GAAR - Tax Avoidance vs. Tax Planning

CA. T. P. OSTWAL

5 December 2014
An arrangement is an “impermissible avoidance arrangement” if:

- **Main purpose or one of the main purposes** is to obtain “tax benefit”
- **Tainted element presence**
  - Creates rights and obligations which are not ordinarily created between persons dealing at arm’s length price
  - OR
  - Results, directly or indirectly, in the **misuse or abuse** of the provisions of Act
    - OR
    - Lacks commercial substance or is deemed to lack commercial substance in whole or in part
      - OR
      - Entered into or carried out by means or in a manner which are not ordinarily employed for bonafide purposes

**Term “tax benefit” widely defined**
Burden of proof to demonstrate the satisfaction of GAAR conditions is on Revenue

5 December 2014
GAAR: Arrangement lacks commercial substance

An arrangement shall be deemed to lack commercial substance if:

- Substance/ effect of arrangement as a whole is inconsistent with or differs significantly from its individual steps or parts

OR

- It involves or includes:
  - Round trip financing
  - Accommodating party
  - Offsetting or self cancelling elements
  - Transaction which disguises value, location, source, ownership or control of funds which are subject matter of transaction

OR

- It involves location of an asset /transaction /place of residence of any party which would not have been so located for any substantial commercial purpose other than obtaining a tax benefit
Consequences of GAAR

Consequences are inclusive; but not limited to that outlined above
GAAR introduction timeline
Tax Avoidance has various definitions in legal rulings and academic literature:–

a) Justice Reddy (in the legendary decision of McDowell) calls it the “art of dodging tax without breaking the law”

b) Black’s law dictionary states that tax avoidance is the “minimization of one’s tax liability by taking advantage of legally available tax planning opportunities”

c) OECD terms tax avoidance as “an arrangement of a taxpayer’s affairs that is intended to reduce his liability and that although the arrangement could be strictly legal is usually in contradiction with the intent of the law it purports to follow”

d) The European Court of Justice (ECJ) views tax avoidance as “artificial arrangements aimed at circumventing law”

e) The Carter Commission Report (Canada, 1966) stated that tax avoidance is “every attempt by legal means to reduce tax liability which would otherwise be incurred, by taking advantage of some provision or lack of provision in the law”

f) In the landmark US Supreme Court ruling of Helvering vs Gregory, the US court says “any one may arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes”
Concept of Tax Avoidance, Tax Evasion & Tax Planning

- **Tax Evasion** has been defined by OECD to mean “illegal arrangements where liability to tax is hidden or ignored, i.e. the taxpayer pays less tax than he is legally obligated to pay by hiding income or information from the tax authorities”.

- **Tax Planning** has been explained by OECD as “an arrangement of a person's business and/or private affairs in order to minimize tax liability”.

- **Known Judgments:**
  - Raman & Co. (67 ITR 11)
  - McDowell (154 ITR 148)
  - Azadi Bacho Andolan (263 ITR 706)
  - Vodafone (329 ITR 126)
A distinction can easily be made between Tax Avoidance and Tax Evasion. The latter is clearly illegal; the former is legal. Another way to look at it is that tax avoidance maybe considered as a breach of social contract whereas tax evasion can easily be considered as a crime. There is no thin line but a gulf between the two; whereas, there is often a thin line between ‘acceptable tax avoidance’ [also known as Tax Planning] and ‘unacceptable tax avoidance’.
Interplay of national tax system gives rise to tax planning opportunities. A sophisticated use of these systems might result in unintended benefits such as:

- Double non-taxation
- Double deduction
- Artificial generation of foreign tax credits
- Hybrid Mismatch arrangements
SAAR, TAAR & GAAR

- **SAAR**
  - Tax driven intragroup leverages
  - Indirect transfer of assets
  - Shifting of passive income to low tax jurisdictions
  - Beneficial ownership

- **TAAR**
  - Limiting treaty benefits
  - Section 94 A

- **GAAR** - domestic anti avoidance rules
Impermissible Avoidance Arrangement

- Essential two conditions:
  1. The **Main Purpose** + Obtain **Tax Benefit** (part or whole or in **any step** of such arrangement)
  2. “Either of the given **four conditions**”:
     a) Not at Arm’s Length
     b) Represents Misuse or Abuse of the provisions of the Code
     c) “Lacks Commercial Substance”
     d) Entered or carried on in a manner not normally employed for “Bona-fide Purposes”.

Let us see few examples……
Example 1

A Pvt. Limited (‘APL’) is an Indian company engaged in manufacturing of inorganic chemicals having mainly industrial use.

60% of total turnover comes from exports.

Considering a high volume market, APL intends to setup a central place of operation in European continent to serve as a storage facility to facilitate logistics of chemicals and thereby reduce delivery time.

This will increase the sales from existing markets by 20% and will also result into new markets contributing around US$ 5 million to the gross turnover of the group.

For this purpose, APL is recommended by its international tax consultants to setup a branch in Poland.
Why Branch in Poland?
   a) Centrally located connecting with major markets
   b) Favorable VAT regime (Assumed)
   c) Administrative convenience and Cost Effective
   d) Marketing Agent of Poland & is handling major international operations
   e) Corporate tax rate of 19%

“India has a favorable DTAA with Poland where under branch profits of Indian company are not subject to further taxes in India when repatriated back because of the exemption method of elimination of double tax avoidance provided under Art. 24.”

Even Newly amended Poland DTAA continue this benefit

Whether GAAR override treaty?
Example 1

APL had following options to arrange the transaction:

- **APL**
  - India
  - Poland
  - Branch

- **APL**
  - India
  - Poland
  - Subsidiary

- **APL**
  - WOS
  - Subsidiary

- **APL**
  - WOS
  - Inv. Hold Co. [Cyprus]

- **APL**
  - WOS
  - Inv. Hold Co. [Greece]

- **APL**
  - WOS
  - Inv. Hold Co. [Mauritius]
  - WOS
  - Inv. Hold Co. [UAE]
  - WOS
  - Subsidiary

- **APL**
  - WOS
  - Subsidiary [Poland]

5 December 2014
Example 2

Reverse Merger

Facts

XY GROUP

X LTD [INDIA]

Loss Making Company

Y LTD [INDIA]

Profit Making Company

5 December 2014
Example 2

Re-organization in the form of MERGER

XY GROUP

Y Ltd. merges X Ltd.

XY LTD [INDIA]

New Merged Entity

Setoff of the losses of X Ltd. against the profits of Y Ltd.

5 December 2014
Example 2

• Tax benefit obtained, is it a misuse or abuse of DTC or carried out in a manner which would not normally be employed for bonafied purposes
• Consequences recharacterise it as forward merger.

Sec 124(1) “Accommodating party” means a party to an arrangement who, as a direct or indirect result of his participation, derives any amount in connection with the arrangement, which shall—

(a) ….

(b) not be included in his total income which would have otherwise been included in the total income of another party;

(c) be treated as a deductible expenditure, or allowable loss, by the party which would have otherwise constituted a non-deductible expenditure, or non allowable loss, in the hands of another party; or

(d) …….
Example 2

- Mergers are approved by the court
- Alternatively, if reverse merger of a Giant with a small/dormant company in unrelated field
- Whether change of name suggests “misuse of provision” to take tax advantage?

**Can X Ltd. be covered under the scope of the term “Accommodating Party”?**

&

**Whether the said reorganization within the Group (i.e. Reverse Merger) be covered under the scope of GAAR?**
Example 3

- Parent Co. in Delaware has a subsidiary in Singapore (‘Sing. IHC’)
- Sing IHC is regional holding company holding business investments in its operating subsidiaries in countries like China, Indonesia, Malaysia etc.
- US Parent Co. decides to set up an operating company in India (‘Indian Co’).
- Whether to hold investments in India directly from US or through Singapore IHC.

5 December 2014
Would this be termed as an arrangement whose main purpose is to obtain the tax benefit i.e. avoidance of tax under the Indian DTC because of the existence of the capital gains exemption under the Singapore-India Tax Treaty?

Whether the in light of proposed GAAR in the Indian DTC, above transaction interposing Singapore IHC raise a concern of lacking commercial substance even if there are genuine commercial transactions.
N Ltd. is in India having a foreign branch in Italy & also a subsidiary in Italy.

- Italian subsidiary will opt for group taxation regime in Italy under the domestic tax laws, wherein profits/losses of Italian branch will be aggregated.
- Italian branch suffers tax losses on account of interest paid on debt taken to fund subsidiary operations.
- In India, under domestic tax law, N Ltd, will consolidate branch accounts for tax purposes
- Therefore, losses of the branch would be set off against the profits of H.O. i.e. N Ltd.
- Considering the group taxation regime being adopted in Italy, the Italian branch losses would also be adjusted against the income of the O Ltd.
Example 4

Since the benefit of loss at branch is claimed twice both in two different countries, Can Indian tax authorities apply the provisions of GAAR?

- No tax benefit for N Ltd. in India
- Tax benefit has arisen in Italy, reduced tax liability in Italy brings more tax in India
- What happens if Poland was involved in place of Italy and theoretically there also exist a concept of group taxation like Italy.
Example 5

Germany

Cyprus/Netherlands

India

Direct conduit structure

div./int./roy.

div./int./roy.
# Other Domestic transactions under GAAR

<table>
<thead>
<tr>
<th>TRANSACTION</th>
<th>TAX BENEFIT OBTAINED?</th>
<th>ADDITIONAL CONDITION</th>
<th>CONSEQUENTIAL REACTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of shares instead of assets/ business</td>
<td>Yes (on account of beneficial rate of tax)</td>
<td>Results in misuse or abuse of DTC</td>
<td>Re-characterisation of income</td>
</tr>
<tr>
<td>Sale on 1\textsuperscript{st} April while negotiations fully completed in third week of March</td>
<td>Yes (as it achieves deferment of tax)</td>
<td>Carried out in manner which would not normally be employed for bonafide purposes</td>
<td>Disregard the step of postponement of date</td>
</tr>
<tr>
<td>Gift of house to sons so as to enjoy benefit S.54F exemption</td>
<td>Yes (as it achieves reduction in tax)</td>
<td>Results in misuse or abuse of DTC Or Creates rights and obligations which would not normally be created between persons dealing at ALP</td>
<td>Treat sons as accommodating parties Or Deem persons who are connected to be one and the same person</td>
</tr>
</tbody>
</table>
### Other Domestic transactions under GAAR

<table>
<thead>
<tr>
<th>TRANSACTION</th>
<th>TAX BENEFIT OBTAINED?</th>
<th>ADDITIONAL CONDITION</th>
<th>CONSEQUENTIAL REACTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuance of bonus shares and sale of original shares</td>
<td>Yes (Due to reduction in profit or increase of loss)</td>
<td>Results in misuse or abuse of DTC Or Carried out in manner which would not normally be employed for bonafide purposes</td>
<td>Re-characterise as if it is proportionately sale of bonus shares</td>
</tr>
<tr>
<td>Lease of house purchased by employee’s wife from employee’s loan and employer funds to employee who in turn allots to employee</td>
<td>Yes (as lower perquisite valuation rule applies)</td>
<td>Entered into carried out in a manner which would not normally be employed for bonafide purposes</td>
<td>Treat as if IAA not entered into (or) in any appropriate manner for preventing/ diminishing tax benefit</td>
</tr>
</tbody>
</table>

5 December 2014
Strategy

How to make business structures and strategic investments GAAR proof?

- Careful structuring of the transaction
- Commercial in the transaction
- Strong business purpose behind the transaction
Future of GAAR in BEPS

BEPS based on three central ideas

- Coherence
- Substance
- Transparency
Solution to GAAR

Only solution
Is
Substance
Substance
Substance

5 December 2014
The Supreme Court 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 accrues or arises 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 lawfully be circumvented.
The Supreme Court held that the tax planning may be legitimate provided it is within the frame-work of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid the payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.
Apex Court has correctly explained McDowell and set the law in the right perspective in India. While observing that the extreme view of Chinappa Reddy J ‘actually militates against the observations of the majority of the Judges’ in McDowell, the Supreme Court has emphasized the relevance of Shah J’s view in CIT v Raman & Co, approved the view of the Gujarat High Court in Banyan and Berry, broadly agreed with the Madras High Court’s decision in Valiappan, and has categorically stated that ‘the principle in Duke of Westminster is very much alive and kicking in the country of its birth and held Treaty Shopping valid with the following seminal observations:

"There is elaborate discussion in Baker's treatise on the anti abuse provisions in the OECD model and the approach of different countries to the issue of "treaty shopping". True that several countries like the USA, Germany, Netherlands, Switzerland and United Kingdom have taken suitable steps, either by way of incorporation of appropriate provisions in the international conventions as to double taxation avoidance, or by domestic legislation, to ensure that the benefits of a treaty/convention are not available to residents of a third State. Doubtless, the treatise by Philip Baker is an excellent guide as to how a State should modulate its laws or incorporate suitable terms in tax conventions to which it is party so that the possibility of a resident of a third State deriving benefits there-under is totally eliminated. That may be an academic approach to the problem to say how the law should be. The maxim "judicis est jus dicere, non dare" pithily expounds the duty of the court. It is to decide what the law is, and apply it; not to make it."

Vodafone Case

- The Revenue cannot start with the question as to whether the impugned transaction is a tax deferment/saving device, but it should apply the “look at” test to ascertain true legal nature of the transaction.

- The authorities may invoke the “substance over form” principle or “piercing the corporate veil” test only after it is able to establish on the basis of the facts and circumstances surrounding the transaction that the impugned transaction is a sham or tax avoidant. Every strategic foreign investment coming into India should be looked at in a holistic manner, bearing in mind factors such as: the concept of participation in investment, the duration of time during which the holding structure exists; the period of business operations in India; the generation of taxable revenues in India; the timing of the exit; and the continuity of business on such exit.

- Merely because at the time of exit, capital gains tax becomes not payable or exigible to tax would not make the entire “share sale” (investment) a sham or a tax avoidant.

- The McDowell decision cannot be read as leading to a conclusion that all tax planning is illegal, illegitimate or impermissible and that there is no conflict between the Supreme Court’s decisions in the McDowell and the Azadi Bachao Andolan case.

- The question of providing “look through” in the Statute or in the tax treaty is a matter of policy and has to be expressly provided for. Similarly, Limitation of Benefits (LOB) has to be expressly provided for in the tax treaty. Such clauses cannot be read into the Section by interpretation.