form of the transaction put through by the assessee is to be considered and not the substance thereof.

(ii) The above rule cannot naturally apply where the transaction, as put through by the assessee, is not genuine but colourable or is a mere device. For here, the question is not one between 'form' and 'substance' but between appearance and truth.

(iii) In deciding whether the transaction is a genuine or colourable one, it will be open to the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction.

(iv) Where the authorities are charged under the Act with the duty of determining the nature or purpose of and payment or receipt on the facts of a case, it is open to them to work at the substance of the matter and the formal aspect may be ignored.

(v) Where the terms of a transaction are embodied in a document, it should not be construed only in its formal or technical aspect. While the words used should be looked at, too much importance should not be attached to the name or label given by the parties and the document should be interpreted so as to accord with the real intention of the parties as appearing from the instrument.

As noted earlier, the decisions of the Supreme Court in the cases of *Mc Dowell, Karthikeya Sarabhai and Associated Rubber Industries,* clearly show a preference for the 'substance' over the 'form', if the circumstances of the case warrant such a preference. Where the transactions are genuine, perfectly authentic and not sham, the mere fact that the transaction results in less liability or no liability to tax should not put the transaction to a legal scrutiny questioning the substance of the transaction, attributing a motive behind it. It is up to the Court to take stock of the situation, weigh out sophisticated legal devices and expose the devices for what they really are.

(5) **Doctrine of Precedence:** Doctrine of Precedence would be applicable in case of tax laws. The following principles which govern the rule of precedence may be noted.

- **Supreme Court:**

  (i) The Supreme Court judgments are *absolutely binding* on all the courts, Tribunals and authorities.

  (ii) Not only the *ratio decidendi*[1], but also *obiter dicta*[2] of the Supreme Court are binding on all the Courts.

  (iii) When there are two irreconcilable decisions of the Supreme Court on some point of law, the decision of a larger Bench shall prevail.

  (iv) When there are two irreconcilable decisions of two Benches of similar strength, the decision later in time will have to be followed by the lower courts.

  (v) The Supreme Court judgments cannot be ignored by the lower courts though such judgments are *per incuriam.*

  (vi) The Supreme Court, though expected to follow its own judgments, is not bound to follow them and in appropriate cases it can review its earlier judgment.

- **High Courts:**

  (i) A Division Bench of a High Court is generally bound by its earlier decision, but it may refuse to follow the same if the earlier judgment is *per incuriam*[3].

---

[1] *the rationale for deciding a case*
[2] *things said by the way (additional observations, remarks, and opinions given while deciding a case)*
[3] *Without referring to the statutory provision*

(ii) If the Division Bench of a High Court does not agree with its earlier judgment it will have to either follow the same or refer the issue to a Full Bench.

(iii) A Division Bench of High Court is bound to follow a decision of the Full Bench of the same High Court.

(iv) A single judge of a High Court is bound by a decision of a Division Bench or of the Full Bench of the same High Court.

(v) A single judge of a High Court is not bound to follow the decision of another single judge, though he is expected to follow the same.

(vi) All the lower authorities, Commissioner (Appeals) and Tribunals are absolutely bound to follow the decision of a High Court within whose jurisdiction they function. Here, the High Court decisions include decision of a single judge.

(vii) The lower authorities and courts can ignore a decision of a High Court only if it is overruled by a larger Bench of the same High Court, or by the Supreme Court or by a later enactment.

♦ **Others:**

(i) The Assessing Officer and the Commissioner, while acting under section 263, cannot refuse to follow the decision of the High Court. They cannot pass orders which are inconsistent with the decisions of the High Court within whose jurisdiction they function, even for the purpose of keeping the issue alive.

(ii) In all Indian Acts like the Income-tax Act, 1961, to keep the uniformity of law, a High Court should normally follow the decision of another High Court, unless it finds an overriding reason not to follow the same.

(iii) The lower appellate authorities are bound to follow the decision of another High Court, though they do not function within the jurisdiction of the said High Court, if there is no contrary decision of any other High Court.

(iv) The Assessing Officer or the Commissioner need not follow the decision of another High Court if the department has not accepted the said decision and has taken the matter to Supreme Court.

(v) The Bench of the Appellate Tribunal, should generally follow the orders of other Benches of the Tribunal, unless those orders of the Tribunal are *per incuriam.*

(vi) An order of a Full Bench of a Tribunal is binding on the ordinary Bench of the Tribunal.

(vii) If an ordinary bench of a Tribunal does not agree with an order of another Bench of the Tribunal, and that order of another Bench of the Tribunal is not *per incuriam*, the Bench cannot differ from the view taken by the other Bench. It can only get the matter referred to a larger Bench. But this is subject to the general rule that as far as possible, the Bench should try to follow the orders of the Benches.

(viii) The Tribunal orders are binding on the Commissioner (Appeals) falling within the territorial jurisdiction of the Tribunal passing the order in question.

(ix) The Assessing Officer and the Commissioner are bound by the order of the Tribunal (falling within the jurisdiction of the Tribunal unless the Department has not accepted the decision of the Tribunal.)

Summary for Quick Reference of Doctrine of Precedence:

Decision of	Will precede over the decision of
Supreme Court	
Supreme Court	All the Courts, Tribunals and authorities
Larger Bench of Supreme Court	Smaller Bench of Supreme Court
Supreme Court at a later point in time (if same strength)	Supreme Court at an earlier point in time
High Court	
High Court (even if single judge decision)	All the lower authorities, Commissioner (Appeals), Joint Commissioner (Appeals) and Tribunals functioning within the jurisdiction of the High Court
Full Bench of High Court	Division Bench of same High Court and single judge of same High Court
Division Bench of High Court	Single Judge of same High Court
Appellate Tribunal	
Full Bench of a Tribunal	Ordinary Bench of the Tribunal
Tribunal	Assessing Officer, Commissioner and Commissioner (Appeals)

11.2 GENERAL ANTI-AVOIDANCE RULES

There is a growing concern amongst the revenue in many countries that taxpayers structure transactions to reduce the tax costs. The Base Erosion and Profits Shifting (BEPS) project of the

Organization for Economic Cooperation and Development ("OECD") along with G-20 countries sort to tackle this issue. The BEPS Action plans have come out with various recommendations on the issue, both to address it within the international treaty framework (for example, introducing the principle purpose test, limitation of benefits clause, amending the permanent establishment clause, etc.) and in the domestic tax law context (for example, controlled foreign corporation rules, equalization levy, etc.).

Tax avoidance is not defined in taxing statutes. Tax avoidance is, nevertheless, the outcome of actions taken by the assessee, none of which or no combination of which is illegal or forbidden by the law as such. International literature on the subject tends to describe it in the following ways:

- Tax avoidance involves the legal exploitation of tax laws to one's own advantage.
- Every attempt by legal means to prevent or reduce tax liability which would otherwise be incurred, by taking advantage of some provisions or lack of provisions in the law.
- An arrangement entered into solely or primarily for the purpose of obtaining a tax advantage.

Taxpayers consider it their legitimate right to arrange their affairs in a manner as to pay the least tax possible. However, tax authorities internationally consider aggressive tax planning schemes by taxpayers to erode the tax base unnaturally, particularly when effective rates of tax diminish significantly. Several countries have, therefore, legislated to prevent tax avoidance in various ways

The General Anti-Avoidance Rules (GAAR) provisions aim at combating 'impermissible tax avoidance'. Many countries, like the United Kingdom, China, South Africa, Australia, Canada and Brazil have incorporated General Anti-Avoidance Rules in their domestic tax laws to deal with aggressive tax planning.

The Indian GAAR

In India, the GAAR concept was initially introduced in the Direct Taxes Code Bill, 2009 [DTC Bill, 2009]. Later, a Revised Discussion Paper was released. The Direct Taxes Code Bill, 2010 [DTC Bill, 2010] proposed to introduce GAAR from 1st April 2012 onwards. The GAAR provisions were introduced in the Income-tax Act, 1961 vide the Finance Act, 2012 by insertion of new Chapter X-A. Chapter X-A was substituted by the Finance Act, 2013.

The Government subsequently set up a panel under Parthasarathy Shome to review the proposals. The Committee suggested that the rules be deferred by three years to 2016-17, arguing that more time is needed to create administrative machinery for its implementation and called for intensive training of officials.

The Shome Committee Report explains the need for and rationale of GAAR as under:

(i) GAAR has been enacted as a codification of the proposition that, while interpreting the tax legislation, substance should be selected over a legal form.

(ii) Transactions have to be real and are not to be looked at in isolation.

(iii) The fact that the transactions are legal, does not imply that they are acceptable with reference to the underlying meaning embedded in the fiscal statute.

(iv) Thus, where there is no business purpose except to obtain a tax benefit, the GAAR provisions would not allow such a tax benefit to be availed through the tax statute. These propositions have comprised part of jurisprudence in direct tax laws as reflected in various judicial decisions.

The GAAR provisions codify this ‘substance over form’ basis of the tax law.

The CBDT, vide Press Release dated January 27, 2017, clarified that the GAAR provisions shall be effective from A.Y.2018-19 onwards, i.e., financial year 2017-18 onwards. The provisions of GAAR are contained in Chapter X-A of the Income-tax Act, 1961. The necessary procedures for application of GAAR and conditions under which it shall not apply, have been enumerated in Rules 10U to 10UC of the Income-tax Rules, 1962.

Prior to A.Y. 2018-19, the Act contained only Specific Anti-Avoidance Rules (SAARs) to prevent tax avoidance. SAAR targets known tax planning schemes which are commonly used by taxpayers but are not acceptable owing to misuse or abuse of tax laws, or they result in a consequence unintended in the law. In the Act, the following may, *inter alia*, be considered specific examples of SAAR -

(i) Section 40A(2) on excessive or unreasonable payments to related parties not deductible

(ii) Section 80-IA(8) on transactions with tax exempt entities to be valued at market value.

(iii) Sections 92 to 92F on transfer pricing regulations applicable to international transactions. These provisions are also made applicable to specified domestic transactions by the Finance Act, 2012.

(iv) Section 93 on avoidance of tax by transfer of income to non-residents through transfer of assets, rights or interest.

(v) Section 94 on avoidance of tax by certain transactions in securities.

(vi) Section 94A on transactions with persons located in notified jurisdictions.

(vii) Section 2(22)(e) on deemed dividend.

(viii) Section 40(a)(i) and (ia) on the disallowance of expenses for non-deduction of tax at source.

(ix) Section 9 on scope of 'income deemed to accrue or arise in India'. The Finance Act, 2012 had widened its scope to overcome the Supreme Court's ruling in Vodafone and some other cases.

(x) *Explanations 1 to 13* to section 43(1) on determination of actual cost of assets ignoring agreements, etc., in certain cases.

Tax treaties also provide certain anti-avoidance rules for instance, the Limitation of Benefit (LOB) Clause and concept of Beneficial Ownership.

The above list of provisions relating to SAAR other than section 94 are discussed in the respective chapters of the Study Material. Before moving to the discussion on provisions of GAAR, let's understand section 94.

Special provisions for avoidance of tax by certain transactions in securities [Section 94]

Section 94 aims at preventing avoidance of tax by an assessee by sale or purchase of securities under different circumstances.

Dividend and Income Stripping transactions [Section 94(7)]

(a) If any person buys or acquires any securities or unit within a period of three months prior to the record date and

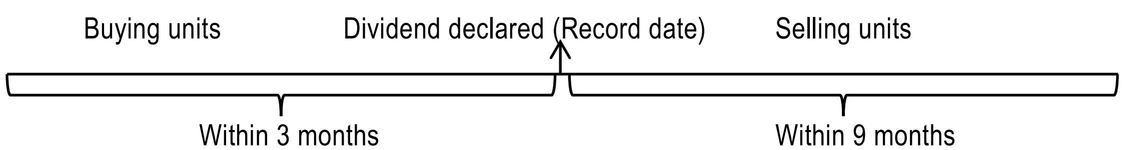
(b) such person sells or transfers –

(i) such securities **within a period of three months** after such date, or

(ii) such unit within a period **of nine months after such date** and

(c) the dividend or income on such securities or unit received or receivable by such person is exempted,

then, the loss, if any, arising therefrom shall be ignored for the purposes of computing his income chargeable to tax. Such loss would be ignored to the extent of the amount of dividend or income received or receivable on such securities or unit.



***Note** – Since dividend and income from units of mutual fund specified under section 10(23D) and UTI is taxable in the hands of shareholders/unitholders, the provisions of section 94(7) are currently not relevant in relation to such income.*

In case of dividend from units of business trust, the same would be taxable in the hands of unitholders, if the Special Purpose Vehicle (SPV) exercises the option under section 115BAA, in which case the provisions of section 94(7) would not be attracted. However, if the SPV does not exercise option under section 115BAA, dividend component of income distributed to unit-holders would be exempt in the hands of unit-holders, in which case the provisions of section 94(7) would be attracted if the person buys and sells or transfers units within the specified period mentioned above.

Bonus Stripping Transactions [Section 94(8)]

According to section 94(8), where

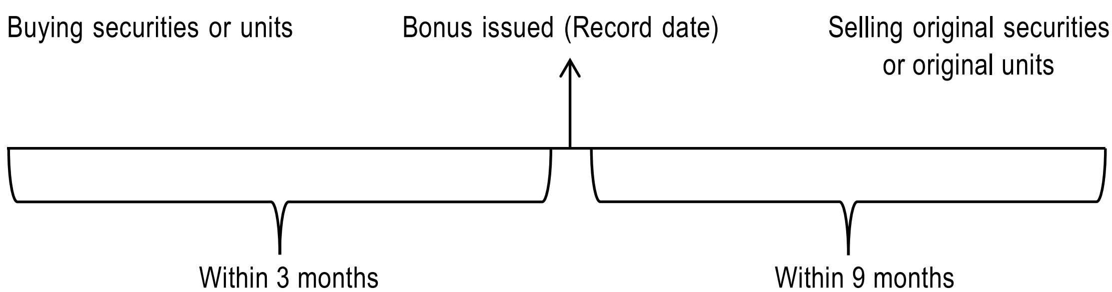
(a) any person buys or acquires any securities or units within a period of **<u>three months</u>** prior to the record date;

(b) such person is allotted additional securities or units without any payment on the basis of holding such securities or units on such date;

(c) such person sells or transfers all or any of the securities or units referred to in (a) above within a period of **<u>nine months</u>** after such date, while continuing to hold all or any of the additional securities or units referred to in (b), then –

  (i) the loss on sale of original securities or units sold within a period of 9 months after the record date will be ignored for the purpose of computing his income chargeable to tax and

  (ii) the amount of such loss so ignored will be deemed to be the cost of purchase or acquisition of the bonus securities or units referred to in (b) above, held by him on the date of such sale or transfer.



Meaning of certain terms

	Term	Meaning
(i)	Record date	Such date as may be fixed by - (i) a company; or (ii) a mutual fund or the Administrator of the specified undertaking or the specified company as referred to in the Explanation to section 10(35); (iii) A business trust (iv) An Alternative Investment Fund defined under regulation 2(1)(b) of the SEBI (AIF) Regulations, 2012 made under the SEBI Act, 1992 for the purposes of entitlement of the holder of the securities or units, as the case may be, to receive dividend, income, or additional securities or unit without any consideration, as the case may be.
(iii)	Securities	The term includes stocks and shares.
(iv)	Unit	It means (i) unit of a business trust (ii) unit of a mutual fund specified in section 10(23D) or unit of the Unit Trust of India. (iii) beneficial interest of an investor in an Alternative Investment Fund, and shall include shares or partnership interests.

Applicability of General Anti-Avoidance Rule [Section 95]

(i) Section 95 of the Act with regard to the applicability of GAAR provides that an arrangement entered into by an assessee may be declared to be an impermissible avoidance arrangement and the consequence in relation to tax arising there from may be determined subject to the provisions of this Chapter.

(ii) The section further clarifies that the provisions of this Chapter may be applied to any step in, or a part of, the arrangement as they are applicable to the arrangement.

(iii) The section starts with a non-obstante clause which means, if there is a conflict with provisions in other sections, then this section shall prevail over other conflicting provisions.

(iv) The term arrangement referred to in section 95 of the Act, has been defined in section 102 under clause (1) and 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;

The term 'Step' has been defined in section 102 under clause (9) to include a measure or an action, particularly one of a series taken in order to deal with or achieve a particular thing or object in the arrangement.

Example 1

Facts:

M/s India Chem Ltd. is a company incorporated in India. It sets up a unit in a Special Economic Zone (SEZ) in F.Y. 2019-20 for manufacturing of chemicals. It claims 50% deduction of profits earned from that unit in F.Y. 2024-25 and subsequent years as per section 10AA of the Act. Is GAAR applicable in such a case?

Interpretation:

There is an arrangement of setting up of a unit in SEZ which results in a tax benefit. However, this is a case of tax mitigation where the tax payer is taking advantage of a fiscal incentive offered to him by complying with the conditions imposed and economic consequences of the provisions in the legislation e.g., setting up the business unit in SEZ area. Hence, the Revenue would not invoke GAAR as regards this arrangement.

Example 1A

Facts:

In the above example 1, let us presume M/s India Chem Ltd. has another unit for manufacturing chemicals in a non-SEZ area. It then diverts its production from such manufacturing unit and shows the same as manufactured in the tax exempt SEZ unit, while doing only the process of packaging there. Is GAAR applicable in such a case?

Interpretation:

This is a case of misrepresentation of facts by showing production of non-SEZ unit as production of SEZ unit. Hence, this is an arrangement of tax evasion and not tax avoidance.

Tax evasion, being unlawful, can be dealt with directly by establishing correct facts. GAAR provisions will not be invoked in such a case.

Example 1B

Facts:

In the above example 1A, let us presume that M/s India Chem Ltd. does not show production of non-SEZ unit as a production of SEZ unit but transfers the product of non-SEZ unit at a price lower than the fair market value to SEZ unit and does only some insignificant activity in SEZ unit. Thus, it is able to show higher profits in SEZ unit than in non-SEZ unit, and consequently claims higher deduction in computation of income. Can GAAR be invoked to deny the tax benefit?

Interpretation:

As there is no misrepresentation of facts or false submissions, it is not a case of tax evasion. The company has tried to take advantage of tax provisions by diverting profits from non-SEZ unit to SEZ unit. This is not the intention of the SEZ legislation. However, such tax avoidance is specifically dealt with through the provisions contained in section 10AA(9), as per which provisions of section 80-IA(8) would get attracted in such a case. Further, if the aggregate of such transactions entered into in the relevant previous year exceed the threshold of ₹ 20 crore, domestic transfer pricing regulations under section 92BA would be attracted. Hence, the Revenue need not invoke GAAR in such a case, though GAAR and SAAR can co-exist as per clarification given in the CBDT Circular.

Example 1C

Facts:

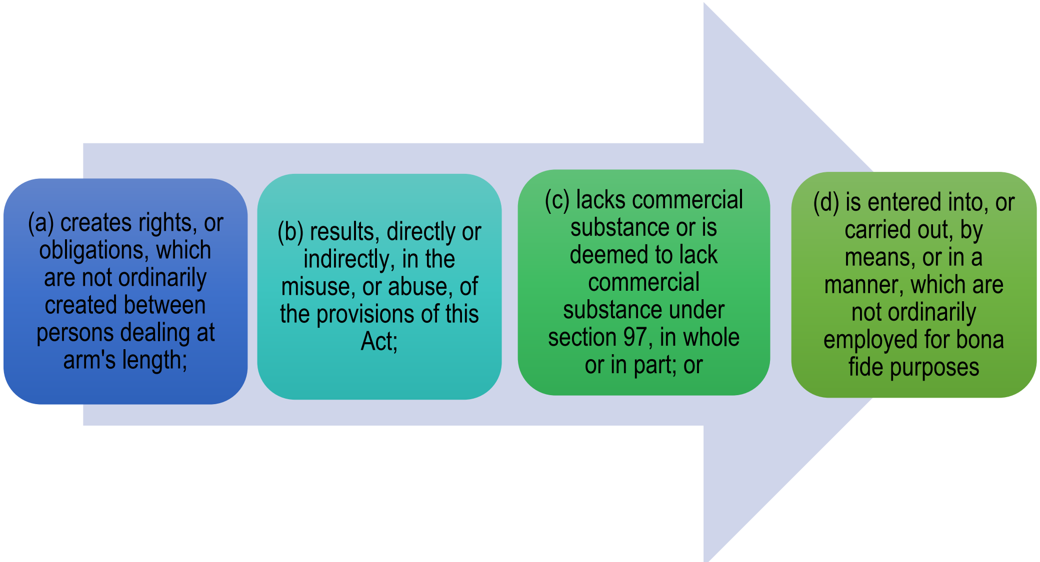
In the above example 1B, let us presume, that both units in SEZ area (say A) and non-SEZ area (say B) work independently. M/s India Chem Ltd. started taking new export orders from existing as well as new clients for unit A and gradually, the export from unit B declined. The company offered lower profits from unit B in computation of income. Can GAAR be invoked on the ground that there has been shifting or reconstruction of business from unit B to unit A for the main purpose of obtaining tax benefit?

Interpretation:

The issue of tax avoidance through shifting/reconstruction of existing business from one unit to another has been specifically dealt with in section 10AA of the Act. Hence, the Revenue need not invoke GAAR in such a case, though GAAR and SAAR can co-exist as per clarification given in the CBDT Circular.

Impermissible Avoidance Agreement [Section 96]

(1) An impermissible avoidance arrangement (IAA) means an arrangement, the main purpose or one of the main purposes of which is to obtain a tax benefit and also any of the following tests is satisfied:



(2) **The purpose test of obtaining tax benefit and tainted element test as under clauses (a) to (d)** above are **twin conditions** that satisfy an impermissible avoidance arrangement. The purpose test requires that the main purpose or one of the main purposes is to obtain tax benefit. The term "tax benefit" has been defined in section 102 clause (10) as under -

(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,

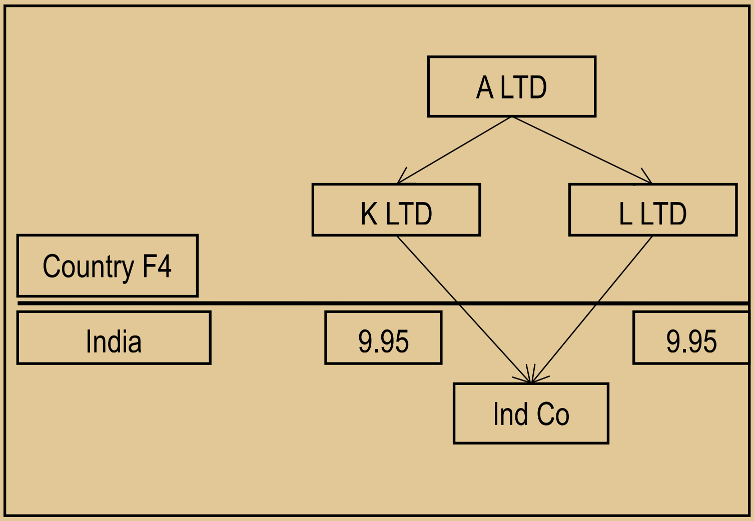
in the relevant previous year or any other previous year.

(3) **The first tainted element** refers to non-arm's length dealings where an arrangement creates rights and obligations, which are not normally created between parties dealing at arm's length. As there are specific transfer pricing regulations (SAAR) applicable to international transactions and certain specified domestic transactions, this tainted element is to be examined only in those transactions which are not covered by Transfer Pricing regulations and where the main purpose of the arrangement is to obtain tax benefit.

(4) **The second tainted** element refers to an arrangement which results in misuse or abuse of the provisions of the Act. It implies cases where the law is followed in letter or form but not in spirit or substance, or where the arrangement results in consequences which are not intended by the legislation, revealing an intent to misuse or abuse the law.

Example 2

Facts:



Under the provisions of a tax treaty between India and country F4, any capital gains arising from the sale of shares of Indco, an Indian company, would be taxable only in F4 if the transferor is a resident of F4 except where the transferor holds more than 10% interest in the capital stock of Indco. A company, A Ltd., being resident in F4, makes an investment in Indco through two wholly owned subsidiaries (K Ltd. and L Ltd.) located in F4. Each subsidiary holds 9.95% shareholding in the Indian Company, the total adding to 19.9% of equity of Indco. The subsidiaries sell the shares of Indco and claim exemption as each is holding less than 10% equity shares in the Indian company. Can GAAR be invoked to deny treaty benefit?

Interpretation:

The above arrangement of splitting the investment through two subsidiaries appears to be with the intention of obtaining tax benefit under the treaty. Further, there appears to be no commercial substance in creating two subsidiaries as they do not change the economic condition of investor A Ltd. in any manner (i.e. on business risks or cash flow), and reveals a tainted element of abuse of tax laws. Hence, the arrangement can be treated as an impermissible avoidance arrangement by invoking GAAR. Consequently, treaty benefit *would be denied by ignoring K and L, the two subsidiaries, or by treating K and L as one and the same company for tax computation purposes.*

(5) **The third tainted** element refers to an arrangement which lacks commercial substance or is deemed to lack commercial substance**.**

(6) **The fourth element** refers to an arrangement which is entered into, or carried out, by means of, or in a manner which is normally not employed for a bona fide purpose. In other words, it means an arrangement that possesses abnormal features. This is not a purpose test but a manner test.

Arrangement to lack commercial substance [Section 97]

Another alternate condition of an impermissible avoidance arrangement is that the arrangement lacks commercial substance or is deemed to lack commercial substance in whole or in part.

(1) Under section 97, certain arrangements have been deemed to lack commercial substance as under –

(a) the substance or effect of the arrangement as a whole, is inconsistent with, or differs significantly from, the form of its individual steps or a part; or

(b) it involves or includes—

(i) round trip financing;

(ii) an accommodating party;

(iii) elements that have effect of offsetting or cancelling each other; or

(iv) a transaction which is conducted through one or more persons and disguises the value, location, source, ownership or control of funds which is the subject matter of such transaction; or

(c) it involves the location of an asset or of a transaction or of the place of residence of any party which is without any substantial commercial purpose other than obtaining a tax benefit (but for the provisions of this Chapter) for a party.

(d) 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 (but for the provisions of this Chapter)

(2) Clause (a) is the codification of **substance v. form doctrine**. It implies that where the substance of an arrangement is different from what is intended to be shown by the form of

the arrangement, then the tax consequence of a particular arrangement should be assessed based on the ―substance of what took place. In other words, it reflects the inherent ability of the law to **remove the corporate veil and look beyond form**.

(3) Sub-clause (i) of clause (b) deems an arrangement, which includes round tripping of funds, to lack commercial substance. For this purpose, the phrase round trip financing has been further defined. Round trip financing includes any arrangement in which, through a series of transactions—

(a) funds are transferred among the parties to the arrangement; and

(b) such transactions do not have any substantial commercial purpose other than obtaining the tax benefit (but for the provisions of this Chapter),

without having any regard to—

(A) whether or not the funds involved in the round trip financing can be traced to any funds transferred to, or received by, any party in connection with the arrangement;

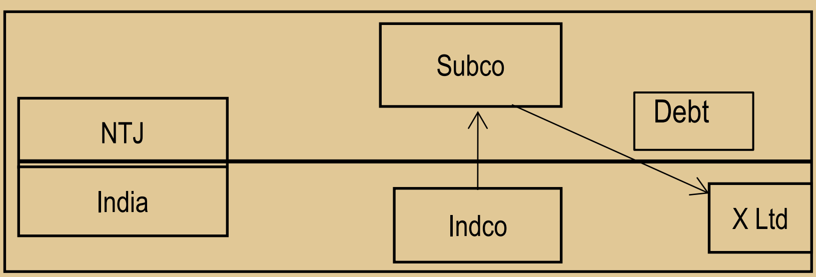
(B) the time, or sequence, in which the funds involved in the round trip financing are transferred or received; or

(C) the means by, or manner in, or mode through, which funds involved in the round trip financing are transferred or received.

Example 3

Facts:

Indco incorporates a Subco in a LTJ (Low Tax Jurisdiction) with equity of US $100. Subco gives a loan of US $ 100 to another Indian company (X Ltd.) at the rate of 10% p.a. X Ltd. claims deduction of interest payable to Subco from the profit of business. There is no other activity in Subco. Can GAAR be invoked in such a case?



Interpretation:

The arrangement appears to avoid payment of tax on interest income by Indco in case loan is directly provided by Indco to X Ltd. The arrangement involves round tripping of funds even though the funds emanating from Indco are not traced back to Indco in this case. Hence, the arrangement may be deemed to lack commercial substance.

Consequently, in the case of Indco, Subco may be disregarded and the interest income may be taxed in the hands of Indco.

(4) Sub-clause (ii) of clause (b) deems an arrangement which includes an accommodating party to lack commercial substance. For this, the phrase "accommodating party" has been further defined. A party to an arrangement shall be an accommodating party, if the main purpose of the direct or indirect participation of that party in the arrangement, in whole or in part, is to obtain, directly or indirectly, a tax benefit (but for the provisions of this Chapter) for the assessee whether or not the party is a connected person in relation to any party to the arrangement.

It means that where a party is included in an arrangement mainly for obtaining tax benefit to the taxpayer, then such party may be treated as an accommodating party and consequently the arrangement shall be deemed to lack commercial substance. Also, it is not necessary that such party should be connected to the taxpayer.

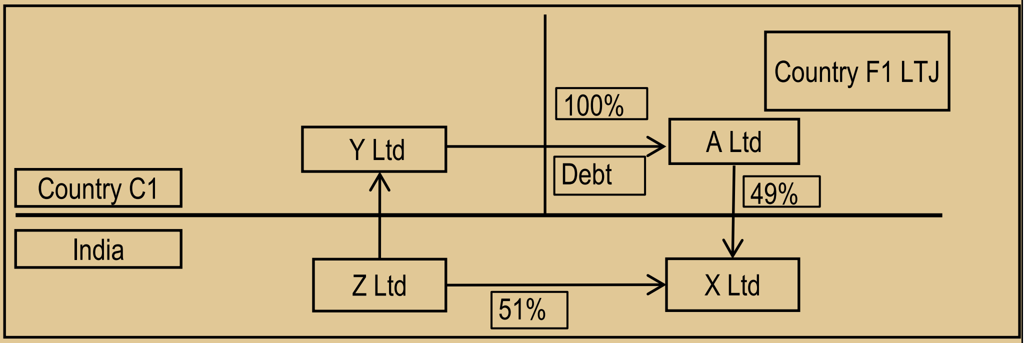
(5) Sub-clause (iii) of clause (b) deems an arrangement, which includes elements that have effect of offsetting or cancelling each other to lack commercial substance.

(6) Sub-clause (iv) of clause (b) deems an arrangement, which disguises value, source or location etc. of funds, to lack commercial substance. In other words, such arrangements have an element of deceit as regards funds.

(7) Clause (c) deems an arrangement to lack commercial substance where it involves the location of an asset or of a transaction or of the place of residence of any party and such location is without any substantial commercial purpose. It means if a particular location is selected for an asset or transaction or residence, and such selection has no substantial commercial purpose, then such arrangement shall be deemed to lack commercial substance.

Example 4

Facts:



(i) Y Ltd. is a company incorporated in country C1. It is a non-resident in India.

(ii) Z Ltd. is a company resident in India.

(iii) A Ltd. is a company incorporated in country F1 and it is a 100% subsidiary of Y Ltd.

(iv) A Ltd. and Z Ltd. form a joint venture company X Ltd. in India after the date of commencement of GAAR provisions. There is no other activity in A Ltd.

(v) The India-F1 tax treaty provides for non-taxation of capital gains in the source country and country F1 charges no capital gains tax in its domestic law.

(vi) A Ltd. is also designated as a permitted transferee of Y Ltd. Permitted transferee means that though shares are held by A Ltd, all rights of voting, management, right to sell etc., are vested in Y Ltd.

(vii) As per the joint venture agreement, 49% of X Ltd's equity is allotted to A Ltd. and 51% is allotted to Z Ltd.

(viii) Thereafter, the shares of X Ltd. held by A Ltd. are sold to C Ltd., a company connected to the Z Ltd. group.

As per the tax treaty with country F1, capital gains arising to A Ltd. are not taxable in India. ***As per the India – Country C1 tax treaty, capital gains is chargeable to tax in the source country.*** *Can GAAR be invoked to deny the treaty benefit?*

Interpretation:

The arrangement of routing investment through country F1 results in a tax benefit. Since there is no business purpose in incorporating company A Ltd. in country F1 which is an LTJ, it can be said that the main purpose of the arrangement is to obtain a tax benefit. The alternate course available in this case is direct investment in X Ltd. joint venture by Y Ltd.

The tax benefit would be the difference in tax liabilities between the two available courses.

The next question is, does the arrangement have any tainted element? It is evident that there is no commercial substance in incorporating A Ltd. as it does not have any effect on the business risk of Y Ltd. or cash flow of Y Ltd. As the twin conditions of main purpose being tax benefit and the existence of a tainted element are satisfied, GAAR may be invoked.

Additionally, as all rights of shareholders of X Ltd. are being exercised by Y Ltd instead of A Ltd, it again shows that A Ltd lacks commercial substance.

Hence, it is possible to invoke GAAR in this case.

(8) In section 97(4), the following factors are considered relevant but not sufficient for determining whether an arrangement lacks commercial substance or not, namely—

(i) the period or time for which the arrangement (including operations therein) exists;

(ii) the fact of payment of taxes, directly or indirectly, under the arrangement;

(iii) the fact that an exit route (including transfer of any activity or business or operations) is provided by the arrangement.

Consequence of impermissible avoidance arrangement [Section 98]

(1) If an arrangement is declared to be an impermissible avoidance arrangement, then the consequences may include denial of tax benefit or a benefit under a tax treaty. The consequence may be determined in such manner as is deemed appropriate in the circumstances of the case. Certain illustrations of the manner have been provided, namely:—

(a) disregarding, combining or re-characterizing any step in, or a part or whole of, the impermissible avoidance arrangement;

(b) treating the impermissible avoidance arrangement as if it had not been entered into or carried out;

(c) disregarding any accommodating party or treating any accommodating party and any other party as one and the same person;

(d) deeming persons who are connected persons in relation to each other to be one and the same person for the purposes of determining tax treatment of any amount;

(e) reallocating amongst the parties to the arrangement—

(i) any accrual, or receipt, of a capital or revenue nature; or

(ii) any expenditure, deduction, relief or rebate;

(f) treating—

(i) the place of residence of any party to the arrangement; or

(ii) the situs of an asset or of a transaction,

at a place other than the place of residence, location of the asset or location of the transaction as provided under the arrangement; or

(g) considering or looking through any arrangement by disregarding any corporate structure.

(2) It has also been provided that –

(i) any equity may be treated as debt or *vice versa*;

(ii) any accrual, or receipt, of a capital nature may be treated as of revenue nature or vice versa; or

(iii) any expenditure, deduction, relief or rebate may be recharacterised.

Treatment of connected persons and accommodating party [Section 99]

(1) As per section 99, for the purposes of Chapter X-A, in determining whether a tax benefit exists—

(i) the parties who are connected persons in relation to each other may be treated as one and the same person;

(ii) any accommodating party may be disregarded;

(iii) such accommodating party and any other party may be treated as one and the same person;

(iv) the arrangement may be considered or looked through by disregarding any corporate structure.

(2) The term 'connected person' is defined in section 102 clause (4). Connected person means any person who is connected directly or indirectly to another person and includes –

If Connected Person is an				A Company/Firm /AOP/BOI/HUF having substantial interest in the business of the person or any director/partner/member or any relative of such director/partner/member	A Company/Firm/ AOP/BOI/HUF whose director/partner/ member has substantial interest in the business of the person or family or any relative of such director/partner/ member	Any person who carries on business – being an individual or any relative of such person has substantial interest in the business of that other person – being a company/ Firm/AOP/BOI/HUF or any director /partner/member or any relative of such director/partner/member has substantial interest in the business of that other person
Individual: any relative or who has substantial interest in the business of the person or any relative of such individual	**Company:** any director or relative of such director	**Firm/ AOP/ BOI:** any partner/ member or relative of such partner/member	**HUF:** Any member or relative of such member			

Framing of guidelines under Income-tax Rules [Section 101]

The provisions of Chapter XA have to be applied in accordance with such guidelines and subject to such conditions as may be prescribed. These guidelines are contained in Rules 10U to 10UC.

(1) As per Rule 10U, the provisions of General Anti Avoidance Rule are not applicable to

(a) an arrangement where the tax benefit in the relevant assessment year arising, in aggregate, to all the parties to the arrangement does not exceed a sum of rupees three crores.

(b) a Foreign Institutional Investor -

(i) who is an assessee under the Act;

(ii) who has not taken benefit of an agreement referred to in section 90 or section 90A as the case may be; and

(iii) who has invested in listed securities, or unlisted securities, with the prior permission of the competent authority, in accordance with the Securities and

Exchange Board of India (Foreign Institutional Investor) Regulations, 1995 and such other regulations as may be applicable, in relation to such investments.

(c) a person, being a non-resident, in relation to investment made by him by way of offshore derivative instruments or otherwise, directly or indirectly, in a Foreign Institutional Investor.

(d) 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 1st day of April, 2017 by such person.

However, the provisions of GAAR shall apply to any arrangement [other than specified in (d) above], 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 1st day of April, 2017.

(2) Where a part of an arrangement is declared to be an impermissible avoidance arrangement, the consequences in relation to tax shall be determined with reference to such part only [Rule 10UA].

(3) The Assessing Officer shall, before making a reference to the Commissioner under section 144BA(1), issue a notice in writing to the assessee seeking objections, if any, to the applicability of provisions of GAAR in his case [Rule 10UB(1)].

Implementation of GAAR Provisions under the Income-tax Act, 1961

Clarifications on certain queries about implementation of GAAR [Circular No.7 of 2017 dated 27-1-2017]

The provisions of Chapter X-A of the Income-tax Act, 1961 relating to General Anti-Avoidance Rule came into force from 1st April, 2017. Certain queries were received by the Board about implementation of GAAR provisions. The Board constituted a Working Group in June, 2016 for this purpose. The Board has considered the comments of the Working Group and the following clarifications were issued:

Question no. 1: *Will GAAR be invoked if SAAR applies?*

Answer: *It is internationally accepted that specific anti avoidance provisions may not address all situations of abuse and there is need for general anti-abuse provisions in the domestic legislation. The provisions of GAAR and SAAR can coexist and are applicable, as may be necessary, in the facts and circumstances of the case.*

Question no. 2: *Will GAAR be applied to deny treaty eligibility in a case where there is compliance with LOB test of the treaty?*

Answer: *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.*

Question no. 3: *Will GAAR interplay with the right of the taxpayer to select or choose method of implementing a transaction?*

Answer: *GAAR will not interplay with the right of the taxpayer to select or choose method of implementing a transaction.*

Question no. 4: *Will GAAR provisions apply where the jurisdiction of the FPI is finalised based on non-tax commercial considerations and such FPI has issued P-notes referencing Indian securities? Further, will GAAR be invoked with a view to denying treaty eligibility to a Special Purpose Vehicle (SPV), either on the ground that it is located in a tax friendly jurisdiction or on the ground that it does not have its own premises or skilled professional on its own roll as employees.*

Answer: *For GAAR application, the issue, as may be arising regarding the choice of entity, location etc., has to be resolved on the basis of the main purpose and other conditions provided under section 96 of the Act. GAAR shall not be invoked merely on the ground that the entity is located in a tax efficient jurisdiction. If the jurisdiction of FPI is finalized based on non-tax commercial considerations and the main purpose of the arrangement is not to obtain tax benefit, GAAR will not apply.*

Question no. 5: *Will GAAR provisions apply to (i) any securities issued by way of bonus issuances so long as the original securities are acquired prior to 01 April, 2017 (ii) shares issued post 31 March, 2017, on conversion of Compulsorily Convertible Debentures, Compulsorily Convertible Preference Shares (CCPS), Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs), acquired prior to 01 April, 2017; (iii) shares which are issued consequent to split up or consolidation of such grandfathered shareholding?*

Answer: *Grandfathering under Rule 10U(1)(d) will be available to investments made before 1st April 2017 in respect of instruments compulsorily convertible from one form to another, at terms finalized at the time of issue of such instruments. Shares brought into existence by way of split or consolidation of holdings, or by bonus issuances in respect of shares acquired prior to 1st April 2017 in the hands of the same investor would also be eligible for grandfathering under Rule 10U(1)(d) of the Income-tax Rules, 1962.*

Question no. 6: *The expression "investments" can cover investment in all forms of instrument - whether in an Indian Company or in a foreign company, so long as the disposal thereof may give rise to income chargeable to tax. Grandfathering should extend to all forms of investments including lease contracts (say, aircraft leases) and loan arrangements, etc.*

Answer: *Grandfathering is available in respect of income from transfer of investments made before 1st April, 2017. As per Accounting Standards, 'investments' are assets held by an enterprise for earning income by way of dividends, interest, rentals and for capital appreciation. Lease contracts and loan arrangements are, by themselves, not 'investments' and hence grandfathering is not available.*

Question no. 7: *Will GAAR be invoked if arrangement is sanctioned by an authority such as the Court, National Company Law Tribunal or is in accordance with judicial precedents etc.?*

Answer: *Where the Court has explicitly and adequately considered the tax implication while sanctioning an arrangement, GAAR will not apply to such arrangement.*

Question no. 8: *Will a Fund claiming tax treaty benefits in one year and opting to be governed by the provisions of the Act in another year attract GAAR provisions? An example would be where a Fund claims treaty benefits in respect of gains from derivatives in one year and in another year set-off losses from derivatives transactions against gains from shares under the Act.*

Answer: *GAAR provisions are applicable to impermissible avoidance arrangements as under section 96. In so far as the admissibility of claim under treaty or domestic law in different years is concerned, it is not a matter to be decided through GAAR provisions.*

Question no. 9: *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?*

Answer: *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.*

Question no. 10: *Can GAAR lead to assessment of notional income or disallowance of real expenditure? Will GAAR provisions expand the scope of charging provisions or scope of taxable base and/or disallow the expenditure which is actually incurred and which otherwise is admissible having regard to diverse provisions of the Act?*

Answer: *If the arrangement is covered under section 96, then the arrangement will be disregarded by application of GAAR and necessary consequences will follow.*

Question no. 11: *A definite timeline may be provided such as 5 to 10 years of existence of the arrangement where GAAR provisions will not apply in terms of the provisions in this regard in section 97(4).*

Answer: *Period of time for which an arrangement exists is only a relevant factor and not a sufficient factor under section 97(4) to determine whether an arrangement lacks commercial substance.*

Question no. 12: *It may be ensured that in practice, the consequences of a transaction being treated as an 'impermissible avoidance arrangement' are determined in a uniform, fair and rational basis. Compensating adjustments under section 98 of the Act should be done in a consistent and fair manner. It should be clarified that if a particular consequence is applied in the hands of one of the participants, there would be corresponding adjustment in the hands of another participant.*

Answer: *Adequate procedural safeguards are in place to ensure that GAAR is invoked in a uniform, fair and rational manner. In the event of a particular consequence being applied in the hands of one of the participants as a result of GAAR, corresponding adjustment in the hands of another participant will not be made. GAAR is an anti-avoidance provision with deterrent consequences and corresponding tax adjustments across different taxpayers could militate against deterrence.*

Question no. 13: *Tax benefit of INR 3 crores as defined in section 102(10) may be calculated in respect of each arrangement and each taxpayer and for each relevant assessment year separately. For evaluating the main purpose to be obtaining of tax benefit, the review should extend to tax consequences across territories. The tax impact of INR 3 crores should be considered after taking into account impact to all the parties to the arrangement i.e. on a net basis and not on a gross basis (i.e. impact in the hands of one or few parties selectively).*

Answer: *The application of the tax laws is jurisdiction specific and hence what can be seen and examined is the Tax Benefit' enjoyed in Indian jurisdiction due to the 'arrangement or part of the arrangement'. Further, such benefit is assessment year specific. Further, GAAR is with respect to an arrangement or part of the arrangement and therefore limit of INR 3 crores cannot be read in respect of a single taxpayer only.*

Question no. 14: *Will a contrary view be taken in subsequent years if arrangement held to be permissible in an earlier year?*

Answer: *If the PCIT/Approving Panel has held the arrangement to be permissible in one year and facts and circumstances remain the same, as per the principle of consistency, GAAR will not be invoked for that arrangement in a subsequent year.*

Question no. 15: *No penalty proceedings should be initiated pursuant to additions made under GAAR at least for the initial 5 years.*

Answer: *Levy of penalty depends on facts and circumstances of the case and is not automatic. No blanket exemption for a period of five years from penalty provisions is available under law. The assessee, may at his option, apply for benefit u/s 273A if he satisfies conditions prescribed therein.*

TEST YOUR KNOWLEDGE

Questions

1. *Distinguish between Tax planning and Tax Evasion.*

2. *Specify with reason, whether the following acts can be considered as (i) Tax planning; or (ii) Tax management; or (iii) Tax evasion.*

   (i) *Mr. P deposits ₹ 1,00,000 in PPF account so as to reduce his total income from ₹ 5,90,000 to ₹ 4,90,000.*

   (ii) *SQL Ltd. maintains a register of tax deduction at source effected by it to enable timely compliance.*

   (iii) *An individual tax payer making tax saver deposit of ₹ 1,00,000 in a nationalised bank.*

   (iv) *A partnership firm obtaining declaration from lenders/depositors in Form No. 15G/15H and forwarding the same to income-tax authorities.*

   (v) *A company installed an air-conditioner costing ₹ 75,000 at the residence of a director as per terms of his appointment but treats it as fitted in quality control section in the factory. This is with the objective to treat it as plant for the purpose of computing depreciation.*

   (vi) *RR Ltd. issued a credit note for ₹ 80,000 as brokerage payable to Mr. Ramana who is the son of the managing director of the company. The purpose is to increase the total income of Mr. Ramana (paying tax under section 115BAC) from ₹ 6,20,000 to ₹ 7,00,000 and reduce the income of RR Ltd. correspondingly.*

   (vii) *A company remitted provident fund contribution of both its own contribution and employees' contribution on monthly basis before due date.*

3. *Examine the doctrine of form and substance in the context of tax planning.*

4. *The merger of a loss making company with a profit making one results in losses setting off profits, a lower net profit and lower tax liability for the merged company. Would the losses be disallowed by applying GAAR?*

5. *A choice is made by a company by acquiring an asset on lease over outright purchase. The company claims deduction for lease rentals in case of acquisition through lease rather than*

depreciation as in the case of purchase of the asset. Would the lease rent payment, being higher than the depreciation, be disallowed as expense under GAAR?

6. *M/s Global Architects Inc is a company incorporated in country F1. It is engaged in the business of providing architectural design services all over the world. It receives an offer from Lovely Resorts Pvt Ltd, an Indian company, for design and development of resorts all over India.*

   India-F1 tax treaty provides that architectural services are technical services and payment for the same to a company may be taxed in India. However, if such professional services are provided by a firm or individual, then payment for such services are taxable only if the firm has a fixed base in India or stay of partners/ employees in India exceed 180 days. Limitation of benefit clause does not exist in tax treaty between India-F1.

   M/s Global Architects Inc forms a partnership firm with a third party (director of the company) having only a nominal share in the F1. The firm enters into an agreement to carry out the services in India. The company seconded its trained manpower to the firm.

   Thus, the partnership firm claimed the treaty benefit and no tax was paid in India. Can such an arrangement be examined under GAAR?

Answers

1. Tax planning is carried out within the framework of law by availing the deductions and exemptions permitted by law and thereby minimizing tax liability. Tax planning is an arrangement by which full advantage is taken of the concessions and benefits conferred by the statute, without violation of legal provisions. Tax evasion on the other hand is an attempt to reduce tax liability by dubious or artificial methods or downright fraud. It is illegal and denies the State its legitimate share of tax.

2. **Tax Planning / Tax Management / Tax Evasion**

	Answer	Reason
1.	**Tax planning**	Depositing money in PPF and claiming deduction under section 80C is as per the provisions of law.
2.	**Tax management**	Maintaining a register of payments subject to TDS helps in complying with the obligations under the Income-tax Act, 1961.
3.	**Tax planning**	Making a tax saver deposit of ₹ 1,00,000 in a nationalized bank for claiming deduction under section 80C by an individual is a permitted tax planning measure under the provisions of income-tax law.

4.	**Tax management**	Obtaining declaration from lenders/depositors in Form No. 15G/15H by a partnership firm and forwarding the same to Income-tax authorities is in the nature of compliance with statutory obligation under the Income-tax Act, 1961.
5.	**Tax evasion**	An air conditioner fitted at the residence of a director as per the terms of his appointment would be a furniture qualifying for depreciation @10%, whereas an air conditioner fitted in a factory would be a plant qualifying for a higher depreciation @15%. The wrong treatment unjustifiably increases the amount of depreciation and consequently, reduces profit and consequent tax liability. Treatment of air-conditioner fitted at the residence of a director as a plant fitted at the factory would tantamount to furnishing of false particulars in an attempt to evade tax.
6.	**Tax evasion**	Issuance of a credit note for ₹ 80,000 by RR Ltd. as brokerage payable to Mr. Ramana, the son of the Managing Director, to increase his total income from ₹ 6.2 lakh to ₹ 7.00 lakh and to correspondingly reduce the company's total income is a method of reducing the tax liability of the company by recording a fictitious transaction. The company is liable to tax at a flat rate of 30%/25%/22%, as the case may be, whereas Mr. Ramana would not be liable to pay any tax as per the default regime under section 115BAC, since his total income does not exceed ₹ 7,00,000, consequent to which he would be eligible for tax rebate of entire tax under section 87A. Reducing tax liability by recording a fictitious transaction would tantamount to tax evasion.
7.	**Tax management**	Remitting of own contribution to provident fund and employees contribution to provident fund on a monthly basis before the due date is proper compliance with the statutory obligations.

3. The following are certain principles enunciated by the Courts on the question as to whether it is the form or substance of a transaction, which will prevail in income-tax matters:

(i) **Form of transaction is to be considered in case of genuine transactions -** It is well settled that when a transaction is arranged in one form known to law, it will attract tax liability whereas, if it is entered into in another form which is equally lawful, it may not. Therefore, in considering whether a transaction attracts tax or not, the form of the transaction put through is to be considered and not the substance. **However, this rule applies only to genuine transactions.** [*CIT v. Motor and General Stores (P) Ltd. v. CIT (1967) 66 ITR 692(SC).*

(ii) **True legal relation is the crucial element for taxability -** It is open for the authorities to pierce the corporate veil and look behind the legal facade at the reality of the transaction. The taxing authority is entitled as well as bound to determine the true legal relation resulting from a transaction. The true legal relation arising from a transaction alone determines the taxability of a receipt arising from the transaction *[CIT v. B.M. Kharwar (1969) 72 ITR 603 (SC)]*

(iii) **Substance (i.e. actual nature of expense) is relevant and not the form –** Under section 97, an arrangement shall be deemed to lack commercial substance if 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. Accordingly, such arrangement would be impermissible avoidance arrangement and be subject to GAAR. However, GAAR provisions will be applicable only to an arrangement where the tax benefit in the relevant A.Y. arising, in aggregate to all parties to the arrangement exceeds ₹ 3 crores. The Income-tax Act, 1961 also contains Specific Anti-avoidance provisions to address the concern of tax avoidance.

Some examples where Supreme Court has upheld substance over form are -

(a) In case of an expenditure, the mere fact that the payment is made under an agreement does not preclude the department from enquiring into the actual nature of the payment [*Swadeshi Cotton Mills Co. Ltd. v. CIT (1967) 63 ITR 57(SC)*].

(b) In order to determine whether a particular item of expenditure is of revenue or capital nature, the substance and not merely the form should be looked into. [*Assam Bengal Cement Co. Ltd. v. CIT (1955) 27 ITR 34 (SC)*].

4. As regards setting off of losses, the provisions relating to merger and amalgamation already contain specific anti-avoidance safeguards. Therefore, GAAR need not be invoked when SAAR is applicable, though as per *CBDT Circular No. 7/2017 dated 27.01.2017,* GAAR and SAAR can co-exist. Further, since merger and amalgamation would be carried out under the order of the National Company Law Tribunal (NCLT), GAAR need not be invoked if the NCLT has explicitly and adequately considered the tax implication while sanctioning the merger scheme.

5. GAAR provisions would not apply in this case as the taxpayer merely makes a selection out of the options available to him under the provisions of the Act for which he is eligible and satisfies the stipulated conditions, if any. Even if choice of such option results in lower tax liability, the same is a result of tax planning.

6. It is obvious that there was no commercial necessity to create a separate firm except to obtain the tax benefit. The firm was only on paper as the manpower was drawn from the company. The firm did not have any commercial substance. Moreover, it is a case of treaty abuse. Hence, GAAR may be invoked to disregard the firm and tax payment for architectural services as fee for technical services. However, the rate of tax on such payment shall be as applicable under the treaty, if more beneficial.